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IN THE SUPREME COURT OF THE STATE OF OREGON

HEWLETT-PACKARD COMPANY,
Plaintiff-Respondent,

v.

BENTON COUNTY ASSESSOR,
Defendant,

and

DEPARTMENT OF REVENUE,
Defendant-Appellant.

Tax Court Case No. 4979
Supreme Court Case No. S061456

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SUPREME COURT
COURT OF APPEALS

RESPONDENT'S ANSWERING BRIEF (SUPREME COURT)

Appeal from the Judgment of the Oregon Tax Court
The Honorable Henry C. Breithaupt, Judge
Judgment Filed: June 6, 2013

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I. STATEMENT OF THE CASE

A. Nature of Action or Proceeding.

Plaintiff-Respondent Hewlett-Packard Company ("Hewlett-Packard") accepts Defendant-Appellant Oregon Department of Revenue's (the "Department") statement of the Nature of the Action or Proceeding.

B. Nature of Judgment Sought to be Reviewed.

Hewlett-Packard accepts the Department's statement of the Nature of Judgment Sought to be Reviewed.

C. Statutory Basis of Appellate Jurisdiction.

Hewlett-Packard accepts the Department's statement of the Basis of Appellate Jurisdiction.

D. Date of Entry of the Judgment and Notice of Appeal.

Hewlett-Packard accepts the Department's statement of the Date of Entry of the Judgment and Notice of Appeal.

E. Questions Presented on Appeal.

1. Is the Tax Court's determination of the Real Market Value of Hewlett-Packard's real property an issue of law within the scope of review by this court?

2. Was there other substantial evidence in the case that supports the Tax Court's determination of the Real Market Value of Hewlett-Packard's real property in addition to the cost approach?

3. If the Tax Court committed error, was that error harmless?

4. Did Hewlett-Packard's appraisal, relied upon by the Tax Court, properly determine functional obsolescence in the cost approach pursuant to the Department's administrative rule and consistent with proper appraisal theory to arrive at the Real Market Value of Hewlett-Packard's real property?

F. Summary of Arguments.

1. The Tax Court found that the Highest and Best Use (HBU) of Hewlett-Packard's buildings and structures was as determined by Hewlett-Packard's appraiser (which the Department does not challenge) and that no value should be assigned to the excess, non-core building space. The determination of the HBU of Hewlett-Packard's real property, and the resulting Real Market Value at that use, is a factual determination, not an issue of law. At trial, the Department conceded that Hewlett-Packard's appraiser correctly applied the functional obsolescence formula in the Department's administrative rules to the buildings and structures, and properly followed the templates for calculating Real Market Value by both the Reproduction and Replacement Cost Indicator of value contained in the Department's rules. The Department challenges the "inputs" used by Hewlett-Packard's appraiser in calculating functional obsolescence of the improvements under the Department's rules, which are questions of fact, not law. Because the Tax Court's decision as to the HBU and the Real Market Value of Hewlett-Packard's real property are issues of fact, and because the Department has not challenged the factual findings of the Tax Court, the Tax Court's decision cannot be reviewed by this court pursuant to ORS 305.445.

2. The Department is incorrect in its assertion that Hewlett-Packard's appraiser, and, therefore, the Tax Court, relied exclusively upon

the cost approach to arrive at the real market value of the subject property. The determination of the real market value of Hewlett-Packard's real property was based upon the totality of the evidence introduced at trial, including the sales comparison approach, to value not just upon the reproduction and replacement cost approaches to value.

3. Any purported error was harmless as the only evidence the Tax Court found credible supported the valuation as found by the Tax Court. Hewlett-Packard's appraiser valued the property using two approaches, the "cost approach" and the "sales comparison approach." The Department's sole assignment of error involves the cost approach and, even if that valuation is discarded, the sales comparison approach supports the Tax Court's decision.

4. The Tax Court properly relied upon Hewlett-Packard's calculation of functional obsolescence in the cost approach to value, which is consistent with a proper construction of the Department's administrative rule, and consistent with appraisal theory, to arrive at the Real Market Value of Hewlett-Packard's real property. The Department's argument that hypothetical rental income from leasing the excess, non-core property (which was developed by Hewlett-Packard's appraiser in his HBU analysis) should have been used as an "input" in calculating functional obsolescence for determining the Real Market Value of Hewlett-Packard's real property, confuses an analysis of HBU with the development of a valuation indicator of value, and is directly contrary to the Tax Court's finding as to the Highest and Best Use of the excess, non-core property. The Tax Court found that the "costs of maintaining the excess space and converting it to space that would be attractive to the market would exceed the value to be produced by the potential rental of that space" and properly rejected the Department's

calculation of functional obsolescence that relied upon the potential rental income from leasing the excess, non-core property.

G. Summary of Material Facts.

The Department's recitation of the facts is incomplete and fails to alert the Court to material facts in the record that bear on the Assignment of Error the Department raises in its appeal. Respondent accepts the facts set forth in the Tax Court's Opinion in this case as supplemented by citation to the record in the body of the brief:

Of the great many facts established and discussed during the course of the trial on this matter, a summary of some are helpful to the court's analysis. Other facts are mentioned in the portions of this Opinion where they have relevance.

The buildings in question were constructed on a large campus of approximately 180 acres in Corvallis, Oregon. (Ptf's Ex 1 at 23–25.) The buildings were constructed over the period from the 1970s to the late 1990s. The buildings together contain an area of approximately 2 million gross square feet and were specifically constructed for the owner-occupant. The buildings were initially used in the manufacturing of Plaintiff's (taxpayer's) well known hand held calculators. With the development of taxpayer's proprietary ink-jet printer technology in the 1980s, the use of the buildings for manufacturing of calculators ceased and the focus of use of the then existing buildings shifted to the ink-jet business. The growth of that business was explosive and eight buildings were constructed in the 1990s. (*Id.*)

The original use of some of the early buildings included manufacturing of silicon wafers and integrated circuits. That use became relatively quickly outdated as evolving technology outstripped the physical limitations of the buildings. By 2007 only two of an original four "fab" areas remained at all operative. However, the rapid growth of the ink-jet business brought the employee population in the buildings to a high of

approximately 8,000. As of the assessment dates at issue in this case the employee population had been reduced to between 2,000 and 2,500. (Transcript at 791.) The reduction in work force reflected a decision by taxpayer to outsource many of the functions previously performed in Corvallis.

The land use approvals applicable to the campus contemplate manufacturing uses and related support functions with the related functions to be secondary in character. (Ptf's Ex 1 at 23.) The buildings are constructed along a long corridor that links most of the buildings together. Utilities and other services to the buildings, such as air conditioning, are centrally supplied and not separately metered to the buildings, another reflection of the construction of the buildings by an owner-occupant.

* * *

A. Highest and Best Use

* * *

The appraiser for the department did no HBU analysis. (Defs' Ex A at 25-26). * * *

On the question of HBU analysis and any reflection of that in her report, the testimony of the department's appraiser was that no evaluation was contained in her report. * * * The department continually confuses analysis of HBU with development of an income indicator of value.

The appraiser for taxpayer did perform an HBU analysis. (Ptf's Ex 1 at 42.) That analysis looked at the costs, over time, of converting the existing space into space suitable for leasing to others and then weighed that cost against reasonably expected returns over time. Taxpayer's appraiser concluded that the HBU of a significant portion of the property—the so-called “non-core property”—did not contribute any value to the improvements as a whole as the cost of conversion to marketable space exceeded the benefits of such conversion.

In arriving at that conclusion, taxpayer's expert evaluated

the market and concluded that a potential buyer of the property at issue would buy it to use approximately 1.2 million square feet (the "core property") for a variety of uses typical of a manufacturing and research and development operation but would pay nothing for the remaining building space. The square footage numbers relate to rentable square feet rather than gross square feet. The "core property," as determined by taxpayer's appraiser, is approximately the same square footage as was occupied by taxpayer on the assessment dates. The testimony of that appraiser indicates that he looked at market usage of such spaces and not just the actual usage by taxpayer. On these points the conclusions of taxpayer's appraiser are highly persuasive. Further it does not, as suggested by the department, confuse market evidence with the actual use by the existing owner. The analysis done by taxpayer's expert assumed that the owner of the core space would, in effect, pay market rates for the space it used. (Transcript at 1031.)

* * *

The analysis of HBU performed by the appraiser for taxpayer, while perhaps not free from criticism, is, in the opinion of the court, properly supported. The expert for taxpayer actually tackled the problem rather than relying on axioms. The disjointed and at times confused cross-examination of taxpayer's appraiser did little if anything to weaken the credibility of that witness. More importantly, the most important conclusion in the analysis—that there is a significant amount of space in the improvements that does not contribute value to the property—is consistent with the unrebutted testimony of witnesses for taxpayer with knowledge of these improvements in particular and the market for space in Corvallis in general. The court accepts the conclusion that the costs of maintaining the excess space and converting it to space that would be attractive to the market would exceed the value to be produced by the potential rental of that space. In addition, the record shows that there are not insignificant questions about the legal obstacles that would be presented by trying to lease out the excess space.

The court finds that the HBU as found by the appraiser

for taxpayer is the HBU of the property. Accordingly, the valuation exercise is of the core area as determined by that appraiser, with no value assigned to the non-core space.

* * *

B. The Indicators of Value; Choice of Indicators

* * *

As to the core space, the appraiser for the taxpayer used the cost approach and an indicator based on what market rent would be for the owner occupant. The court agrees with that approach to valuation for owner occupied property.

The department suggests that the failure by taxpayer's appraiser to develop an income indicator of value is fatal to his appraisal (Def's Opening Post-Tl Br at 13. That is not so. In cases where the HBU is occupation and use of a special purpose facility by the owner, it is an accepted view that the income indicator is not practically available or useful. That judgment of the appraiser for the taxpayer is supported in this record and accepted by the court.

* * *

C. The Comparable Sales Indicator

* * *

The appraiser for taxpayer examined several sales of properties of size comparable to the core area of the subject. The evidence developed by the witness indicated that there was a size adjustment necessary in comparing properties of significantly different sizes, a conclusion consistent with *The Appraisal of Real Estate*. Although the conclusions of taxpayer's witness as to comparability and appropriate adjustments are not free from any criticism, the evidence he adduced and his approach to adjustments is by far superior to the work of the department's witness in those areas.

* * *

D. The Cost Factor

Both appraisal witnesses agreed on the basic approach in developing a cost indicator of value: determination of replacement cost and subtraction from that figure of physical depreciation, functional obsolescence and economic obsolescence.

* * *

The appraiser for the department also concluded that the campus buildings suffered from no functional obsolescence. Given the testimony as to the original construction of the buildings and a comparison of their historic with the use this appraiser concluded would be the highest and best, the conclusion of the witness on this point is simply not credible. * * * Many of the buildings were quickly and inexpensively constructed in order to meet immediate needs of taxpayer, with no concern for alternative uses or ultimate disposition. Large floor plates and interior improvements of, in most cases, limited quality result in buildings that would need significant investment in order to be used for the purposes that the department's witness concluded would be their highest and best use. With the possible exception of Building 10, this is especially true of the space which the department's witness concluded would be capable of being leased at class A rates.

* * *

As stated above, the court accepts the HBU conclusion of taxpayer and rejects that of the department. From that point it follows that taxpayer's conclusion as to functional obsolescence due to superadequacy is accepted. It also follows that the department's conclusion that there is no functional obsolescence must be rejected.

* * *

The acceptance of taxpayer's conclusion also fits the evidence. This campus is the product of an explosion of growth related to a technology—printer heads—in a location removed from technology or manufacturing centers and poorly located in

terms of transportation and labor force. When the printer head technology was developed to the point that manufacturing was most economically outsourced, the workforce at the campus was radically reduced and many of the activities that had occurred there were curtailed. The change in technology production realities made significant portions of the campus superadequate to taxpayer's needs. However, in terms of market value analysis, the record developed by taxpayer also shows that the campus became superadequate for typical market needs for campuses of buildings of this type.

The conclusions as to the cost indicator reached by the appraiser for taxpayer are accepted and those of the appraiser for the department are rejected.

V. CONCLUSION

The appraiser for taxpayer had significantly more experience in the valuation of properties of the type present here. Notwithstanding the attempts by the department to suggest that he was not credible, the court found him experienced, understandable, careful and credible. The same cannot be said for the appraiser for the department.

For the foregoing reasons, the real market values for the subject property as found by the appraiser for taxpayer are accepted by the court as the real market values for the subject properties as of the respective assessment dates.

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II. HEWLETT-PACKARD'S ANSWER TO THE DEPARTMENT'S ASSIGNMENT OF ERROR

A. The Tax Court's Determination of the Real Market Value of Hewlett-Packard's Real Property, Including the "Inputs" into the Calculation of Functional Obsolescence, are Issues of Fact.

1. Introduction to Hewlett-Packard's Response to the Assignment of Error.

a. *Factual Context.*

This appeal involves the real market value of eleven buildings constructed between 1976 and 1997 as an industrial manufacturing campus by Hewlett-Packard in Corvallis, Oregon (the "subject property").¹ The campus comprises 178 acres of land zoned general industrial with a planned development overlay. The eleven buildings total approximately 2,000,000 square feet and, although the buildings are primarily standalone structures, they are connected by a long corridor called I-5 and share a common utility and power source system. Tr 87. The campus was originally developed for Hewlett-Packard's calculator business. Tr 52. When Hewlett-Packard developed its inkjet technology in the 1980's the campus use transitioned and Hewlett-Packard repurposed existing space and added new buildings, including a semiconductor facility. Tr 148-149.

As of the three assessment dates at issue in this appeal appeal, January 1, 2008, January 1, 2009, and January 1, 2010, the campus use had again

¹ As noted by the Tax Court, "the parties have no disagreement as to land value or machinery and equipment (M & E), but are significantly separated on their views of the real market value (RMV) of the buildings and structures located at a site in Corvallis, Oregon." Opinion p 1. Thus, only the RMV of the buildings and structures is at issue in this appeal.

transitioned and Hewlett-Packard had vacated completely, or was in the process of vacating, five of the eleven buildings and approximately one-half of another. Tr 790, Ex 53 p 3. The vacated buildings constituted approximately 800,000 gross square feet of the 2,000,000 square foot campus. The 800,000 gross square feet of unused buildings is referred to as the “excess, non-core space.” Hewlett-Packard was vacating the excess, non-core space because the buildings were functionally obsolete and no longer economically viable to Hewlett-Packard which, like most of the high-tech industry, had moved its manufacturing facilities off shore and was now contracting out advanced fabrication work previously performed in its semiconductor facility. Tr 212, 263, Ex 7, p 1-8; Ex 8, p 21.

Hewlett-Packard and the Department presented very different views on the real market value of the property. The difference in opinion regarding the real market value of the subject property was due to the differing conclusions regarding the “highest and best use” (“HBU”) of the 800,000 gross square feet of the excess, non-core space. The Department took the position that the excess, non-core space could be profitably used by leasing it to other businesses.² Hewlett-Packard maintained that it was not

² A view that was soundly rejected by the Tax Court:

“[T]he most important conclusion in the [HBU] analysis – that there is a significant amount of space in the improvements that does not contribute value to the property – is consistent with the unrebutted testimony of witnesses for taxpayer with knowledge of these improvements in particular and the market for space in Corvallis in general. The court accepts the conclusion that the costs of maintaining the excess space and converting it to space that would be attractive to the market would exceed the value to

financially feasible to lease up the excess, non-core property when analyzing the market conditions including the net absorption needed to lease up the facility and the costs associated with converting the buildings to an alternative use.³ According to the appraisal relied on by the Tax Court, the HBU of the property was as a “specially designed single purpose campus style owner occupied manufacturing facility,” the improvements having a significant amount of functional obsolescence resulting in the non-core, excess space having no real market value. Ex 1, p 41.

The following table identifies the value on the assessor’s roll and the valuations placed on the subject property by the two parties’ appraisals:

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be produced by the potential rental of that space. In addition, the record shows that there are not insignificant questions about the legal obstacles that would be presented by trying to lease out the excess space.” Opinion, p 6-7.

³ Hewlett-Packard allowed a non-profit (ONAMI) to use building 11, a warehouse building comprising 78,990 square feet of the excess, non-core space free of rent, in exchange for ONAMI maintaining the building and paying operating costs. Tr 345. Importantly, the court heard from three witnesses that, with the exception of smaller leases in Building 10 (the newest building on the campus), Hewlett-Packard had been actively marketing the excess, non-core space but had been unable to secure tenants. Tr 750-752, 840-843; Ex 34, 34A, 35. Only 150,264 square feet of the excess, non-core space had been rented, and five of these six leases were for less than 30,000 square feet. There were substantial costs associated with creating smaller leasable space and there was little demand in Corvallis for industrial or office space. Ex 1; Tr 181-182; Ex 3A, p 6; Tr 412, 432; Ex 20; Tr 728, Tr 756-57.

Tax Year	Assessed Value	HP Valuation at Trial	DOR Valuation at Trial	Difference
2008-09	\$ 75,937,420	\$65,000,000	\$210,000,000	\$145,000,000
2009-10	\$ 79,751,940	\$68,000,000	\$217,000,000	\$149,000,000
2010-11	\$200,000,000	\$64,000,000	\$179,000,000	\$115,000,000

The first question that must be addressed in a credible appraisal is the question of HBU of the subject property. *Freedom Fed. Savings and Loan v Dept of Rev.*, 310 Or 723, 801 P2d 809 (1990). The Tax Court found that “the appraiser for the [D]epartment did no HBU analysis [and]’assumed’ a hypothetical purchaser would use all of the buildings comprising the subject property.” Opinion, p 4-5. Hewlett-Packard’s appraiser did do a “highest and best use” analysis and, in that analysis, examined the financial feasibility of converting the excess, non-core space to marketable space that could be leased to multiple tenants.⁴ The Tax Court found that:

⁴ To determine whether it was financially feasible to lease out the excess, non-core space to other users in his HBU analysis, Hewlett-Packard’s appraiser, Mr. Litolff, projected what potential rental income might be received and compared the amount of the potential rental income with the cost of converting the excess, non-core property to a multi-tenant property and the costs of leasing up the space (leasing commissions, tenant improvements, etc.). Ex 1, p 48-63. Mr. Litolff concluded, and the Tax Court agreed, that it was not financially feasible to attempt to lease up the excess, non-core space and that its HBU was to remain vacant. *Id* at 62; Opinion p 6-7. Mr. Litolff’s HBU analysis becomes important later when the Department attempts to use the hypothetical rental income from the excess, non-core property developed in the HBU analysis in determining the value of the subject property. As explained later in this brief, the

Taxpayer's appraiser concluded that the HBU of a significant portion of the property – the so-called 'non-core property' – did not contribute any value to the improvements as a whole as the cost of conversion to marketable space exceeded the benefits of such conversion. Opinion, p 4.

Hewlett-Packard's appraiser, who the Tax Court found credible, determined that the excess, non-core space caused Hewlett-Packard to incur excess operating expenses for utilities (electricity, gas, water, waste), security, custodial, maintenance and taxes. Ex 1, p 53; Ex 65. On appeal, the Department does not challenge the Tax Court's findings regarding the HBU determination that this excess, non-core space did not contribute value to the property or that the excess, non-core space caused ongoing operating expenses. When improvements are not necessary to the current or anticipated use of the property and add no value, they are "superadequate" and contribute to the "functional obsolescence" of the property.

The Department's brief focuses on one small part of the determination of value, ignoring the other indicia of value relied on by the Tax Court and mixes and matches numbers from various parts of Hewlett-Packard's appraisal in an attempt to present an argument that the Tax Court committed an error of law. Because the Department incorrectly identifies the valuation issue as a question of law, ignores the other indicia of value presented at

Department's use of hypothetical rental income of the excess, non-core space developed in the HBU analysis to value the subject property is inappropriate under appraisal theory and contrary to the Tax Court's unchallenged finding in the HBU analysis that it was not economically feasible to attempt to lease the excess, non-core property.

trial, and fails to recognize that Hewlett-Packard's appraisal follows the rule and proper appraisal theory, this court should reject the Department's arguments and affirm the Tax Court's decision.

b. Legal Context.

(1) Real market value is a question of fact.

The only question the Tax Court was called upon to decide in this case was the real market value of Hewlett-Packard's buildings and structures. ORS 308.205 (1) defines real market value as follows:

Real market value . . . , means the amount in cash that could reasonably be expected to be paid by an informed buyer to an informed seller, each acting without compulsion in an arm's-length transaction occurring as of the assessment date for the tax year.

The Tax Court, the Court of Appeals and this court have held that the question of the real market value (also called "true cash value" under an earlier statute) or fair market value of property is a question of fact in every case, whether in an ad valorem tax case or a condemnation case. *Mittleman v. Commission*, 2 OTR 105 (1965) ("* * * true cash value of the property . . . is a question of fact to be determined from the evidence, the same as in any other case."); *Pacific Power & Light Co. v. Dept. of Rev.*, 286 Or 529, 533, 596 P2d 912 (1979) ("* * * whether in any given assessment one [valuation] approach should be used exclusive of the others or is preferable to another or to a combination of approaches is a question of fact. . ."); *Chart Development Corp. v. Dept. of Rev.*, 16 OTR 9 (2001) ("The value of property is ultimately a question of fact"); *See, also, Mid Oil Co. v. Dept. of Rev.*, 297 Or 583, 686 P2d 1020 (1984); *Leaper v. Dept. of Rev.*, 19 OTR 388 (2008) ("The value of property is ultimately a question of fact."); *City of*

Bend v. Jupiter Utility Co., 242 Or App 9, 252 P3d 341 (2001) (“Fair market value in condemnation cases is ultimately a question of fact.”);⁵ *Yarbrough v. Dept. of Rev.*, 2012 WL 4094875 (“The RMV of a given parcel of real property is a question of fact.”)

(2) Functional obsolescence.

With regard to the calculation of functional obsolescence in the cost approach to value, which is the core issue in the Department’s appeal, this court’s holding in *Reynolds Metals Co. v. Dept. of Rev.*, 299 Or 592, 594, 705 P2d 712 (1985), is instructive:

In this appeal by the Department of Revenue (Department) from a decree of the Oregon Tax Court, we are presented with two major issues of fact and one issue of law. We are required to determine the true cash value of the plaintiff taxpayer’s plant, i.e., its buildings and machinery and equipment as of January 1, 1980. The major issues of fact are the dollar value of physical depreciation and the dollar value of functional obsolescence in the plant. (Emphasis added.)

In short, the issue before the Tax Court, as well as this court, is entirely a question of fact, not law.

The Tax Court, as the trier of fact, weighed the testimony of the witnesses in this case, the evidence introduced, and the arguments made by the parties in extensive written post-trial briefs in arriving at its determination that Hewlett-Packard’s appraiser, Mr. Litolff, was much more

⁵ The Court of Appeals cited *State of Oregon Department of Transportation v. Lundberg*, 312 Or 568, 825 P2d 641 (1992); “The question of the highest and best use of particular property is not a question of constitutional magnitude or of law, but is a question of fact that relates to the question of value.”

credible in his determination of HBU, his selection of the appropriate appraisal approaches to utilize to value this special purpose, specially designed, and owner-occupied property, and his ultimate conclusion of the real market value of the subject property for the three assessment years based upon the sales comparison and cost approaches to value, including his calculation of functional obsolescence in the cost approach. “[T]he [tax] court has jurisdiction to determine the real market value or correct valuation on the basis of the evidence before the court, without regard to the values pleaded by the parties.” ORS 305.412.⁶ The Tax Court’s decision of the real market value is an issue of fact that cannot be reviewed as an error of law by this court.

(3) Property valued as if exchanged in an open market transaction.

The Department correctly cites ORS 308.205(1) defining real market value and that ORS 308.205(2) provides that “Real market value in all cases shall be determined by *methods and procedures* in accordance with rules adopted by the Department of Revenue.” (Emphasis by the Department) App Br at 7. Unfortunately, the Department did not cite the complete language in ORS 308.205(2)(a), which goes on to require that the Department’s rules shall be “in accordance with . . . [t]he amount a typical seller would accept or the amount a typical buyer would offer that could

⁶ The burden of proof in an appeal to the Tax Court is a preponderance of the evidence. ORS 305.427. The burden falls upon the party seeking affirmative relief. ORS 305.427. In this case, both parties sought relief before the Tax Court and each side therefore shoulders the burden of proof. *Union Pacific Railroad v Dept of Rev.*, 315 Or 11, 17, 843 P2d 864 (1992).

reasonably be expected by a seller of property.” In other words, regardless of the Department’s rules, the Tax Court’s primary objective is to determine real market value, *i.e.* the amount for which the property would exchange hands between a typical seller and a typical buyer which, again, is a factual issue.

This court has decreed that in property tax cases “[t]he *first* issue is the highest and best use of the property; the *second* issue is the market value of the property at that use.” *Freedom Federal Savings and Loan v. Dept. of Rev.*, 310 Or 723, 727, 801 P2d 809 (1990) (Emphasis in original). Both are factual issues.

B. The Determination of the Real Market Value of the Subject Property by the Tax Court in this Case was Based on the Totality of the Evidence Introduced at Trial, Not Just Upon Mr. Litolff’s Cost Approach.

The Department asserts that Hewlett-Packard’s appraiser and, therefore, the Tax Court, which relied on that appraisal, placed 100% weight upon the cost approach to determine the subject property’s value. Department Opening Appeal Brief at 3, n 1.⁷ The Department repeats this assertion later in its brief:

“Litolff gave 100% mathematical weight to his

⁷ That footnote in the Department’s Opening Brief on Appeal states as follows:

“Litolff used two approaches to determine value, a replacement cost approach and a market data (comparable sales) approach. (Plaintiff’s Exhibit 1 at 88). Litolff gave 100% weight to his replacement cost approach, and the Tax Court adopted that weighting. (Plaintiff’s Exhibit 1 at 88). This brief, therefore, focuses on Litolff’s replacement cost approach.”

replacement cost approach. . . . The Tax Court agreed with Litolff's weighting, and the department does not challenge that determination. Accordingly, we focus on Litolff's replacement cost approach." Department Opening Appeal Brief at p 12.

That statement is incorrect and, because the Department challenges neither the other indicator of value – the comparable sales approach – nor the other evidence before the Tax Court, this court must affirm the Tax Court's opinion.

In his appraisal, Mr. Lutoff relied upon two different indicators of value.⁸ At the conclusion of his appraisal, Mr. Litolff reconciled his two approaches to value by looking at the resulting real market value conclusions for each approach, the average and the mean of the approaches and arrived at a final estimate of real market value. Ex 1, p 88. The appraisal concludes with a "Reconciliation and Final Value Estimate":

"Two of the three approaches to value were utilized to provide a check whereby all factors are considered in each approach. Inherent in each is an interpretation of market conditions as they affect the property. *If only one approach was used, a factor may be overlooked or misinterpreted. The quality and quantity of the data in each approach has been considered*, along with the relevancy of each for the property.

"The Cost Approach relies on the proposition that the real market value of the property is no more than the cost of

⁸ Q: Having determined the highest and best use of the subject property is continued use as a specially designed single purpose building, what's the next step in – your valuation analysis?

A (Litolff) We did two approaches to value, the cost approach to value and the sales comparison approach to value. Tr 1039

producing substitute properties with the same utility as the subject. This approach is utilized in establishing replacement cost new less depreciation from all causes. In this case the Cost Approach is a reliable approach, based on our opinion that ***the highest and best use is for continued use as [a] special purpose, specially designed campus style owner occupied manufacturing facility.***

“The Sales Comparison approach is considered representative of the procedure by which buyers and sellers transfer this type of property. Buyers and sellers of industrial buildings constantly compare properties that have sold and those that are offered for sale in the marketplace. *Based on the characteristics of the sales in relation to the subject we were able to arrive at a supported estimate of value that provides appropriate market support for the value of the property.*” Ex 1, p 88 (bold emphasis in original, italicized emphasis added).

In other words, neither Hewlett-Packard’s appraiser, nor the Tax Court, gave “100% weight” to the replacement cost approach; he specifically concluded that he was “able to arrive at a supported estimate of value” based on the sales comparison approach.⁹

During the trial, Mr. Litolff devoted a substantial part of his appraisal and testimony comparing recent sales (and a listing) of large high tech and semiconductor plants to the subject property. Ex 1, p 66-78, Tr 1039 -1095.

⁹ Mr. Litolff’s final conclusion of value for each of the three tax years at issue is the higher of the two approaches to value, *i.e.* the value determined by cost approach. However, this is consistent with what the Tax Court observed as a tendency of Mr. Litolff to be “conservative” in his methods and to take positions that “you might describe as charitable to your opponent” Tr 1177-78. Thus, it is improper to argue that Mr. Litolff relied exclusively upon the cost approach to value the subject property.

Mr. Litolff inspected each comparable (Ex 1, p 66) and went to great lengths to adjust for differences in features between the subject property and the comparable plants. Ex 1, p 74-78. Additionally, Mr. Litolff conducted a nationwide search of sales of semiconductor property. Ex 1, p 79 -80, Tr 1089 -1095. Mr. Litolff developed a conclusion of real market value from his sales comparison approach that was independent from, but which was very close to, his conclusion of real market value via the cost indicator of value. Ex 1, p 88.

In describing how he reconciled his two approaches to value, Mr. Litolff testified:

A Well, we considered the fact that both approaches were viable indicators of value * * * [a]nd while we felt that the — the sales comparison approach is a very viable and a good indicator of value, there's no reason not to conclude that the cost approach to value, which is also a viable indicator of value.

* * *

Q *Well, was your opinion of value based solely on the cost approach?*

A *Absolutely not, no.*

* * *

Q Based upon your cost approach and income [sic] approach, in your opinion as an expert, is it conceivable that this property would exchange hands in the marketplace between a willing buyer and a willing seller, neither being under any undue influence and being well informed of an arm's length transaction, could possibly be over \$200 million [the Department appraiser's opinion of the real market value]?

A Not in my opinion, no.

Q Why not?

A 'Cause I think I've analyzed the property according to appropriate appraisal methodology. *We've used what we feel are comparable sales in the sales comparison approach and there's no indicator to indicate that this is outside the range of \$30 to \$35 a square foot.*

Q Did you see any sales of high-tech semiconductor property of the size of over 500,000 square feet that would approach a value of \$200 million on a square foot basis?

A No, I did not.

Tr 1147-48 (emphasis added).

Consequently, Mr. Litolff did not put 100% percent of his weight upon the cost approach, but also relied on the comparable sales approach in reaching an opinion of real market value. Even accepting for purposes of argument that there was an error in his analysis of the cost approach, this court can affirm the Tax Court's determination of value based solely on the comparable sales approach, which was used by Hewlett-Packard's appraiser and relied on by the Tax Court and is unchallenged in this appeal.

Likewise, the Tax Court determined that the best indicators of real market value for the subject property were the sales comparison approach in addition to the cost approach. Opinion at 8-9. This is a finding of fact, not an issue of law. The Tax Court examined the comparable sales indicators of value prepared by both parties' appraisers in this case. Opinion at 8-9. The Tax Court found that "[a]lthough the conclusions of taxpayer's witness as to comparability and appropriate adjustments are not free from any criticism, the evidence he adduced and his approach to adjustments is by far superior to the work of the department's witness in those areas." Opinion at 9. In arriving at its conclusion of real market value, the Tax Court stated:

The appraiser for taxpayer had significantly more

experience in the valuation of properties of the type present here. Notwithstanding the attempts by the department to suggest he was not credible, the court found him experienced, understandable, careful and credible. The same cannot be said for the appraiser for the department.

For the foregoing reasons, the real market values for the subject property as found by the appraiser for taxpayer are accepted by the court as the real market values for the subject properties as of the respective assessment dates. Opinion at 12.

The Tax Court's determination of real market value was not confined to whether there was a proper calculation of "value of the loss" or the cost to cure in the cost indicator to value, but was based upon significant evidence introduced at trial including that:

- The buildings were old and their use outdated and suffered significant loss in value, including from functional obsolescence: Tr 285, 286, 423, 588.
- High tech hubs were located in the Portland metro area, not rural Benton County which could absorb only 10,000 to 20,000 square feet of vacant space a year. Tr 283, 432, 757; Ex 20.
- Almost one-half the campus had been vacated because it no longer had any economic viability to Hewlett-Packard. Tr 285.
- The high tech industry was moving its manufacturing off-shore. Tr 656.
- The campus, and particularly the excess, non-core space, would not be attractive to a financial buyer, an institutional investor or a strategic buyer due to its size, location, condition (old and dated) and, logistically, far from a major airport and lacked a labor force in this rural area. Tr 476-477, 622-623.

- The Corvallis location would not be attractive to a high tech business because it is too far from a high tech cluster as found in Hillsboro. Tr 280-282; 283, 284.
- There is no market demand for large campuses like Hewlett-Packards because it is an over improvement in terms of size, space and type of buildings for the Corvallis market. Tr 412; and,
- Finding tenants to whom to lease the excess, non-core space was like looking for a needle in the haystack. Tr 432.

The totality of the evidence introduced at trial supports the Tax Court's finding of the real market value of the subject property, and that finding did not rest "100%" on the calculation of functional obsolescence in Mr. Litolff's cost approach.

This understanding of the case is strengthened when one looks at the arguments made by the Department below. For example, counsel for the Department included in his opening statement:

"If this – if Your Honor determines that the highest and best use of the property that is not being used by HP is to allow it to remain vacant, unused from the assessment dates forward in time, if that's the highest and best use of those improvements then we lose." Tr 1753. (Emphasis added.)

By this statement, the Department conceded that the pivotal issue in this case was the HBU of the excess, non-core property, not the calculation of value of the loss or the cost to cure in the functional obsolescence formula. In determining the HBU of the excess, non-core property, the Tax Court found the excess, non-core space does not contribute value to the property because the costs of maintaining the excess space and converting it

to space that would be attractive to the market would exceed the value to be produced by the potential rental of that space. Opinion 6-7.

For the Department to argue here that the Tax Court's determination of real market value should be reversed because the Department's calculation of the value of the loss results in a positive value of the excess, non-core property that leads to a real market value of not \$65 million, but \$113 million, is directly at odds with the evidence in this case and the Tax Court's unchallenged HBU determination that the excess, non-core space had no value.¹⁰ Opinion, p 7.

The Tax Court properly found from all of the evidence in the case that the real market value of the property should be \$65 million, not \$113.5 million, because the excess, non-core space has no value. In short, the Department lost because the evidence in the case supported neither the Department's HBU conclusion, nor its conclusion of the real market value of the subject property.¹¹ The Department does not challenge the other indicator of value – the comparable sales approach – and, therefore, this court must affirm the Tax Court's opinion.

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¹⁰ For the Department's argument to be correct, the court must conclude that Hewlett-Packard can realize significant rental income from the excess, non-core space, a conclusion that is directly contrary to the Tax Court's conclusion that the HBU of that property is to remain vacant.

¹¹ "The factual basis as to conversion costs and rents used by the department appraiser, while they may support the conclusion reached by that witness, are simply not credible. The court rejects those conclusions." Opinion 11-12.

C. Any Error by the Tax Court is, at Best, Harmless Error and the Department's Rights Were not Substantially Affected by the Error.

ORS 19.415(2) provides that "No judgment shall be reversed or modified except for error substantially affecting the rights of a party." This court has held that:

"The possibility that an error might have resulted in a different [result] is insufficient under the statute. Instead, the court must be able to conclude, from the record, that the error 'substantially affect[ed]' the rights of the losing party. Moreover, the statute protects the trial court judgment from reversal or modification 'except for' error substantially affecting a party's rights, indicating that reversal of a judgment is the exception, not the rule. The rule embodied in ORS 19.415(2) is neutral as between plaintiffs and defendants; it places the burden to make a record that demonstrates prejudicial error on whichever party loses in the trial court and then seeks reversal or modification of the judgment on appeal." *Shoup v. Wal-Mart Stores, Inc.*, 335 Or 164, 173-4, 61 P3d 928 (2003).

In other words, if the record supports the Tax Court's conclusion, notwithstanding any error, this Court is required to affirm the decision because the appealing party cannot show that the error "substantially affected" their rights.

In this case, as discussed above, Hewlett-Packard's appraiser relied on two indicators of value – the cost approach and the sales comparison approach. The Department's sole assignment of error contests only an aspect of the cost approach; the Department does not challenge any aspect of the sales comparison approach. In a similar situation, the court noted that it is the appellant who suffers the consequences when one of two theories could support the lower court's result:

“Plaintiffs' claims of error may or may not be well taken, but they depend on an assumption that the jury's verdict was based on one rationale only. The present record does not support plaintiffs' assumption, and, because they are asserting error, the consequences of the inadequacy of the record in that respect fall on plaintiffs.” *Lyons v. Walsh & Sons Trucking Co., Ltd.*, 337 Or 319, 326, 96 P3d 1215 (2004).

In this situation, the Department has not made its record to demonstrate “prejudicial error” and the consequences of that failure must fall on the Department.

Even if the error was not harmless, the Department still has not made the case for overturning the Tax Court’s decision. In this case, the Tax Court made express findings regarding the creditability of the appraisals before the Tax Court:

Notwithstanding the attempts by the department to suggest [Hewlett-Packard’s appraiser] was not credible, the court found him experienced, understandable, careful and credible. The same cannot be said for the appraiser for the department. Opinion at 12.

Even if this court were to disregard the cost approach to value used by Hewlett-Packard’s appraiser, the trier of fact found that the Department failed to introduce any credible evidence of value. The only remaining evidence of value is the sales comparison approach developed by Hewlett-Packard’s appraiser, which actually supports a lower value for the Property. Accordingly, the only credible evidence in the record supports the Tax Court’s opinion and this Court should affirm the Tax Court’s decision.

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D. Hewlett-Packard's Appraiser and the Oregon Tax Court Properly Followed the Functional Obsolescence Formula Found in the Department's Administrative Rules and any Disagreement as to the "Inputs" to be Plugged into the Formula is an Issue of Fact.

The issue in this case, at trial and on appeal, is, and always has been, whether the abandoned 800,000 square feet of excess, non-core space a part of Hewlett-Packard's Corvallis campus has any value. In his opening statement to the Tax Court the Department's attorney stated that if the court finds that the HBU of the excess, non-core space is to remain vacant "we lose." Tr 1753. At trial, the Department's appraiser testified that she did not determine as part of her HBU analysis whether it was financially feasible to convert the excess, non-core space to an alternative use (Tr 2440-2441, 2473); but, simply "assumed" the excess, non-core space had value and the entire property would be purchased and used by an investor. Tr 2897-98. In its post-trial brief to the Tax Court, the Department argued it should be "axiomatic" that leasing the vacant space "is a more valuable use than maintaining it vacant." Department of Revenue's Opening Post-Trial Brief at 16-17.

The Tax Court examined the evidence and the testimony of the witnesses, evaluated the credibility of the expert witnesses, and made a factual finding that the HBU of the excess, non-core space was to remain vacant because the cost of converting the space, which was obsolete for modern manufacturing purposes, to another use exceeded the value of the property after conversion – *i.e.* the excess, non-core space has no value. This appeal is not about an error of law – *i.e.* whether Hewlett-Packard's appraiser failed to follow the Department's administrative rule in calculating functional obsolescence. In its post-trial brief to the Tax Court, the Department admitted Hewlett-Packard's appraiser did follow the template

set out in the administrative rule for calculating functional obsolescence. Department's Opening Post-Trial Brief, Appendix VIII, Page App 8-1, 8-2, and 8-4.

This appeal is about the Department's refusal to accept the Tax Court's finding that the HBU of the excess, non-core property is to remain vacant; and, hence, has no value. The Department's argument is that the excess, non-core property has value -- \$22 million in value -- that was not properly inputted by Hewlett-Packard's appraiser into the calculation of the value of the loss in the Department's administrative rule. The foundation of the Department's argument is directly contrary to the Tax Court's factual finding that the excess, non-core space has no value because its HBU is to remain vacant.

In addition to arguments raised by Hewlett-Packard, above, the reason the Department's arguments, and its appeal, must ultimately fail is because, under the guise of challenging the calculation of functional obsolescence adopted by the Tax Court, the Department is really challenging the Tax Court's factual determination of HBU of the excess, non-core space and the Tax Court's determination that the excess, non-core space has no value. This is not a proper basis for appeal to this court of the Tax Court's decision.

1. Mr. Litolff, Hewlett-Packard's Appraiser, Correctly Followed the Functional Obsolescence Formula Found in the Department's Administrative Rule, and any Disagreement as to the Inputs into the Formula are Issues of Fact.

In its Post-Trial Opening Brief submitted to the Tax Court, the Department carefully examined Mr. Litolff's functional obsolescence calculations and compared his calculations to the Department's

administrative rules regarding functional obsolescence. Department's Opening Post-Trial Brief, Appendix VIII, p 8-1 through 8-36. The Department concluded that Mr. Litolff's cost approach methodology "does correctly apply the functional obsolescence formula under OAR 150-308.205-(F)(1)(a)," that his approach "is identical to the [functional obsolescence] template drawn from OAR 150-308.205-(F)(1)(a)" and "[s]ince the use of the Functional Obsolescence formula in OAR 150-308.205-(F)(1)(a) yields the identical result as plaintiff's calculation, plaintiff has used the formula correctly." Department's Opening Post-Trial Brief, Appendix VIII, Page App 8-1, 8-2, and 8-4.

Likewise, the Department conceded that "Litolff's appraisal also correctly applies the Replacement Cost formula pursuant to OAR 150-308.205-(F)(3)(b)." Department's Opening Post-Trial Brief, Appendix VIII, Page App 8-7. The Department concludes by stating: "So, while not addressing the inputs, Litolff's use of the Functional Obsolescence formula, the Reproduction Cost Approach formula, and the Replacement Cost formula under OAR 150-308.205-(F) is correct." Department's Opening Post-Trial Brief, Appendix VIII, Page App 8-9 and 8-10. (Emphasis added.)

The Department only challenges the "inputs" Hewlett-Packard's appraiser, Mr. Litolff, makes to the functional obsolescence formulas – the "value of the loss" and the "cost to cure" – not that Mr. Litolff did not follow functional obsolescence formulas in the Department's rules. What "inputs" are appropriate to use in the functional obsolescence formulas in the cost approach to value are issues of fact. The Tax Court considered and rejected the identical arguments now made by the Department to this court, ruling that the "the conclusions as to the cost indicator reached by the appraiser for

taxpayer are accepted and those of the appraiser for the department are rejected.” Opinion at 11.

2. The Department’s Calculation of “Value of the Loss” and “Cost to Cure” Misapplies the Department’s Rule, is Contrary to the Tax Court’s Conclusion of the Highest and Best Use, and does not Result in the Real Market Value of Hewlett-Packard’s Real Property.

In order to understand the flaws in the Department’s argument as to the inputs into the functional obsolescence formula, it is necessary to review Mr. Litolff’s calculation of “value of the loss” and the “cost to cure” in his cost approach to value. In his calculations, Mr. Litolff began by determining that the reproduction cost new less physical depreciation of the entire two million square foot campus was \$210,930,602. Ex 1, p 85;¹² Tr 1109-1113. He then determined the reproduction cost new, less physical depreciation of the “replacement plant” (*i.e.* the core area of 1,204,358 square feet that Hewlett-Packard uses) to be \$103,483,578. Ex 1, p 85; Tr 1115. The difference between the two reproduction cost new less physical depreciation numbers is \$107,447,000 – the excess capital costs Hewlett-Packard incurred in constructing the excess, non-core space. In other words, if the campus was to be rebuilt the excess, non-core space is “superadequate” to the market’s needs and neither Hewlett-Packard, nor someone else, would spend \$107 million to build the excess, non-core space.

¹² This figure of \$210,930,602 for the 2008-09 tax year can be found on the line entitled “total” at the bottom of the table on page 85 of Exhibit 1. The same calculations were made for the other years as well, *see* pages 86 and 87 of Exhibit 1.

Tr 1115. This conclusion, that the excess, non-core space would not be built in a replacement plant, is consistent with the Tax Court's finding that under the correct HBU analysis the excess, non-core space has no value. Opinion at 7.¹³

However, Mr. Litolff found that, because the excess, non-core space does, in fact, exist, Hewlett-Packard incurs a penalty in the form of excess costs to operate the excess, non-core space; *i.e.* the operating expenses that could be saved if the excess, non-core space did not exist, were \$5,553,090 annually. Ex 1, p 85; Tr 1116. From these annual excess operating costs Mr. Litolff subtracted the \$916,933 in rental income that Hewlett-Packard was receiving from rent of a small portion of its campus, thereby reducing the penalty. Finally, he calculated the after-tax, present value of those annual excess operating costs (minus rental income) over the remaining life of the vacated buildings, which resulted in a present value of \$38,525,819 for the net excess operating costs. Ex 1, p 85; Tr 1123. The present value of

¹³ In light of the arguments that follows, it is curious that the Department concedes this point:

"Litolff appropriately took that first step by estimating the cost to build a new hypothetical plant similar to the subject property. That new hypothetical plant was smaller than the subject property because it correctly did not include the excess space (626,000 square feet). That exclusion of the excess space was justified because Litolff's highest and best use analysis correctly indicated that constructing the excess space was not cost effective." Department Brief at 13.

The 626,000 square feet the Department describes as the "excess space" is the net square footage of potentially leasable space. The gross square footage of the excess, non-core space is approximately 800,000 square feet.

the net excess operating cost is the “value of the loss” to Hewlett-Packard from the excess, non-core, space due to expenses for utilities, security, custodial and maintenance services and taxes. Ex 1, p 85; Tr 1123, 1128. This calculation follows exactly the Department’s rules.

Although the Department concedes that Hewlett-Packard’s appraiser, Mr. Litolff, correctly followed the Department’s formula for calculating functional obsolescence and the Department’s template for determining the real market value by both the Reproduction and Replacement Cost Indicator of value, the Department argues that Mr. Litolff failed to correctly calculate one of the “inputs” to the functional obsolescence formula --the “value of the loss” – *i.e.*, Mr. Litolff’s calculation of the excess operating costs in the amount of \$38,525,819. In its opening brief, at page 14, the Department cites this court to its rule that defines the “value of the loss” as:

The *value of the loss* equals the present value of the after-tax loss in anticipated income from the continuing operation of the property with a deficiency or superadequacy compared to the projected operation of the replacement property. (Emphasis in original).

Unfortunately, there, the Department did not quote the entire administrative rule. Upon reviewing the entire rule, the court can see that the rule supports Mr. Litolff’s use of the excess operating costs as the “value of the loss” in the functional obsolescence formula. The entire rule states:

“The value of the loss equals the present value of the after-tax loss in anticipated income from the continuing operation of the property with a deficiency or superadequacy compared to the projected operation of the replacement property. ***For industrial plants, this loss of income is often the result of excess operating costs*** due to inefficiencies in the subject plant compared to the subject property when cured of the functional

obsolescence. The present value includes factors for the time period that the plant will continue to incur the loss of income and an appropriate discount rate. See OAR 150-308.205-(C) for the appropriate method of calculating the discount rate.” OAR 150-308.205-(F) (3) (k). (Emphasis added.)

Mr. Litolff properly calculated the “value of the loss” by determining the after-tax present value of the net excess operating costs, consistent with the Department’s rule and generally accepted appraisal theory. Ex 1, p 85, Tr 1175.

THE APPRAISAL OF REAL ESTATE, Ex 41, p 28-29, contains an example demonstrating the proper method to calculate the “value of the loss” in determining functional obsolescence due to a superadequacy – *i.e.* excess ceiling height that is not curable. In that example, the excess ceiling height costs the owner \$5,000 more per year to heat and cool the property than compared to comparable properties. In calculating functional obsolescence, the annual \$5,000 in excess operating costs capitalized over the life of the building results in a “value of the loss” of \$40,000. *Id.* As already discussed in this case, Mr. Litolff determined the excess operating costs to be \$5,553,090 annually, for a total present value of \$38,525,819 over the remaining life of the excess, non-core space. Thus, by both the Department’s rule and generally-accepted appraisal theory, Mr. Litolff correctly calculated the “value of the loss” as part of his determination of functional obsolescence in the cost approach to value.¹⁴

¹⁴ In its Opening Post-Trial Brief presented to the Tax Court, the Department states that “* * * by rule and appraisal theory, the value-of-the-loss is the portion of functional obsolescence representing the consequences of operating functionally obsolete property and should be added to the

The Department argues that Mr. Litolff did not follow the rule's definition of "value of the loss" because he failed to use the difference in "anticipated income" over the remaining economic life between the entire Hewlett-Packard property (which includes the excess, non-core property) and the income generated from the smaller hypothetical core replacement property. Department Opening Appeal Brief at 14. The Department points to the "anticipated income" as that hypothetical income from leasing the excess, non-core property calculated by Mr. Litolff in his analysis of the financial feasibility of leasing the excess, non-core property in the HBU portion of his appraisal:

The highest and best use is a property's most profitable use * *

* Litolff's spreadsheet (Plaintiff's Exhibit 1 at 60) indicates his estimated "anticipated income" from the excess space for that determination of the highest and best use. . . . After the first six years, however, Litolff estimated that the "excess" space will generate an increasing positive cash flow up to year 14. And he estimated that from years 15 to 36 this "excess" space will continue to earn a positive cash flow of at least \$10,934,967 per year when the income has stabilized as the vacancy has decreased, as indicated for year 14 in Litolff's spreadsheet." Department Opening Appeal Brief, p 15.

The first flaw in the Department's argument is the use of "anticipated income" that hypothetically could come from actually leasing the excess, non-core space. As part of his HBU analysis, Mr. Litolff concluded that it was not financially feasible to spend the money to convert the existing space

'depreciated' capital costs associated with functionally obsolete property." Opening Post-Trial Brief at 47. (Emphasis added.)

to an alternative use such as leasing it to multiple tenants. Ex 1, p 62. The Tax Court agreed, stating the court

“* * * accepts the conclusion that the costs of maintaining the excess space and converting it to space that would be attractive to the market would exceed the value to be produced by the potential rental of that space. In addition, the record shows that there are not insignificant questions about the legal obstacles that would be presented by trying to lease out the excess space.

“The court finds that the HBU as found by the appraiser for taxpayer is the HBU of the property. Accordingly, the valuation exercise is of the core area as determined by that appraiser, with no value assigned to the non-core space.” Opinion at 6-7 (emphasis added).

Consequently, because it would not be financially feasible to convert the excess, non-core space to leasable space, no conversion would take place and there is neither any “anticipated income” from the non-core space to be used to calculate the “value of the loss,” nor is there any value contributed by the excess, non-core space to the core area.¹⁵ The underlying premises of the Department’s argument for calculating the “value of the loss” is that the excess, non-core space would be leased, that there will be additional anticipated income from leasing the excess, non-core space, and that the excess, non-core space would have a value of over \$21 million. Department Opening Appeal Brief at 15-16. The premises supporting the Department’s argument are directly contradicted by the evidence in the case and, more

¹⁵ The Tax Court understood the Department’s error and noted that “[t]he department continually confuses analysis of HBU with development of an income indicator of value.” Opinion at 4. And, the Department does so again on appeal.

importantly, contrary to the unchallenged finding of fact by the Tax Court in the Tax Court's HBU analysis that it was not financially feasible for Hewlett-Packard, or anyone else, to attempt to lease out the excess, non-core space.

The second flaw in the Department's argument is that neither the plain language of the Department's administrative rule, nor generally accepted appraisal theory, hold that the "value of the loss" is calculated by comparing the difference between the "anticipated income" of the entire Hewlett-Packard campus and the smaller core replacement property. The portion of OAR 150-308.205 (F) (3) (k) that the Department did quote states:

The value of the loss equals the present value of the after-tax *loss* in anticipated income from the continuing operation of the property with a deficiency or superadequacy compared to the projected operation of the replacement property. (Emphasis added.)

Thus, the rule looks at the "after-tax loss of anticipated income" from operating the property, as compared to any loss of income that would be avoided in operating the replacement, or core property, without the superadequacy (the excess, non-core) property. And this is exactly what Mr. Litolff did. He determined that the after-tax loss of income was the \$5,553,090 in annual excess operating costs for maintaining the excess, noncore property that would not be incurred if only the core property existed -- without the burden of the excess, non-core space.

Likewise, as discussed earlier, THE APPRAISAL OF REAL ESTATE clearly states that the value of the loss is the annual excess operating costs capitalized over the life of the building. Ex 41 at pp 28-29, *supra*.

Hewlett-Packard's appraiser correctly followed the formula in OAR

150-308.205-(F)(3)(k) in determining the “value of the loss” and, based upon the Tax Court’s holding as to the HBU of the excess, non-core property, the Tax Court committed no error of law in accepting Mr. Litolff’s calculation of the “value of the loss” that he inputted into the functional obsolescence template in calculating the total amount of functional obsolescence in the cost indicator of value.

3. It is Physically Impossible to Eliminate the Excess Operating Costs Resulting from Maintaining the Excess, Non-core Space, so the Superadequacy is Incurable and the “Cost to Cure” is Meaningless.

In its appeal to this court, the Department neither contests the Tax Court’s finding that the excess, non-core space is a superadequacy that adds no value to the core campus property, nor that its existence results in excess operating expenses. Instead, the Department argues:

Eliminating (curing) the superadequacy (excess space) at Hewlett-Packard’s property could be done, for example, by demolishing all of the excess space, demolishing a portion of the excess space if another portion of it could be leased, or donating the space to another owner to avoid ongoing expenses, if any, from maintaining the excess space. Under OAR 150-308.205 (F) (3) (h), the cost of eliminating the excess space is the “cost to cure.” Department Opening Appeal Brief at 20.

Again, assuming for purposes of argument that Mr. Litolff committed an error in calculating the cost to cure in the functional obsolescence formula of the cost approach, both parties, for different reasons, agree that Mr. Litolff’s supposed “erroneous *cost to cure* calculation should not affect the outcome of this case.” Department Opening Appeal Brief at 23. (Underlined emphasis added.)

The Department believes that Mr. Litolff's calculation of the cost to cure does not affect the outcome of this case "since the *"value of the loss"* (\$10,022,031) due to the excess, non-core space actually contributes to the overall real market value of the subject property, it will always be selected over the cost to cure in the replacement cost formula." *Id.* As discussed above, the Department's calculation of the "value of the loss" is based upon several erroneous premises that, in turn, make its estimate of the "value of the loss" erroneous.

In fact, Mr. Litolff's calculation of the cost to cure does not affect the outcome of this case because it is neither physically possible, nor financially feasible, to remove the superadequacy that causes the majority of the excess operating costs – hence, there is no cost to cure. Whether it is physically possible or financially feasible to demolish the excess, non-core space to avoid the ongoing excess operating expenses is a factual issue to be decided by the Tax Court. The testimony in this case is that it would not be physically possible or financially feasible to demolish Fab 21, the semiconductor fabrication facility Hewlett-Packard decommissioned in 2009 that became part of the excess, non-core property, which causes the majority of the excess operating costs. Tr 1193-1194, 1203.

The excess, non-core space consists of several buildings: Building 1 (B1), Building 6 (B6), Building 9 (B9), Building 10 (B10), and approximately one-half of Building 2 (B2). Tr 1151. B2 is a two-story integrated circuit manufacturing building, with a basement, built in 1990. Ex 19; Tr 68. With 456,988 g.s.f. of floor space, it is the largest building on HP's Corvallis campus. Ex 19; Tr 3242. B2 houses three semiconductor chip fabrication facilities ("Fabs") -- Fab 21, Fab 22 and 23. Fab 21 and 22 are mirror images of each other and each clean room is 25,000 square feet

for each Fab. Tr 68.

A Fab facility can be described like an Oreo cookie. Tr 68, 70, 71, 73-78. The Fab clean room is in the middle of the building. The air handling system to support the Fab function is the upper floor above the Fab clean room. The air handling system circulates the air from the upper floor pushing it down and around the sides of the building, and forcing it through the clean room floors through open floor grates. Tr 77. The other process support equipment for the Fab facilities in B2 are located in the basement and are integrated into the building structure. Tr 68-71. This process support equipment includes the central utilities and waste treatment facilities for the operation of the Fab facilities. This process support area comprises 209,454 of the overall square footage of B2. Ex 1, p 24. By April 2009, the clean room function of Fab 21 was completely shut down. Tr 230, 264.

After Hewlett-Packard decommissioned the clean room function of Fab 21, Hewlett-Packard continued to require the piping, access to "DI water," air handling equipment, gases and vacuum pumps and other process support equipment necessary in B2 to continue to run the other two Fabs. Tr 238-39. Consequently, it would not be physically possible or financially feasible to demolish that portion of B2 that housed Fab 21 because that would prohibit Hewlett-Packard's operation of essential support equipment that services all of the Fabs and would severely affect the ability of Hewlett-Packard to continue to operate Fabs 22 and 23 in B2. Thus, when Mr. Litolff was questioned on whether he considered demolition as a cost to cure in his functional obsolescence analysis, he testified that it was his opinion "it's not physically possible to tear down half of Building 2." Tr 1193-1194. Mr. Litolff was asked whether it was possible to physically demolish B1, B10, B11, B9 or B6. Tr 1193. He responded that it did not matter whether

these other buildings could be demolished because their demolition would not affect the \$38 million in excess operating costs – “Building 2 is the tail that wags the dog.” Tr 1194.

What did Mr. Litolff mean when he stated that “B2 is the tail that wags the dog?” He explained that it is very expensive to demolish a Fab because encapsulation may be required to address environmental concerns. Tr 1203. Additionally, tearing down the excess, non-core property other than B2 would not materially alleviate the bleeding – the \$38 million in excess operating costs. This is because of all of Hewlett-Packard’s excess, non-core space, B2 accounts for the majority of the annual excess operating expenses. Tr 384-385; *see, also*, graph, Ex 5, p 14, showing HP’s annual operating expenses (“OPEX”) per building.

From its fiscal year ending in 2007, through the second quarter of fiscal year 2009, Hewlett-Packard’s costs only for the utilities for the property on its inactive list (“IPP”), *i.e.*, excess, non-core property, was \$20,868 per quarter. Ex 65, p 2, line item “Utilities” in box entitled “Property Costs.” In the second and third quarter of 2009, Hewlett-Packard’s utility costs increased to \$41,868 per quarter for its inactive, excess, non-core property. *Id.* However, in the third quarter of 2009, HP’s utility costs for its inactive, excess non-core property jumped to \$274,800 and, then, to \$320,397 in the fourth quarter of fiscal year 2009 – over a 1000% increase in utility costs. What happened in the third and fourth quarters of HP’s fiscal year 2009? Fab 21 had been decommissioned and completely shut down, putting approximately one-half of B2 on Hewlett-Packard’s inactive property list. Tr 229-30, 264.

What this shows is that, indeed, B2 is the tail that wags the dog. Because it is physically impossible to demolish one-half of B2 and allow

Hewlett-Packard to continue to operate Fab 22 and 23 in B2, even if all of the other excess, non-core property were to be demolished, the bulk of the \$38 million in excess operating costs attributable to one-half of B2 would continue to be incurred by Hewlett-Packard. And, in addition to losing approximately \$916,933 in annual rent if B10 and B11 were demolished, Hewlett-Packard would incur the costs of demolition and the costs of separating the interconnected IT, electrical, and power from the core and non-core space.

Mr. Schultz, Hewlett Packard's Global Real Estate World Wide Disposition Manager for the inactive property program and who manages the disposition of surplus space that Hewlett-Packard is not occupying,¹⁶ described Hewlett-Packard's experience in separating buildings in a project in Houston:

—these buildings are all designed – you know, when they were built, as I said, they were never built with an exit strategy. So the – the cheapest and most efficient way was, you know, to have them all interconnected with IT and electrical and power. And so when you try to strip that out, you know, it creates – it creates quite an issue and very, very expensive, you know. For instance, we had a project in Houston where it cost \$17 million, you know, to separate the buildings out for the Lone Star College sale. So it's very complicated, because when these things were built nobody ever dreamed that, you know, we weren't going to be occupying the whole thing.

Tr 408-09. (Emphasis added.)

Likewise, Mr. DePuy, the Department's expert called to criticize

¹⁶ Tr 394.

Mr. Litolff's cost to cure analysis, testified that because of the "interrelated systems that serve Fab 21, Fab 22 and Fab 23 * * * [it didn't seem] feasible to demolish that portion of Building 2 that wasn't being occupied because of the effects it might have on the part that is being used, utilized." Tr 1871.

Mr. DePuy, in response to the questioning of the Tax Court admitted that any excess operating costs "cannot be cured by demolishing" Building 2. Tr 1870.

The Department's criticism of Mr. Litolff's calculation of the cost to cure is based upon the premise that it is physically possible and financially feasible to eliminate the excess operating costs caused by the superadequacy of the property. The example the Department uses to illustrate the "correct application of the *cost to cure* formula set forth in the rule" from *The Appraisal of Real Estate* is based upon a methodology used to calculate "***Curable*** Functional Obsolescence Caused by a Superadequacy." THE APPRAISAL OF REAL ESTATE, p 440 (not p 436), Ex 41 at 27 (emphasis added). The testimony in the case is clear - it is neither physically possible nor financially feasible to eliminate the excess operating costs by demolishing a portion of Building 2; *i.e.*, the functional obsolescence due to the superadequacy is incurable. Simply put, the Department used the wrong example to illustrate its rule.

As to incurable functional obsolescence, THE APPRAISAL OF REAL ESTATE explains that "[o]ften, especially for superadequate components, there may be no economically feasible or practical method to cure the problem. In this case the component is incurable and the property must

endure the loss in value.”¹⁷ The text provides a simple example that illustrates the method by which incurable functional obsolescence caused by superadequacy is calculated.

In the text’s example, incurable functional obsolescence caused by a superadequacy is excess ceiling height that has no value but causes the owner of the building to incur utility costs of \$5,000 more per year. The cost of a building with 24-ft ceiling heights is \$1.2 million as opposed to cost of a building with a market norm height of 18-feet of \$1 million, a \$200,000 difference (the excess capital cost). The incurable functional obsolescence is estimated to be \$40,000 (the excess operating costs of \$5,000 per year capitalized at 0.125). Where reproduction cost is used to calculate functional obsolescence, THE APPRAISAL OF REAL ESTATE illustrates the calculation of incurable functional obsolescence caused by a superadequacy as follows:

1. Reproduction cost of existing item	\$200,000
2. Less depreciation previously charged	- 20,000
<i>plus</i>	
3. Cost to cure (all costs)	--
<i>or</i>	
Value of the Loss	+ 40,000
4. Less cost if installed new	<u>0</u>
5. Equals depreciation from functional obsolescence	\$ 220,000 ¹⁸

There is no entry in step 3 for cost to cure because the cost to cure –

¹⁷ THE APPRAISAL OF REAL ESTATE at 436, Ex 41 at 23.

¹⁸ THE APPRAISAL OF REAL ESTATE, p 442, Ex 41 at 29.

tearing out the ceiling and reconstructing the building at a lower height – is neither practical, nor economically feasible. Consequently, the “value of the loss” – the present value of excess operating costs due to the superadequacy – is \$40,000. Thus, the amount of functional obsolescence in the reproduction cost model is a total of the depreciated excess capital costs (\$180,000) plus the present value of excess operating costs (\$40,000), or \$220,000. In essence, this is how Mr. Litolff calculated his total depreciation for incurable functional obsolescence due to a superadequacy (the excess, non-core space):

1. & 2. Reproduction cost less physical depreciation of the superadequacy	\$107,447,024
<i>plus</i>	
3. Cost to cure (all costs)	---
<i>or</i>	
Value of the Loss	\$ 38,525,819
4. Less cost if installed new	<u>0</u>
5. Equals depreciation from functional obsolescence	\$145,972,843 ¹⁹

The problem with the Department’s administrative rule is that it defines incurable functional obsolescence as follows: “Functional obsolescence is incurable if the cost to cure is greater than the “value of the loss.” OAR 150-308.205-(F) (3)(f). The dilemma is that if the cost to cure, *i.e.* demolition, is not practical or economically feasible, or is physically impossible, unlike THE APPRAISAL OF REAL ESTATE that skips the cost to cure in step 3, the Department’s interpretation of the rule requires the

¹⁹ Ex 1, p 85.

appraiser to place a zero in the cost to cure in step 3. Thus, according to the Department's read of the rule, the cost to cure in such a situation is always less than the "value of the loss," thereby affording no functional obsolescence due to excess operating costs. OAR 150-308.205-(F)(1). This makes no sense and the rule should not be interpreted in this manner.

Consequently, upon determining that the cost to cure the superadequacy by demolishing one-half of B2 was neither physically possible, nor economically feasible, and that demolishing the other excess, non-core property would not have a significant effect upon reducing excess operating costs because the bulk of those costs were with regard to the shuttered Fab 21 in one-half of B2, Mr. Litolff should not have put any value in the cost to cure. Consequently, how Mr. Litolff calculated the cost to cure has no effect on the outcome of this case.

Subtracting the total amount of functional obsolescence attributable to the excess, non-core property (\$107,447,024 excess capital costs plus \$38,525,819 excess operating costs) from the total Reproduction Cost New Less Physical Depreciation of the entire plant of \$210,930,602 results in a value by Mr. Litolff's cost approach of \$64,957,759, rounded to \$65,000,000.²⁰ This result conforms to THE APPRAISAL OF REAL ESTATE's requirements for calculating incurable functional obsolescence due to superadequacy and is also a proper interpretation of the Department's rule.

Ultimately, this determination of the cost to cure has little relevance as both the Department and Hewlett-Packard agree that the correct number to plug into the functional obsolescence formula is the "value of the loss."

²⁰ Ex 1, p 85.

Nonetheless, it is worth noting, if only to explain why the Department's arguments are incorrect.

III. CONCLUSION

The Tax Court, as the trier of fact, weighed the testimony of the witnesses in the case, the evidence introduced, and the arguments made by the parties in arriving at its conclusion as to the HBU and the Real Market Value of the subject property. The Tax Court found that Hewlett-Packard's appraiser, Mr. Litolff, was more credible in his determination of the HBU of the property than the Department's appraiser (who, the Tax Court found, "did no HBU analysis") and that the excess, non-core space did not contribute any value to the improvements as a whole, as the cost of conversion to marketable space exceeded the benefits of conversion.

In this appeal the Department neither challenges directly the Tax Court's finding of HBU of the property, nor did it raise the Tax Court's HBU finding as an error of law. The Department's attack on Mr. Litolff's appraisal is nothing more than an attempt to relitigate the Tax Court's finding of the HBU of the excess, non-core property. The basis of the Department's attack on Mr. Litolff's functional obsolescence calculation is that Mr. Litolff, in calculating one of the inputs into the functional obsolescence formula in his valuation analysis -- the "value of the loss" -- should have taken into account the rent that potentially could be received if the excess, non-core space was leased out. The Department attributes a present value of net income from leasing the excess, non-core of over \$10

million in its calculation of the value of the loss.²¹ The premise of the Department's argument as to how functional obsolescence should have been calculated in Mr. Litolff's valuation analysis is directly at odds with the Tax Court's finding of fact that the HBU of the excess, non-core space has no value and should remain vacant. Opinion at 6-7.

The Tax Court's determination of the Real Market Value of the subject property was supported by the cost approach, the sales comparison approach, and other substantial evidence in the record. As the trier of fact, the Tax Court found the taxpayer's appraiser more credible and experienced than the Department's appraiser and held the "real market values for the subject property as found by the appraiser for taxpayer are accepted by the court as the real market values for the subject properties." Op 12. The Department's assertion that Mr. Litolff, and in turn the Court, relied solely 100% on a single valuation analysis -- the cost approach -- is disingenuous and incorrect.

In conclusion, the Department's assignment of an error of law is not based upon Mr. Litolff's failure to follow the Department's administrative rules. To the contrary, the Department simply cannot accept the Tax Court's

²¹ The Department states that the proper calculation of the "'anticipated income' produced from the 'excess' space....yields a present value for the net income from the excess space in the amount of \$10,022,031." including the land beneath the excess space "yields a present worth of a positive \$21,067,694. Department Opening Appeal Brief at 16. The Department goes on to state: "So the correct formula indicates that the excess space is an asset rather than a burden to the subject property." *Id.* (Emphasis added.) Finally, the Department concludes that the excess, non-core space " * * * actually contributes to the overall real market value of the subject property * * * " Appellant's Opening Brief at 23. (Emphasis added.)

HBU finding and attempts to cobble together an argument that, at its core, is based upon a different HBU for the excess, non-core property than was found by the Tax Court.

Because there was no error of law on the part of the Tax Court in determining the factual issues of HBU and Real Market Value of the subject property, the Tax Court's opinion must be affirmed.

DATED this 8th day of April, 2014

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I certify that (1) this brief complies with the word-count limitation in ORAP 5.05(2)(b) and (2) the word-count of this brief (as described in ORAP 5.05(2)(a)) is 12,197 words.

I certify that the size of the type in this brief is not smaller than 14 point for both the text of the brief and footnotes as required by ORAP 5.05(4)(f).

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CERTIFICATE OF FILING

I hereby certify that on April 8, 2014 I filed by hand the original and fifteen true copies of **RESPONDENT'S ANSWERING BRIEF (SUPREME COURT)** with the Appellate Court Administrator at this address:

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I hereby certify that on April 8, 2014, I served by U.S. Postal Service, ordinary first class mail, postage prepaid, two true copies of **RESPONDENT'S ANSWERING BRIEF (SUPREME COURT)** on:

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