

No. A05-0442

STATE OF MINNESOTA  
IN SUPREME COURT

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**Kmart Corporation,**

*Relator,*

vs.

**County of Becker,**

*Respondent.*

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**REPLY BRIEF OF RELATOR KMART CORPORATION**

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## TABLE OF CONTENTS

STATEMENT OF FACTS .....	1
ARGUMENT .....	2
I. THE TAX COURT ADOPTED MR. LEIRNESS’ CAPITALIZATION RATE.....	2
II. THE TAX COURT RELIED ON INACCURATE AND UNADJUSTED FIGURES IN ITS SALES COMPARISON ANALYSIS .....	4
A. The range of the adjusted comparables was not between \$28.68 and \$46.78 per square foot .....	4
B. The comparable sales considered by the tax court, contrary to the tax court’s findings, were not fully adjusted.....	5
III. THE ONLY EVIDENCE IN THE RECORD REGARDING THE PROPER ADJUSTMENT FOR THE LEASED FEE SALES IS THAT OF MR. LEIRNESS.....	7
CONCLUSION .....	10

**TABLE OF AUTHORITIES**

**STATE CASES**

*American Express Financial Advisors, Inc. v. County of Carver*,  
573 N.W.2d 651 (Minn. 1998).....9

## STATEMENT OF FACTS

Respondent Becker County criticizes three aspects of Kmart's Statement of the Facts as having no support in the record. Because the three criticisms raised by Becker County do not affect the issues raised on appeal, they are at best a distraction. Nonetheless, contrary to Becker County's allegations, Kmart's factual statements are both supported by the record, and accurate.

First, contrary to Becker County's contention, the record clearly supports the fact that Kmart purchased the Detroit Lakes real estate because it "could operate that store at a lower cost to capital than they could pay rent for the terms of the lease." (Tr. 132). In fact, Kmart's expert appraiser, Alan Leirness, testified at length regarding the Kmart's purchase of the Detroit Lakes real estate, and the basis for doing so. (Tr. 131-33). Moreover, the record contains extensive evidence that the purchase was part of a package or portfolio transaction with two other Kmart properties. (Tr. 131-33).

Second, Becker County argues that the opening of a Super Wal-Mart in Detroit Lakes did not justify a reduction in the value of the real estate. Again, Becker County is mistaken. Mr. Leirness testified at length explaining how the addition of 165,000 square feet of discount retail space in the immediate vicinity negatively affects the value of the supply of the preexisting (and aging) discount retail space in Detroit Lakes. (Tr. 21-23, 32-39).

Third, Becker County contends that the tax court did not find Dwight Dahlen's testimony to be not credible. Again, the record is clear. In its opinion, the tax court specifically quoted Mr. Dahlen's explanation regarding why he accepted the rental rates

as market rents. (App. 26). The tax court then identified the flaw in Mr. Dahlen's analysis, and the absence of evidence to support Mr. Dahlen's position. (App. 26). Ultimately, the tax court found that Becker County, in spite of Mr. Dahlen's testimony and explanation, had failed to provide evidence to support its contention that the leases were at market. (App. 26). In short, the tax court did not find Mr. Dahlen's rationale or testimony credible.

### ARGUMENT

#### **I. THE TAX COURT ADOPTED MR. LEIRNESS' CAPITALIZATION RATE.**

In its initial opinion, the tax court expressly adopted Mr. Leirness' position regarding the applicable capitalization rate. The tax court held: "We find Mr. Leirness' analysis persuasive and use his capitalization rate of 10.25%." (App. 29, emphasis added). As is noted in Kmart's principal brief, it is undisputed that Mr. Leirness used a 10.5% capitalization rate, not a 10.25% rate. In fact, the tax court found in the same paragraph that Mr. Leirness used a capitalization rate of 10.5% (App. 29).

Not surprisingly, rather than focus on the actual language of the tax court's order, Becker County attempts to characterize the tax court's decision as being a compromise. To support its position, Becker County points to evidence in the record that under other circumstances could have justified a 10.25% capitalization rate. In essence, Becker County pretends that the phrase "use his capitalization rate" does not appear in the tax court's order. Imagination alone cannot change the plain meaning of that tax court's language.

Ultimately, the question before this Court is not whether there is any evidence in the record to support a 10.25% rate. The question is whether the tax court, after it has found one expert's testimony persuasive and expressly adopted that expert's capitalization rate, may deviate from its own findings and the record and apply, without explanation, a capitalization other than the one it adopted.<sup>1</sup> Given the circumstances, Kmart respectfully requests that this Court direct the tax court to use Mr. Leirness' 10.5% capitalization rate consistent with the tax court's findings and reasoning.

In its memorandum denying Kmart's motion for amended findings, the tax court characterized the issue regarding the capitalization rate as a "minor clerical and immaterial [error]." (App. 38). If a 10.5% capitalization rate is applied to a net operating income of \$246,000 (the net operating income apparently used by the tax court), a value of \$2,342,857 results. This value is \$57,149 lower than the value found by the tax court, which used a 10.25% capitalization rate. The difference is neither minor, nor immaterial. The tax court's characterization of the issue regarding the capitalization rate as a minor clerical and immaterial error is clearly erroneous.

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<sup>1</sup> In its order denying Kmart's motion for amended findings, the tax court ignored the language of its prior order. As a justification for not using Mr. Leirness' capitalization rate, the tax court pointed to the fact that it had merely found his testimony persuasive, and to other evidence in the record. The tax court did not address the fact that it had not only found Mr. Leirness' testimony persuasive, but stated that it had decided to "use his" capitalization rate. The tax court did not provide an explanation regarding the apparent oversight or clerical error and the inherent discrepancy in its initial order.

## II. THE TAX COURT RELIED ON INACCURATE AND UNADJUSTED FIGURES IN ITS SALES COMPARISON ANALYSIS.

In its analysis of the sales comparison approach, the tax court held:

The three comparables provide a range of **adjusted sales prices of \$28.68 to \$46.78 per square foot**. Mr. Leirness chose \$27.00 per square foot, and Mr. Dahlen chose \$39.00 per square foot. We find \$35.00 per square foot to be reasonable based upon the adjustments discussed above.

(App. 27, emphasis added). In its order denying Kmart's motion for amended findings, the tax court stated that it made an downward adjustment based upon the evidence to reflect the leased fee nature of the comparable sales. (App. 40). The tax court's findings and conclusions contain two significant flaws that compel reversal of the tax court decision.

### A. The range of the adjusted comparables was not between \$28.68 and \$46.78 per square foot.

First, the tax court's finding that the high end of the range of adjusted comparables was \$46.78 is incorrect. In Mr. Dahlen's initial appraisal, Mr. Dahlen calculated the gross price per square foot for Comparable No. 1, before adjustment, to be \$44.67. (App. 78). That calculation, however, did not consider the square footage of the Fashion Bug that was sold as part of the sale. Mr. Dahlen testified that when the Fashion Bug area was properly included, the proper gross price per square foot, before adjustment, for Comparable No. 1 was \$40.88. (Tr. 439).

Becker County concedes that Mr. Dahlen made an error. Becker County Brief, p. 9. Rather than explore the impact of the error on the tax court's analysis, however Becker County simply ignores that impact because it obviously is benefited by the tax

court's ultimate conclusion. In Becker County's eyes, if any evidence in the record supports the tax court's ultimate conclusion of value, the tax court's decision must be affirmed. Due process and fair jurisprudence are not that simplistic.

To determine the price per square foot under the sales comparison approach, the tax court bracketed its conclusion with what it mistakenly thought was the range of the adjusted value of the comparable sales. (App. 27). As is noted above, the bracket considered by the tax court is simply incorrect. When the proper base price per square foot for Comparable No. 1 is inserted into Mr. Dahlen's analysis without any other change, the proper adjusted price per square foot for Comparable No. 1 is approximately \$42.82, well below the \$46.78 referenced by the tax court. Given Mr. Dahlen's testimony, the tax court's finding that the high end of the range of the adjusted value for the comparables was \$46.78 is not supported by the record and is clearly erroneous. The tax court's conclusions, which were based in part on that finding, are equally infirm.

**B. The comparable sales considered by the tax court, contrary to the tax court's findings, were not fully adjusted.**

As is noted above, the tax court found that the "comparables provide a range of adjusted sales prices of \$28.68 to \$46.78 per square foot." (App. 27, emphasis added). It is this finding that provides the basis for the tax court's ultimate conclusion of value in the sales comparison approach.

As is noted above, the \$46.78 per square foot value at the high end of the range was not supported by the record. Equally as important, though, the high end of the range referenced by the tax court did not reflect fully adjusted sales. As is discussed in Kmart's

principal brief, the three comparables considered by the tax court were leased fee, rather than fee simple, sales. (App. 25). The tax court properly recognized that when considering leased fee sales, it must determine whether the leases were above, below or at market. (App. 26). After hearing both experts testify, the tax court found:

Based upon the evidence presented, we accept Mr. Leirness' testimony that the leases were higher than the market rent and make adjustments for the leased fee nature of the comparable sales.

(App. 27).

Accordingly, to provide the range of adjusted comparable sales consistent with the tax court's finding, each of Mr. Dahlen's adjusted sales must be adjusted downward to reflect the leased fee nature of the sales. In short, Mr. Dahlen's Comparable Sale No. 1 (\$42.82 per square foot before leased fee adjustment when corrected pursuant to Mr. Dahlen's testimony), Comparable Sale No. 2 (\$40.77 per square foot before the leased fee adjustment), and Comparable Sale No. 3 (\$35.78 per square foot before leased fee adjustment) all must be adjusted downward.

The tax court's reference to \$46.78, which corresponds to Mr. Dahlen's Comparable No. 1, necessarily does not reflect any downward adjustment for the leased fee nature of the sale. If the tax court is going to use a range of comparables as the basis of its conclusion of value, it must consider the properly adjusted range of those comparables. To recognize that a specific adjustment to certain comparable sales is necessary, then to base a value conclusion on the unadjusted data (as the tax court clearly

did in this case), is clearly erroneous and not consistent with the tax court's statement that the adjustments were made.

**III. THE ONLY EVIDENCE IN THE RECORD REGARDING THE PROPER ADJUSTMENT FOR THE LEASED FEE SALES IS THAT OF MR. LEIRNESS.**

It is undisputed that Mr. Leirness made a 15% downward adjustment to reflect the above market leases in place for each of the comparable sales. (App. 59). The tax court properly recognized that Mr. Dahlen made no adjustment. There is no evidence in the record other than Mr. Leirness' 15% regarding the size of the downward adjustment that should be made to reflect the above market leases in place for each of the comparable sales.

If such a 15% downward adjustment is made to Mr. Dahlen's comparable sales, the range of Mr. Dahlen's comparable sales becomes approximately \$35.85 for Comparable No. 1, \$34.65 for Comparable No. 2, and \$30.41 for Comparable No. 3. The low end of the range remains \$29.64 (Leirness Comparable No. 14), \$28.68 (Leirness Comparable No. 15) and \$28.90 (Leirness Comparable No. 16) (App. 59). As rectified, the data in the record clearly does not support the tax court's finding of \$35.00 per square foot. Given the corrected data, the trial court's finding of \$35.00 per square foot is not supported by the record.

Neither Becker County, nor the tax court, can explain why Mr. Leirness' 15% adjustment should not be applied.<sup>2</sup> For its part, Becker County concedes that an adjustment must be made and that Mr. Dahlen failed to make that adjustment. Nonetheless, Becker County argues that there was enough evidence in the record for the tax court to make the adjustment it found necessary. The problem with Becker County's argument is that it cannot point to a single shred of evidence that any adjustment was made, nor that would justify the tax court's departure from Mr. Leirness' adjustment. In essence, Becker County argues that it is the end which it preferred (\$35.00), not the means (the reasoning and methodology used to reach the end), that matters for the purposes of this appeal.

In response to Kmart's motion seeking amended findings, the tax court had an opportunity to explain its downward adjustment. The tax court chose not to do so. Rather, it simply made the conclusory, if unsupported and illogical statement, that in arriving at \$35 per square foot, it made a reasonable adjustment based upon the evidence. (App. 40). Unfortunately, the tax court did not identify the size of the adjustment it made, the basis for rejecting Mr. Leirness' 15% adjustment, or the evidence in the record that supported the unspecified adjustment that was made.

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<sup>2</sup> For at least part of its analysis, the tax court used Mr. Leirness' 15% adjustment. Specifically, the tax court referenced the lower end of the bracket as \$28.68. (App. 27). This statement is based upon Mr. Leirness' Comparable Sale No. 15, which contained a 15% downward adjustment to reflect the leased fee nature of the sale. (App. 59). If the tax court accepted Mr. Leirness' 15% adjustment for Mr. Leirness' comparable sales, logically it should also have applied the same 15% to Mr. Dahlen's analysis of the sales as well.

Relator fully agrees that the tax court is not bound to accept the valuation of either party's appraiser. *American Express Financial Advisors, Inc. v. County of Carver*, 573 N.W.2d 651, 658 (Minn. 1998). Nonetheless, if the tax court decides to come up with its own analysis, it cannot use illogical reasoning. *American Express*, 573 N.W.2d at 568. In this case, the tax court's statements in its decisions confirm that the tax court relied upon data to reach its value conclusion that was not adjusted consistent with its own findings and reasoning.

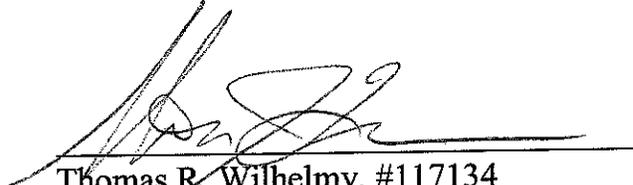
Further, although the tax court has stated that it made a downward adjustment to reflect the leased fee nature of the comparable sales, the bracketing stated by the tax court is inconsistent with such an adjustment actually being made. The tax court has likewise provided no explanation regarding the size or basis for the adjustment it made. Based solely on the tax court's stated findings and reasoning, it is impossible to conclude that the tax court's adjustment was either logical or founded on the record.

The tax court's decision should be reversed. The only evidence in the record regarding the appropriate leased fee adjustment is the testimony and appraisal of Mr. Leirness, testimony that the trial court at least partially accepted (App. 27). This matter should be remanded to the tax court with instructions to adjust Comparable Sale Nos. 1, 2, and 3 downward by 15%, and to recalculate the value of the Subject Property after the tax court has made the proper adjustment, an adjustment the tax court itself found necessary and appropriate based upon the record in these proceedings.

**CONCLUSION**

Relator Kmart Corporation respectfully requests that the Court reverse the tax court's April 1, 2005 Order denying Kmart's post-trial motions and remand with directions to amend the tax court's December 1, 2004 findings of fact and conclusions of law to correct the errors outlined above and in Kmart's principal brief by applying the tax court's own reasoning to use a 10.5% capitalization rate in the income approach to value, to adjustment Mr. Dahlen's sales comparison figures before using them to bracket the final valuation decision, and to rely primarily upon the income approach as opposed to the sales comparison approach to value.

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Dated: August 1, 2005

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**CERTIFICATE OF COMPLIANCE**

**WITH MINN. R. APP. P 132.01, Subd. 3**

The undersigned certifies that the Brief submitted herein contain 2,474 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Brief was prepared using a proportional spaced font size of 13 pt. The word count is stated in reliance of Microsoft Office Word 2000, the word processing system used to prepare this Brief.



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