

Strategically Navigating the Commercial Real Estate Tax Appeal Process During Construction Defect Litigation

Daniel A. Dorfman and Keith S. Brin

Share:



Property owners involved with construction-defect litigation who are also seeking to obtain property tax relief due to the defects and related substantial loss of income have a common dilemma. The problem is that any information shared with the tax authorities would be discoverable by the property owner's adversaries. This interplay can create pitfalls and challenges based upon the very defects that form the foundation of the litigation. On the one hand, the Owner wants to maintain the privilege against disclosure of preliminary analyses of the defects. On the other hand, the Owner wants to openly share information with the tax authority to ensure it proves its entitlement to tax relief. This article addresses the challenging aspects of navigating the real estate tax appeal process under such circumstances.

The Common Scenario

Consider the following common hypothetical whereby an Owner involved in the redevelopment of a commercial revenue-generating property later discovers defects:

- **The Redevelopment Project.** The Owner engages an architect to map out the desired renovation program and develop all the necessary plans, and, engages a general contractor to perform all the construction services for the renovation project. Project costs are budgeted to be well into the millions of dollars. At final walk-through after a year of construction, the project appears to be completed properly, and is both on budget and on time. The Owner executes and processes the final payment applications. The project is complete.
- **Discovery of Post-Completion Defects.** Two years after the project has been completed, the Owner starts noticing problems – water intrusion from the building envelope, HVAC not properly heating or cooling, and organic growth is identified by a tenant (the “Defects”).
- **The Owner’s Consultant’s Preliminary Assessments.** Understandably, the Owner is shocked to discover these defects after spending millions of dollars in the property’s redevelopment. The

Owner wisely engages counsel and a forensic consultant to understand the Defects and whether a third party may be at fault (*i.e.*, liable for remediation costs). The Owner's forensic consultant performs an initial evaluation and determines that (1) the design professional and general contractor performed faulty work; and (2) repairing the Defects will cost millions of dollars, not including the consequential damages of moving and relocating its tenants, and the loss of rent during the remediation project. The Owner obviously intends on ensuring that the parties whose mistakes caused this mess pay for repairs.

- **The Owner's Desire For Property Tax Relief.** Now that the Owner has his consultant's preliminary assessments and is working with counsel on the prospect of litigation, it seeks legal advice concerning what would seem to be a very simple question: "*As the remediation of the project will be exceedingly expensive, can we obtain any sort of property tax relief due to the Defects and substantial loss in income, and, if so, what information can we share in a property tax appeal?*"

The easy answer to the Owner's question is, yes—it is possible to obtain property tax relief and there is nothing stopping you from sharing any information you want with the tax authority. The very big caveat to this answer, however, is: *be careful*. Premature disclosure of certain privileged information about the Defects to third-party tax valuation experts and authorities (*e.g.*, appraisers) have potentially adverse effects within the context of the Owner's litigation to recoup the remediation costs.

Before proceeding with the tax appeal, an Owner should consider the law applicable to expert privilege in the context of construction litigation when deciding which reports and information should be disclosed. The determination of whether a disclosure obligation exists could depend upon whether or not the experts and consultants who provided the information will testify at trial against the architect and contractor (if necessary), and how the consultants are classified under applicable court rules.

A Primer on the Law of Expert Privilege

Often times, parties to litigation, including plaintiffs complaining of construction defects, hire "expert witnesses." For every possible type of legal dispute, there is usually an expert that might have something to offer. The key distinction between expert witnesses and "fact" or "lay" witnesses is that, unlike fact witnesses, experts can provide their professional *opinion*, as opposed to being limited to testifying about *facts* that they personally know. As explained below, some experts never testify at all, but work with counsel to help prepare a case.

Although each state has their own body of law and set of rules that apply in their courts, for simplicity purposes, this article analyzes the privilege issues under federal law and contracting in federal court. Note that what may generally appear to be minor deviations between federal law and the law of a particular state may have a devastating impact on the particulars of your case.

Under the Federal Rules, there are two types of experts:

- **Non-Testifying Expert:** This is an expert “who has been retained or specially employed by another party in anticipation of litigation or in preparation for trial” and who is not expected to testify at trial. These are sometimes also referred to as “consulting experts.”
- **Testifying Expert:** This is an expert who has been “retained or specially employed to provide expert testimony in the case and whose duties as the party’s employee regularly involve expert testimony.”

Aside from limited circumstances, facts known or opinions held by non-testifying experts are generally shielded from disclosure or discovery. Testifying experts, on the other hand, must disclose the facts and data that they considered, and the opinions that they formed, through a written report provided to the adversary—*after* those opinions have been vetted and approved by the client and its counsel. Although draft reports and certain types of communications between the attorney and a testifying expert may be protected from disclosure, generally an adversary is given wide latitude to cross-examine their opinions and the underlying facts on which they rely.

Waiver of Privilege

Waiver of privilege is of paramount concern to any Owner who is concurrently dealing with both construction defect litigation and the tax appeal process. As with any privilege, the protection against disclosure associated with expert work can be waived. At its most basic level, waiver occurs when the holder of the privilege takes some action(s) inconsistent with maintaining confidentiality over the otherwise privileged information. For example, in the expert context, providing a copy of a preliminary report prepared by an expert consultant to a third party can oftentimes result in a waiver of the privilege over the disclosed document.

Expert Privilege in Construction Defect Claims

Construction defect litigation is often complicated and requires precise expert testimony in determining fault and, ultimately, damages. Accordingly, classification of the experts and consultants, and determining what information must be disclosed during the course of a lawsuit, are of critical importance. Moreover, an expert’s role may not be determined at the outset of litigation; an expert intended to be a mere consultant may become a testifier, and vice versa. For example, an expert may end up taking a differing view of the facts than that necessary to prove the Owner’s claim, or information may come to light that would make the expert a liability at trial.

Waiver of privilege is always to be avoided. For example, if an expert ultimately comes to an unhelpful conclusion that is inconsistent with the Owner’s theory of the case, the Owner will want to shield that

information from disclosure. Or, possibly more likely, an early version of an expert's report may contain very preliminary views that ultimately are inconsistent with the final report that the expert tenders. If such information were to come to light before trial, it could put the expert at risk of significant credibility attacks in front of the trier of fact at trial – this can be critical, if not fatal, as construction defect cases are often won (or lost) on the credibility of a party's expert.

When Tax Appraisal Meets Defect Litigation

A property's value for tax purposes is appealable, and ultimately will become the basis for determining a property's real estate bill. The process of appealing a property's assessed value begins with the Owner gathering information for their counsel to substantiate a property's shortfalls to decrease the assessed property value, and hence decrease the real estate tax bill.

In our hypothetical, our Owner can utilize the forensic report (or parts thereof) prepared by its consultant to substantiate the basis for pursuing tax relief. In many cases the Owner will also want to obtain a property appraisal to further argue for a decreased assessed property value. The property appraiser's report should certainly be coordinated with and include the Owner's forensic consultant's findings as to the defects, but will also include general property value information such as vacancies, capitalization rates, comparable properties, and an income and expense analysis, to name a few.

Critically, however, the Owner must realize that the privilege over its expert's opinion that is shared with the tax authority will likely be lost. Accordingly, sharing of such information, and the concomitant waiver of privilege, must be carefully considered. For example, if the Owner wishes to keep a consulting expert's role in the case confidential, it should not disclose that expert's analyses. The Owner should consider the potential ramifications of disclosing a preliminary report done by a to-be testifying expert if there is a possibility that the conclusions in that initial report may change—otherwise the disclosed conclusions could wind up being inconsistent with those presented at trial, harming the strength of the Owner's legal case while increasing the strength of its tax appeal.

Once a final decision has been made as to what otherwise-privileged information should be shared as part of the tax appeal, the Owner and its counsel will proceed with the next step of the appeal according to local procedures. Typically, in the next step of the tax appeal process, the information as to the defects, the forensic consultant's reports, and the appraisals are filed with the assessor or boards of review for a decision as to whether the property should have a decrease in assessed property valuation.

If the Owner's tax counsel argues the issues, problems, and calculations, it will likely result in some level of tax relief. While such an aggressive approach to the property tax appeal effort could result in a lower tax liability, however, the Owner must also consider that such an approach could also significantly impact his position down the line in related litigation. However, without revealing the defects, the basis upon

which the tax relief may be granted may be tenuous, and certainly will not be as strong. Yet not appealing a property's valuation could leave an owner with an even larger real estate tax liability than necessary.

Counsel may be able to tiptoe around revealing the actual defects, or reveal them through publicly available information (such as relying exclusively on publicly filed court documents and non-privileged summaries of the defects), and perform a simplified income analysis. But the Owner's chances of obtaining a higher level of relief increases significantly by bolstering its argument with all facts—and expert analyses—available. If early disclosure of expert opinion is deemed necessary, the Owner, counsel, and the expert should ensure that the analysis provided to the tax authority is as final and polished as possible—in other words, all efforts should be made to ensure that whatever report is provided as part of the tax appeal does not substantially change before it is disclosed in the defect litigation. Concurrently, the Owner should strategize with its counsel and expert to hedge as may be necessary to ensure modifications can be made, as necessary, without substantial negative impact to the expert's credibility.

Balancing Discovery and Timing Issues

As outlined above, without proper oversight and handling as to what information is to be shared with the taxing authorities, the Owner might not only waive privilege but also inadvertently create inconsistent opinions as to the scope and extent of the defects between the tax appeal process and the construction defect litigation. While competent counsel may be able to diffuse the significance of inconsistent opinions at trial, they are best to be avoided.

Of course, this does not mean the Owner should not make disclosures to the tax authority in an attempt lower its real estate tax bill. Rather, the Owner should work closely with counsel during the property appeal process to avoid conflicts in opinions as between both venues (*i.e.*, the construction defect litigation and tax appeal) and so as to properly reduce its real estate tax liability.

Timing of events, however, often presents challenges with regard to balancing discoverable versus non-discoverable information. Property tax appeals generally must be filed during a very narrow window of time in specific calendar years, ¹ while construction defect litigation is only limited by the relevant statute of limitations (generally within a set number of years when the owner “knew or should have known” of the defects). To illustrate how these timing issues may impact owners, consider for example that it's not unusual that owners of a just-purchased commercial property will aggressively pursue reducing the property's valuation for tax purposes, but then in the subsequent 10 years discover defects that warrant litigation. The Owner (and the expert property appraisers and others) may be hard-pressed to explain why the defects were not discovered earlier (*i.e.*, during the tax appeal) in addition to responding to many other questions that could imperil their litigation position.

Conclusion: Determine Whether the Tax Fight Is Monetarily Worth the Risk

It is not news to any property owner that real estate taxes will often make up a substantial operational expense for the property, and an improper valuation could cost an owner tens of thousands of dollars a year (or more), among other possible consequences such as loss of potential tenants. However, as previously discussed, the Owners involved in construction defects litigation who also initiate property tax appeals need to simultaneously and carefully weigh the impact of the tax appeal on the defect litigation.

Successfully reducing property valuations can result in lower assessments and thus significant year after year cash savings for property owners. And, while of course paying a large tax bill can also impact a property's overall economic viability, shouldering the burden of funding construction litigation is likewise not an easy task. The strategic decisions the Owners make when facing these circumstances hold significant and lasting monetary stakes for the Owners.

Property owners must work closely with their tax and litigation counsels to not only walk the proverbial tightrope of disclosures but also to weigh the economic and legal impacts of pursuing the tax appeal. Even sophisticated real estate professionals accustomed to connecting these economic dots of potential costs and benefits will grapple with weighing the considerations and finding an appropriate balance. The Owners may conclude after consultation with counsel experienced in these nuances that pursuing the tax relief will not only be beneficial in the short run but that any potential tax savings as a result may help to fund future or anticipated defects litigation. Consulting the right counsel and experts can mean all the difference for commercial property owners when tackling all the issues and decisions that need to be made simultaneously – or paced strategically – in both forums.

ENTITY:

FORUM ON CONSTRUCTION LAW

TOPIC:

CONSTRUCTION

Authors



Endnotes



