Rebuttal Report Exposing Doubled-Counted Damages

Report Introductory Matter

Contributor
Name: Jack P. Friedman
Degrees: BBA, MBA, PhD
Professional designations: MAI, CPA, ASA, CRE
Company affiliation: Jack Friedman & Associates
Title: President

Report Description
Purpose: Damages, contract cancellation, settlement
Use: Defendant

Principal Litigation Issue
Amount of damages in settlement of case

Outcome
Type of conclusion: Summary judgment, under appeal
Conclusion of case compared with opinions in report: Summary judgment is consistent with this rebuttal report

Usefulness of Report
Demonstrates need to carefully review the other expert’s report. An expert was hired by the plaintiff to estimate damages because of an allegedly poor settlement of a matter in litigation. This expert double-counted damages, which was exposed in the rebuttal report.

Lessons from Litigation
- Expert reports may contain a major flaw that invalidates findings.
- A court may grant summary judgment when it recognizes such a flaw.
EXPERT REPORT OF JACK P. FRIEDMAN

Introduction

My name is Jack Perry Friedman. I am a resident of Dallas, Texas.

Retention


I was provided with a copy of that report, containing ten manuscript pages plus nine exhibits. Also included was a list of Dr. Sullivan's “Testimony 1997–2000” and his resume. Within the same binder with his damages report was an "Appraisal of Real Property: Snow Mass Estates, as of December 1, 1994," prepared by Batsman & Outfield, Inc. This Batsman & Outfield report appears to be a retrospective appraisal, prepared approximately July 2000 to provide a value as of 1994. A Batsman & Outfield appraisal of the same project, dated October 31, 1991 (value as of October 28, 1991, with prospective values upon project completion on December 31, 1993), was also provided to me. A hand-delivered letter dated September 29, 2000, from Berry, Cherry & Raisin to Mark Herron accompanied a corrected Exhibit 2.8, pages 1 and 2.

Background and Qualifications

I am an independent consultant principally in the areas of real estate investments, appraisal, finance, and market analysis. I earned a BBA in finance from Wake Forest University (Winston-Salem, North Carolina) in 1966, an MBA in accounting from Pace University (New York, New York) in 1970, and a Ph.D. in business administration (with a concentration in real estate and urban affairs) from Georgia State University (Atlanta, Georgia) in 1975.
I hold a number of professional designations. I am a certified public accountant (CPA), a Member of the Appraisal Institute (MAI), a Senior Real Estate Analyst (SREA), a Senior Member (Real Property/Urban) of the American Society of Appraisers (ASA), a counselor of real estate (CRE), and a certified real estate appraiser (CRA) in the National Society of Real Estate Appraisers. I also hold Certified General Appraiser and Real Estate Broker licenses in the State of Texas.

I have been a teacher and researcher at Georgia State University (1971–1976), the University of Texas at Arlington (1976–1979), and Texas A&M (1979–1990) and left Texas A&M with the rank of Julio S. Laguarta Chair Professor. I have also developed and taught courses for professional associations, including the Appraisal Institute, the American Institute of Certified Public Accountants, the American Society of Appraisers, the International Association of Assessing Officers, and the National Society of Real Estate Appraisers. For the past ten years I have been employed as an independent appraiser and real estate consultant. My clients have included major corporations and government agencies such as Sears, J. C. Penney, Exxon, Dallas Galleria, AmWest, Amresco, Bank of America, the City of Dallas, the FDIC, and the Internal Revenue Service.

I have written or coauthored more than twenty-five books, which have sold more than one million copies, and have published more than 200 scholarly articles. I am coauthor of Income Property Appraisal and Analysis, a book published by Prentice-Hall that was adopted by two major appraisal associations for use in their educational programs. It has been translated into two foreign languages. I am also coauthor of “Appraisal Review in a Litigation Support Role,” which appears in the January 2000 issue of the Appraisal Journal. This is a refereed journal and is the leading periodical of the appraisal profession.

In 1999 I was elected to a three-year term on the Appraiser Qualifications Board of the Appraisal Foundation. The Appraisal Foundation is an organization, sponsored by the federal government, that provides rules for the fifty states to follow regarding qualifications of appraisers for licensing and certification. It also publishes the Uniform Standards of Professional Appraisal Practice (USPAP).

I am a regional director of the North Texas Chapter of the Appraisal Institute and the current chairman of the Dallas/Fort Worth chapter of the Counselors of Real Estate.

A copy of my resume is attached as Appendix D, followed by a list of prior testimony in Appendix E.

My Opinion

My opinion of the damage estimate of John L. Sullivan is that it is significantly flawed and greatly overstated by a major error. While I have a number of other concerns about the data and analysis, my focus in this report is on one large, egregious error. This error is the result of double-counting a debt and corresponding spending in Dr. Sullivan’s damage calculations. The double-counted amount is $132 million. Upon correction of that error, there are no damages to the plaintiff. Without correction of the error, the overzealous result is that Snow Mass Corporation is seeking to recover a total

1 Accordingly, my use of figures relied on by Dr. Sullivan should not be treated as acceptance of those figures.
amount ($277 million) well in excess of the value of the project ($160 million) if it were completed.

Background and Undisputed Facts

On or about June 9, 1989, the U.S. Military awarded a lease, to be effective for a twenty-year period, to XYZ Realty Corp. On November 4, 1991, XYZ Realty Corp. assigned the rights and obligations of the U.S. Military lease to Snow Mass Corporation (SMC).

The contract contemplated that Snow Mass Corporation would build 1,000 units of housing (townhouses) on approximately 58.33 acres of land in one of the boroughs of New York City. The U.S. Military, as tenant, would pay $15,552,000 in annual rent and sublease the units to its employees.

The $15,552,000 annual rent amounts to an average of $1,296 per unit per month. It is expected to include basic rental and maintenance payments, including debt service, insurance, ad valorem taxes, and management.

In an appraisal as of October 28, 1991, Batsman & Outfield provided these value opinions (Bates # MILITARY-004713; see Appendix B):

Prospective market value of the fee simple interest in the property subject to the lease as of December 31, 1993 (anticipated date of completion of construction), based on analysis on October 28, 1991, will be $160,000,000

Gross sellout value as of October 28, 1991, exclusive of any provision for inflation $148,500,000

Assuming annual net appreciation of 2% per annum during the construction phase, prospective gross sellout value as of December 31, 1993 (estimated completion), based on date of analysis, October 28, 1991, will be $154,500,000

Market value (current) of fee simple interest in land as approved as of October 28, 1991 $35,000,000

Prospective market value of land subject to U.S. Military lease as of December 31, 1993, as of date of analysis, October 28, 1991, will be $40,000,000

Financing for this project closed on December 31, 1991, in the amount of $132 million. Construction commenced January 2, 1992. The costs to construct the project were estimated at $122,322,632 by Batsman & Outfield in an appraisal report dated October 1991, excluding land having an estimated total market value of $35 million.\(^2\)

Construction costs included a 7.5 percent entrepreneurial developer profit on total costs (including land value), which was $10,976,250.\(^3\) Total costs, including developer profit, were expected to be $157 million (rounded).

---

\(^2\)Batsman & Outfield 1991 appraisal, p. 30 (MILITARY-004748).

\(^3\)Ibid.
The U.S. Military lease was terminated on December 8, 1993. At that time, certain construction was completed. This included the following.4

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units complete</td>
<td>333</td>
</tr>
<tr>
<td>Modules set in place</td>
<td>188</td>
</tr>
<tr>
<td>First floor in place</td>
<td>51</td>
</tr>
<tr>
<td>Foundation slabs in place</td>
<td>212</td>
</tr>
<tr>
<td>Infrastructure/site cleared</td>
<td>216</td>
</tr>
<tr>
<td>Total</td>
<td>1,000</td>
</tr>
</tbody>
</table>

According to the Batsman & Outfield appraisal dated as of December 1, 1994, actual costs incurred to the date of termination were $79,974,132, exclusive of land acquisition costs.5

Negotiations between Snow Mass Corporation and the U.S. Military led to settlement payments of $25,000,000 in May 1994 and $101,000,000 on November 30, 1994. This is a total of $126 million.6 In addition, Snow Mass Corporation kept the property free and clear. This was appraised (apparently retrospectively in 2000) by Batsman & Outfield at $28 million as of December 1, 1994.7

**Sullivan Report**

According to Dr. Sullivan, referring to the $126 million of cash and $28 million of property that Snow Mass Corporation received in the 1994 settlement:

Such payments allowed plaintiffs to satisfy existing indebtedness to financial institutions and subcontractors, but failed to restore the benefit of plaintiffs’ bargain with the Military in any significant way. Plaintiffs were left with a relatively small amount of cash and a partly-built housing project, designed and permitted in accordance with Military specifications, which yielded no revenue. Plaintiffs’ damages, therefore, are the difference between the value of what was bargained for with the Military and the value of what was actually received, valued as of December 8, 1993, and adjusted for events up to December 1, 1994, the day following the consummation of the plaintiffs’ settlement with the Military.8

Sullivan provided a worksheet, “Summary of Damages as of December 1, 1994” (Exhibit 2-1). It is reproduced below.

Dr. Sullivan thereby asserts that Snow Mass Corporation is entitled to $123,303,812 in damages.

---

5Ibid., p. E-2.
6Ibid.
7Ibid.
8Sullivan report, p. 3 of 10.
Project in Perspective

To put the project in perspective, it was expected to have 1,000 units and be worth about $160 million on completion on December 31, 1993. This is about $160,000 per unit.

Snow Mass Corporation received $126 million in addition to receiving the land back. The land, now improved, has been appraised at $28 million as of December 1, 1994. Thus, Snow Mass Corporation received in the settlement a total of $154 million in cash and property. One might note that the total is $6 million short of the $160 million in maximum property value that Batsman & Outfield estimated in their 1991 appraisal, had the project been completed subject to the lease. But of course Snow Mass Corporation had already received roughly $9 million in rental and interest payments at the time of settlement. Moreover, to realize the $160 million price would require Snow Mass Corporation to pour in tens of millions of dollars to complete construction. Thus, from a total project value perspective, Snow Mass Corporation was more than made whole by the Military settlement.

If only the equity interest is examined, it is likewise clear that Snow Mass Corporation was more than made whole by the Military. If the project had been completed and rented for twenty years in accordance with the lease, Dr. Sullivan concludes that the present value of the payments to be received by the equity investor would have been $14,594,574 as of December 1, 1994. Dr. Sullivan concludes that the present value of the equity interest on the sale of the property at the end of the lease would have been $6,194,127 as of July 31, 1993. Thus, the present value of the cash flows and reversion is the sum of those two, or about $20 million. The "partly-built project" that Snow Mass got back in the settlement is valued by Snow Mass' expert at $28 million.

Plainly, then, and using Snow Mass Corporation's own numbers, the value of the project that Snow Mass got back (free and clear) in the settlement exceeds the present value of what Snow Mass would expect to receive in equity value if they had seen the project to fruition.

These perspectives demonstrate that Snow Mass Corporation was well compensated by the settlement it struck with the Military. Indeed, this analysis goes a long way toward establishing that the current claim for additional damages is unreasonable. In connection with a claim on a project that (using Snow Mass Corporation's own numbers) would be worth a total of about $160 million in 1994 dollars upon completion, Snow Mass Corporation seeks:

<table>
<thead>
<tr>
<th>$126 million</th>
<th>Cash in settlement received in 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 million</td>
<td>Property in settlement received in 1994</td>
</tr>
<tr>
<td>123 million</td>
<td>Damages asserted currently</td>
</tr>
<tr>
<td>277 million</td>
<td>Total</td>
</tr>
</tbody>
</table>

---

9Batsman & Outfield 1991 appraisal, p. 2 of transmittal letter (see Appendix B of this report).

10Sullivan report, p. 5 of 10.

11Ibid., p. 7 of 10. The inconsistency in dates—July 31, 1993, used to derive the present value of proceeds of sale and December 1, 1994, used to derive the present value of the reversion from resale—is not material to this report.

12Of course, this figure is before taking account of the $20.8 million construction cost overrun.
Snow Mass Corporation is thus seeking to be unjustifiably enriched well beyond the total potential value of the project.

**Damages Analysis—Overview of Error**

Dr. Sullivan’s Summary of Damages is fatally flawed because it double-counts approximately $132 million. He counted what was borrowed and added to that what was spent (even though the amount spent was taken from the loan proceeds). The result is double-counting damages.

In part A of Exhibit 2-1, “Summary of Damages,” the $171,985,529 amount includes $132,070,000 of debt.\(^1\)

In part B of Exhibit 2-1, Sullivan adds to the $171,985,529 the sum of $135,311,255 for 1991–94 “Costs Incurred.” Exhibit 2-6 provides some itemization of the $135,311,255.\(^2\)

Sullivan offset damages by a $20.9 million cost overrun (I agree that a developer should not be paid for gross inefficiencies), plus a total of $9.1 million more: $7 million for rental revenue received and $2.1 million in interest and dividends. He further reduces damages by the $126 million Military settlement and $28 million based on Batsman & Outfield’s 1994 appraised value of the land, now with 333 completed units, and the rest of the property. The result is a damages claim of $123.3 million.

One thing is clear: by counting the debt in JLS-1(A) and adding construction and land costs in JLS-1(B), Sullivan double-counted the amount of damages. The double-counted amount is never removed.

Had the $132,070,000 loan not been counted twice (again, it was counted both as a loan and as a cost incurred, with the two added together), the result would indicate no damages. Indeed, it would show that Snow Mass Corporation had improved its position by about $9 million in the $154 million settlement. That improvement in position was based on a highly conservative value estimate for the return of the land and 1½ years of heavy construction activity, resulting in 333 completed units.

**How Did Sullivan Overstate Damages?**

Dr. Sullivan erred in adding the full debt to the cost of the asset to derive the asset lost. The impropriety of this technique can be demonstrated from an accounting perspective, from a real estate perspective, and also with common-sense analogies.

First, examining the issue from an accounting perspective, the basic balancing formula of accounting is:

\[
\text{Assets} = \text{Liabilities} + \text{Equity}
\]

---

1\(^3\) See Sullivan report, p. 7 of 10, which refers to “the debt of $132,070,000 at lease inception.” Also, Exhibit JLS-2, p. 1 of 3, states the present value of debt at lease inception as $132,070,000.

2\(^4\) This includes $24.4 million “Expensed” (not further described), $80.6 million “Capitalized” (not further described), $27 million land, $2.0 million legal, and $1.2 million payment to RBS, Inc. Amounts are rounded. Exhibits JLS-1, JLS-2, and JLS-6 are in Appendix A of this report. The $80.6 million capitalized approximates the estimated amount of costs incurred to the point when construction was stopped ($79,974,132 according to Batsman & Outfield).
In Sullivan’s damages report, this nonsensical formula has been used:

\[ \text{Assets + Liabilities + Equity} = \text{Damages} \]

Plainly, this is double counting. Because assets are measured by liabilities plus equity, it is incorrect to sum all three components.

Second, from a real estate perspective, there are at least two fundamental methods of measuring the total value of real estate. One is physical: add building to land value. Another is financial: add equity to mortgage debt. Instead of choosing one method or the other, Dr. Sullivan summed the results of the two methods.

One can appraise the value of real estate considering the buildings and land. Batsman & Outfield offered a total value of about $155–$160 million if complete, subject to the Military lease as of December 31, 1993.\(^{15}\) This includes the land at market value, construction costs for improvements, and entrepreneurial profit, as follows:\(^{16}\)

\[
\begin{align*}
\text{Land} & \quad \$35,000,000 \\
\text{Improvements} & \quad 111,350,000 \\
\text{Entrepreneurial profit} & \quad 10,976,250 \\
\text{Total} & \quad \underline{157,326,250} \\
\text{Rounded} & \quad \$157,500,000
\end{align*}
\]

A second well-known technique for valuing property subject to a mortgage is called the mortgage/equity technique. The equity position is valued by first determining the discounted present value of annual cash flow after debt service. The present value of proceeds from resale, to be received by equity, is added to derive the present value of equity.

To estimate resale proceeds, first a resale price is estimated. In this case, such is based on a resale nineteen years after completion of construction. From that, expenses of sale and the mortgage balance at resale are subtracted to derive the proceeds of resale. That lump-sum amount is discounted to a present value.

The result is added to the present value of cash flow to provide a total value for equity. Then the present mortgage balance is added to provide a present value estimate for the property.

\(^{15}\)Batsman & Outfield 1991 appraisal, p. 2 of transmittal letter (MILITARY-004713).

\(^{16}\)Ibid., p. 30 (MILITARY-004748).
The following figures are given in the Batsman & Outfield 1991 appraisal:\textsuperscript{17}

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of 19 years of cash flow (after debt service @ 9.75%) = PV income</td>
<td>$5,311,050</td>
</tr>
<tr>
<td>stream</td>
<td></td>
</tr>
<tr>
<td>Value of proceeds from resale in 19 years after deducting mortgage debt</td>
<td>$20,255,667</td>
</tr>
<tr>
<td>in 19 years = Discounted reversionary value</td>
<td></td>
</tr>
<tr>
<td>Total value of equity (as of December 31, 1993)</td>
<td>$25,566,71</td>
</tr>
<tr>
<td>Add: Amount of debt on December 31, 1993</td>
<td>$133,105.00</td>
</tr>
<tr>
<td>Total value as of December 31, 1993</td>
<td>$158,671.7</td>
</tr>
<tr>
<td>Rounded</td>
<td>$160,000.00</td>
</tr>
</tbody>
</table>

Similarly, Exhibit 2-2 of Dr. Sullivan's report offers a sellout value of $148,500,000 for the 1,000 units, if completed, detailed by unit size and price, as of December 31, 1991, raised to $153,229,856 for appreciation to July 31, 1993.

This demonstrates that a property value can be derived either by summation of the physical assets or by adding the present value of the equity to the mortgage balance. In his damage calculations, however, Sullivan added the $132 million of debt to the $135 million of "costs incurred" for items "expensed" and "capitalized," "land," and legal fees. Thus, he double-counted the $132 million. He counted the $132 million once when it was borrowed and a second time when it was spent.

Third, Dr. Sullivan's error can be appreciated in the following analogies.

\textit{Analogy #1}

You go to an ice cream parlor with a friend but have forgotten your wallet. Your friend cheerfully lends you a dollar to buy a chocolate cone. After paying a dollar and being served, you are accidentally jostled by another customer, and your cone falls and splatters. The offending customer apologizes and offers to pay you damages. You ask for two bucks: one to repay your friend and one to buy another cone. Is that correct? Of course not. One dollar is all you need to buy a new cone, which makes you whole. But damage expert Sullivan wants two dollars.

\textit{Analogy #2}

Suppose that you get a bank loan of $130,000 to buy land and build a house. You then spend the $130,000 loan proceeds plus $20,000 of your own equity to buy the

\textsuperscript{17}Ibid., p. 36 (MILITARY-004753).
land and pay for materials, labor, and subcontractor profit. At the end, you probably have a house worth approximately $150,000—an amount about equal to the amount you spent.\textsuperscript{18} If your house burned to the ground soon after you built it, a reasonable damage estimate would be $150,000 less the value of the land, which is still present and possibly buildable.

Sullivan, however, would add the $130,000 loan to the $150,000 cost to claim $280,000 in damages, before subtracting land. Is the house worth $280,000? Of course not! You can replace it for $150,000 (less land cost).

What of the argument that you can't both replace the house \textit{and} repay the loan (which is still outstanding) with $150,000 of insurance money? It is true that you can't do both. But suppose insurance repaid you $280,000 to replace the house and repay the loan. Upon rebuilding, you would have a $150,000 house \textit{debt free}! That is not the situation you started with. Initially, you built a house with $130,000 of debt, and the debt was still on the house when the fire occurred. The insurance was intended to make you “whole,” meaning to put you back in the same position you were in before it occurred. If you get enough insurance money to rebuild \textit{and} pay off the debt, you would return to a new house, debt free. This would put you in a much better position than you were in before the fire. This is exactly the reasoning used in Dr. Sullivan’s flawed damage model.

\textbf{To Correct Dr. Sullivan’s Damage Calculation}

Removal of the $132 million of debt from part A of Dr. Sullivan’s calculation would reduce the damages by that amount. Since the amount of damages thus becomes negative, the exactness of other figures in his damage calculation becomes moot. There are no damages to be assessed.

\textbf{Summary}

The damages estimate contains a number of questionable assumptions but also, more importantly, one fatal flaw. It duplicates $132 million. Specifically, John L. Sullivan’s damage estimate counts a $132 million loan and adds the same amount (or more) when spent. Thus, the $123 million of damages should be reduced by the double-counted $132 million, resulting in a corrected estimate of \textit{\$9 million} of damages (i.e., the plaintiff was at least \textit{\$9 million} better off as a result of the 1994 settlement than if it had had to complete the project).

Respectfully submitted,

Jack P. Friedman, Ph.D., MAI, CRE, CPA

\textsuperscript{18}The market may value the house at slightly more or less depending on how efficient your spending was, how well market tastes conform to your plans, and changing market conditions during construction.
ASSUMPTIONS AND LIMITING CONDITIONS

General Assumptions
This report has been prepared with the following general assumptions:
♦ The report is intended to be used in litigation. The purpose of the report is to provide information for the intended use.
♦ The information furnished by others is believed to be reliable. However, no warranty is given for its accuracy.
♦ Any illustrative material in this report is included only to assist the reader in visualizing the property or data.

General Limiting Conditions
This report has been prepared with the following general limiting conditions:
♦ Possession of this report, or a copy thereof, does not carry with it the right of publication.
♦ The consultant herein by reason of this report is not required to give further consultation or testimony or to be in attendance in court with reference to the property in question unless arrangements have been previously made.
♦ Neither all nor any part of the contents of this report (including the identity of the consultant or the firm with which the consultant is connected) shall be disseminated to the public through advertising, public relations, news, sales, or other media without the prior written consent and approval of the consultant.
CERTIFICATION

I certify that, to the best of my knowledge and belief:

♦ The statements of fact contained in this report are true and correct.

♦ The reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions and are my personal, unbiased professional analyses, opinions, and conclusions.

♦ I have no present or prospective interest in the property that is the subject of this report, and I have no personal interest with respect to the parties involved.

♦ I have no bias with respect to any property that is the subject of this report or to the parties involved with this assignment.

♦ My compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or the use of, this report.

♦ My analyses, opinions, and conclusions were developed, and the report has been prepared, in conformity with the Uniform Standards of Professional Appraisal Practice.

♦ I have not made a personal inspection of the property that is the subject of this report.

♦ No one provided significant professional assistance to the person signing this report.

♦ This report was prepared in accordance with the Code of Ethics and Standards of Professional Practice of the Appraisal Institute and the American Society of Real Estate Counselors.

♦ The undersigned is in compliance with the continuing education requirements of the organizations that provide the professional designations held.

Jack P. Friedman, Ph.D., MAI, CRE, CPA  Date
LIST OF APPENDIXES [not included]

A. Exhibits 7-1 (1 page), 7-2 (3 pages), and 7-3 (1 page)

B. Transmittal Letter of Batsman & Outfield, dated October 31, 1991 (Bates MILITARY 004712–004713)

C. Executive Summary of Batsman & Outfield Appraisal as of December 1, 1994, pages E-1 and E-2.

D. Resume of Jack P. Friedman

E. Prior Testimony of Jack P. Friedman