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Illegal Leases in Washington

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(Mr. Mellem wishes to acknowledge the assistance of Mr. Patrick Mullaney, Mr. Andrew Carter and Mr. Justin Haag in the preparation of this article.)

Illegal leases result when both the lessor and the lessee knowingly and intentionally contract to use the premises for an illegal purpose. Alternatively, when there is no legal possibility of using the premises for the intended use, the lease is illegal. Leases are generally presumed to be legal, but if the lessor or lessee can show either of the above, the lease may be held void. This article analyzes illegal leases and gives examples of language that may be used to avoid drafting an illegal lease.

I. Overview of Illegal Leases

For over a century, common law courts have held that leases should be construed in favor of their legality. *Shedlinsky v. Budweiser Brewing Co.*, 57 N.E. 620 (N.Y. 1900). In *Shedlinsky*, the lessee contracted to use the premises only for a liquor saloon. The lessor sued to recover rent and the lessee defended on the ground that the lease was illegal because the premises, in violation of the liquor tax law of 1896, were within 200 feet of a grammar school. The court, observing the rule that “[t]he presumption of a lawful intention must always prevail,” held that the lessee failed to establish that the lessor “intended that the statute be violated” or that “no license ever could be obtained by the lessee.” *Id.* at 620. Accordingly, the court enforced the lease.

A lease may be held void and unenforceable if it is established that the parties entered into the lease with knowledge and intent that the premises be put to an illegal use. “A lease made with the *intent* of the landlord and tenant that the demised premises are to be put to an illegal use is void.” 3 *Friedman on Leases*, § 27.302, pp. 1531-32 (emphasis added). An example of an illegal lease is

where both parties intend to use the premises to promote prostitution.

Additionally, a lease may be held void and unenforceable if the lease permits only one use and that use is forbidden under all circumstances. However, if the lease is for a use forbidden by law, but there is a possibility that the use may be validated, then the lease is not illegal. An example of this is a lease for office space in a building that is not currently zoned for office use. If there is a *possibility* that a permit may be obtained to use the premises for office space, then the lease is not illegal.

The two tests introduced above will be discussed in some detail in the next two sections of this article. The subsequent section will discuss allocation of risk principles applicable to lease interpretation. The final section will suggest tips for avoiding drafting an illegal lease inadvertently.

II. Illegal Intent

The Supreme Court of Illinois, in *Hoefeld v. Ozello*, 125 N.E. 5 (Ill. 1919), considered a lease, which the lessee claimed to be illegal based on the intent of the parties. The premises were to be used for a restaurant and saloon. The lessee formally agreed that the business carried on “shall be conducted in accordance with the laws of the state of Illinois and the ordinances of the city of Chicago.” *Id.* at 5. The lease also gave the lessee an option to terminate the lease if state or city authorities closed the saloon or “in the event that the state Sunday closing law is generally enforced in Chicago ...” *Id.*

The question before the court was whether the termination clause rendered the whole lease void. The lessee vigorously argued that the termination clause meant that the parties had either directly or inferentially agreed to violate the law by

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keeping the saloon open on Sundays, and that therefore the lease was void. But the Illinois Supreme Court held that there was nothing illegal about the lease, and that if the lessee chose to carry on his business illegally, that was between him and the police authorities. The court concluded:

While it is undoubtedly true that a contract made for the purpose of violating a state statute must be held void and unenforceable, there is no provision in this lease which showed that a state statute was *intended* to be violated. On the contrary, the lease specifically provides that the demised premises shall be conducted in compliance with the state and local laws. *Id.* at 7 (emphasis added).

The Utah Supreme Court, in *Young v. Texas Company*, 331 P.2d 1099 (Utah 1958), also held that a similar termination clause meant that a lease was not illegal. The lease provided that the lessor was to build a service station, even though there was a zoning ordinance in effect that prohibited the maintenance of a service station on the property. The lease provided that the lessor would obtain all permits required for constructing and operating the service station. The lease further provided that “the lessee could after notice terminate the lease if it were prevented by law or ordinance from establishing or continuing the business of distributing petroleum products.” *Id.* at 1100.

The court noted the “well-recognized general rule that leases made with the knowledge and intent of both parties that the premises are to be used for an illegal purpose are unenforceable” *Id.* The court continued, however, that “it does not follow that because there is a zoning ordinance which makes the contemplated use illegal at the time the lease is executed that it is intended by the parties to use the premises for an illegal purpose where it is possible to obtain a change in the zoning ordinance so that the use can be made legal.” *Id.* at 1100-01. On the

issue of the impact of a termination clause on the legality of a lease, the court held:

[T]he lessee would have the right to terminate the lease if any ordinance or law prevented the construction or maintenance of the service station... . The law will not assume that an illegal use is contemplated where there are provisions such as are included here that the lessee could terminate the lease if the contemplated use should be frustrated because of illegality. *Id.* at 1101.

In *Sachs Steel & Supply Co. v. St. Louis Auto Parts & Salvage Co.*, 322 S.W.2d 183 (Mo. App. 1959), the lessor brought suit against the lessee for rents due under a commercial lease. The zoning regulations restricted use of part of the leased premises to residential use; the salvage company lessee abandoned the lease during the first month of its term when it discovered that fact. The lessee alleged that the lessor had superior knowledge of the zoning restrictions and induced it into believing that the entire premises could be used for business purposes. The lessee won a jury verdict in its favor.

The appellate court reversed, holding that the lessee was imputed with knowledge of the zoning restrictions. *Id.* at 186 (“ignorance of the zoning ordinances is no excuse”). The court held that the lessee could have “protect[ed] itself against the possibility that the intended use of any portion of the premises might be prohibited by prevailing zoning ordinances, or that a variance would not be forthcoming from the zoning authorities” by insisting “that the lease contain conditional clauses or termination privileges based upon these contingencies.” *Id.* at 187. The court held that the lessee “cannot avoid liability for rent on the ground of illegality under these circumstances.” *Id.* at 188.

A lease provision that requires a lessee to comply promptly with all applicable statutes, ordinances, rules, regulations,

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orders and requirements, by itself, should foreclose the argument that the landlord *intended* a tenant to use the premises in an illegal manner.

III. No Possible Legal Use Under the Terms of the Lease

The knowledge and intent required for a lease to be held void for illegality can be presumed where the lease permits only one use and that use is forbidden under *all* circumstances. This means that a lease made for a purpose forbidden by law is enforceable if there is *any* legal possibility for validating its use under the terms of the lease. Professor Friedman, a leading authority, has explained:

A lease made for a purpose forbidden by law is enforceable ***if there is a legal possibility of validating the purpose*** by obtaining a permit or variation under a governing zoning or other law. ***The tenant is therefore under an obligation to seek such validation*** and, if necessary, its renewal, ***and is liable under the terms of the lease, whether or not he succeeds***. He may be liable, then, despite an inability to use the premises for his intended purpose. It is presumed that the tenant knew of the existence of the law and that he assumed the risk of validation as well as the contingency of his failure. 3 *Friedman on Leases*, § 27.302b, p. 1540 (4th ed. (emphasis added)).

If there is any possibility that a permit can be obtained to validate the lessee's use under the lease, the lease is not illegal.

Furthermore, because there is a presumption that a lease was entered into for a legal purpose, the burden of proof in a dispute over an allegedly illegal lease is on the party asserting illegality. *See, e.g., Franklin v. Jackson*, 847 S.W.2d 306, 309 (Tex. App. 1992). Thus, where a permit or license might be required to validate the use, then "it will be presumed [that] the parties contemplated that a license would be obtained." *Entrepreneur, Ltd. v. Yasuna*, 498 A.2d 1151, 1159 (D.C. 1985). The lessee then has the burden of proof of showing that it sought the relevant permit from the city or state. If the lessee is unable to obtain a permit, depending on the allocation of risk in the contract, the lessee still may be bound by the lease. The allocation of risk will be addressed in the next section.

In *McNally v. Moser*, 122 A.2d 555 (Md. 1956), the court held that a tenant who abandoned a lease without pursuing a permit or variance could not demonstrate that the lease was for an illegal purpose. In *McNally*, the local zoning ordinance prohibited the tenant's use of the office space because he did not also reside on the premises. After the local zoning administrator declared the tenant's use illegal, the tenant abandoned the premises rather than seek a variance. The landlord sought a declaratory judgment that

the lease remained in effect and that rent remained payable. The tenant defended on grounds of illegality. *Id.* at 558.

In finding for the landlord, the court placed the burden on the tenant to establish that the local zoning ordinance precluded the tenant's use of the premises. *Id.* at 560. The court determined that the tenant could not carry his burden because he had failed to seek a variance and "could not stand idly by and, because of a notice to that effect from an administrative official, gladly accept as fact that his use of the office was illegal." *Id.* at 561. Rather, the tenant was obligated to prove, through exhaustion of administrative remedies with zoning authorities, that his intended use was, in fact, illegal. *Id.*

The Washington Court of Appeals followed *McNally* in *Stevedoring Servs. of America, Inc. v. Marvin Furniture Mfg., Inc.*, 54 Wn. App. 424, 774 P.2d 44 (1989). There, the Seattle Fire Department notified a tenant that substantial improvements were necessary to bring the tenant's use of the premises into compliance with the fire code. Rather than challenge the Fire Department's enforcement action, the tenant chose to abandon the premises. The landlord sued for breach of lease. The tenant argued the lease was unenforceable because the Fire Department's action had rendered the tenant's continued use of the premises illegal, thereby frustrating tenant's purpose in entering the lease.

The Washington Court of Appeals upheld the trial court's decision granting summary judgment and awarding lost rent to the landlord. Relying on *McNally*, the appellate court's ruling turned upon the tenant's decision to not appeal the Fire Department's determination. The court noted that the tenant "apparently chose for its own reasons to vacate the leased property, rather than take the necessary steps to preserve its right to use the property within the limits of the fire code." *Id.* at 433. The tenant's decision precluded any argument that tenant's use violated the fire code and that the contract was commercially frustrated: "[We] hold that [the tenant] had a duty to attempt to resolve the problem concerning enforcement of the fire code. Only after such an attempt had failed could [the tenant] claim that its principal purpose was frustrated." *Id.* The court concluded that summary judgment in favor of landlord was proper because "[i]n the absence of evidence of an attempt to correct the matter through administrative appeal or legal action, there was no factual issue to be resolved." *Id.*

At least three policy considerations underlie the *McNally/Stevedoring* rule. First, requiring litigants to pursue administrative permits and/or appeals channels directs complex issues involving the interpretation of land use regulations to the agencies with the proper expertise. *See, e.g., South Hollywood Hills Citizens Ass'n v. King County*, 101 Wn.2d 68, 73, 677 P.2d 114 (1984) (discussing policy behind rule that potential litigant must exhaust administrative remedies). Second, the court is thereby saved from needlessly deciding cases that could easily have been

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resolved by a favorable agency response. Finally, the threat of a party relying on alleged code or zoning violations to escape lease obligations is eliminated.

If “a simple notice of violation” issued by a zoning authority were enough by itself to establish an illegality defense, a tenant might be enticed to use illegality as a convenient means to avoid a lease it no longer finds profitable. Worse, the tenant could in bad faith invite the violation notice. This consideration was prominent in *McNally*. “We think that [tenant] having brought about the challenge to the use so that he could escape his responsibilities under the lease, could not stand idly by and, because of notice to that effect from an administrative official, gladly accept as fact that his use of the office was illegal.” *McNally* at 561.

If a lessee fails to pursue a permit to validate its use and does nothing, there is still a **legal possibility** that it could use the premise under the terms of the lease. In this situation, the lease is still valid. On the other hand, if a lessee does exhaust all the administrative possibilities and cannot obtain a permit for its intended use, the lease is likely void, depending on the allocation or risk. Some courts further require the lessee to challenge adverse agency action in court, and to exhaust judicial as well as administrative remedies.

A termination clause in a lease may allow the tenant to terminate the lease if the state or city materially interrupts or restricts the tenant’s use of the premises. In this situation, a lessee can terminate the lease if it has exhausted all possibilities of using the premises for a legal purpose under the lease. Termination clauses of this nature serve to protect a lessee from a situation where it could not possibly legally use the premises under the terms of the lease.

IV. Allocation of Risk

If a lessee seeks a permit from the relevant authorities to validate its contemplated use of the premises and is denied, the lessee may still be bound to pay rent under the terms of the lease. The lease may have allocated to the lessee the risk of failure to comply with the applicable laws and regulations. In *Scott v. Petett*, 63 Wn. App. 50, 57, 816 P.2d 1229 (1991), the court ruled, “A party bears the risk of mistake when the risk is allocated to him by contract” (citing Restatement (Second) of Contract, § 154(a)). If the risk is allocated to the lessee, and the lessee is unable to obtain a permit to validate its use, the lessee is still bound by the terms of the lease. But if the contract allocates the risk to the lessor and the lessee cannot after diligent efforts obtain a permit to validate its use, then the lessee may be able to escape its obligations under the lease.

If the risk is not allocated by the contract, a party bears the risk if it has limited knowledge with respect to a mistake in the lease but treats this knowledge as sufficient. In *Scott*, the buyer purchased a parcel of land. After the sale closed, the buyer learned that the land contained wetlands subject to federal permit

requirements. The buyer brought suit for rescission of the purchase and sale agreement on the grounds that the parties were mutually mistaken with regard to what land use law applied to the parcel.

Affirming the trial court, the appellate court recognized that mutual mistake as to a basic assumption of a contract, including the application of land use laws, may serve to relieve the parties of their obligations. The court noted, however, that “a party seeking to avoid the contract must not have borne the risk of mistake.” *Scott* at 57. The court added that a party bears the risk of mistake not only where the risk is allocated by contract. Rather, a party also “bears the risk of the mistake, when, at the time the contract is made, the party is aware of limited knowledge with respect to the facts to which the mistake relates but treats such limited knowledge as sufficient.” *Id.* at 57-58.

Regarding this latter point, the court observed that the buyer had at least been aware that there were potential land use issues encumbering the parcel. Nevertheless, the buyer chose to proceed to sign the contract. The court concluded this decision brought the buyer “squarely within the doctrine which places the risk of mistake on the party who proceeds with limited knowledge with respect to the fact involving the alleged mistake.” *Id.* at 59. The court explained, “It is said in such a situation that there is no mistake; instead, there is an awareness of uncertainty, a conscious ignorance of the future.” *Id.* (quoting *PUD 1 v. WPPSS*, 104 Wn.2d, 353, 362, 705 P.2d 1195 (1985)).

A lessor can specifically allocate to the lessee the risk of the consequences of a failure to obtain needed permits by including a risk allocation provision in the contract. Additionally, as shown above, if a lessee has limited knowledge that there may be a zoning or permitting issue associated with the property and treats this knowledge as sufficient, a court may allocate the risk to the lessee. A good example of this is where certain premises has been subject to a long and complicated land-permitting history and the lessee is not fully informed, but nevertheless treats as sufficient the information that it acquired before executing the lease.

V. How To Avoid Problems With Illegality

The following tips can help both lessors and lessees avoid problems associated with the potential illegality of their leases:

- Both parties should be sure that they are not intending to put the premises to an illegal use. If an illegal use is both the lessor’s and the lessee’s objective intention, the lease may be held illegal at the instance of either of them.
- To foreclose the possibility of an intended illegal use, the lessor should include a provision in the lease that informs the lessee that it must comply with relevant laws. For example, “Tenant must comply promptly with all applicable statutes, ordinances, rules, regulations, orders and requirements.”
- If the lease is for a use of the premises that is presently forbidden, the lessor should satisfy itself that there is at least

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Alaska's Five-Year Experience with Self-Settled Discretionary Spendthrift Trusts Part I

by David G. Shaftel, Law Offices of David G. Shaftel, Anchorage, Alaska

In 1997, Alaska was the first state to enact a usable statute authorizing self-settled discretionary spendthrift trusts (“SSDS Trusts”).¹ In addition, Alaska made its first attempt to abolish the rule against perpetuities, so as to allow for the formation of Alaska perpetual trusts.² Five years have elapsed. Many non-Alaska practitioners have inquired about Alaska’s experience with SSDS trusts. For the period from 1997 to the present, the following experience has been reported.³

Alaska trustees report that approximately 850 trusts have been formed under Alaska law by nonresidents of Alaska.⁴ Of these, approximately 300 are SSDS Trusts, and the balance are perpetual trusts. Most of the SSDS Trusts also use a perpetual trust plan. Approximately 100 attorneys provided the legal services for the creation of these trusts.

Alaska estate planning attorneys report that approximately 125 SSDS Trusts have been formed for Alaska residents. In addition, 200 to 300 perpetual trusts have been created for Alaskans. Several attorneys report that their standard “default plan” for medium and large estates now is based upon a perpetual trust dispositive plan. Approximately 60 percent of both the resident and nonresident SSDS Trusts have involved contributions of assets that were completed gifts for federal gift tax purposes.

When the Alaska Legislature enacted statutes authorizing the creation of SSDS Trusts in 1997, the initial focus was on asset protection. Gifts to such pure asset protection trusts would often be structured to be “incomplete” for gift tax purposes.⁵ This allows substantial funding without payment of gift tax. Advocates of foreign trusts correctly pointed out that persons seeking maximum asset protection should look offshore.⁶ As a result, in the five years since passage of the Alaska statutes, the primary focus of Alaska SSDS Trusts has changed to transfer tax reduction. The use of SSDS Trusts for such tax reduction is also the focus of this article.

The following “planning dilemma” example illustrates the use of SSDS Trusts for transfer tax reduction planning. The

balance of this article discusses how such trusts have been structured and implemented in Alaska, the use of SSDS Trusts by nonresidents, how an SSDS Trust could fail, and planning analysis in view of the authority that exists. Tax and asset protection issues are identified, and their merit is discussed. However, an in-depth analysis of these issues is not the goal of this article. Such analysis has been accomplished in the articles cited in the endnotes.

I. The Planning Dilemma: Early Gifting Versus Future Possible Needs

Consider this planning situation: your clients are a couple in their fifties. One or both is a small business owner, executive, or professional. Their net worth is in the range of \$3,000,000 to \$10,000,000. Substantial estate taxes could be saved if your clients made annual exclusion and applicable credit gifts to irrevocable trusts for their children and/or grandchildren. The gifts could be structured so that they qualify for valuation discounts, and the growth of the gifted assets would be kept out of your clients’ estates.⁷ Based upon your clients’ net worth, and anticipated future earnings, it appears that they would not need these gifted amounts. However, your clients are reluctant to give away significant assets at this point in their lives. They tell you that they might need these assets in the future if they have an unexpected financial reversal.

Your clients ask if they can be added as discretionary beneficiaries of the trust, so that the trustee can make distributions to them if needed. You respond that if they were added as discretionary beneficiaries, the IRS could successfully argue that the trust assets should be included in their gross estates at death and be subject to federal estate taxation, because your state has a statute (or case law) that provides that if the settlors are discretionary beneficiaries, then the settlors’ creditors can reach the maximum amount that the trustee could distribute to the

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a **possibility** that a permit might be obtained to allow the lessee’s intended use.

- The lessee should make sure that the lease contains a termination clause so it can escape its obligations under the lease if it cannot after diligent effort obtain a permit to use the premises for its intended purposes.
- The parties would be well advised to allocate the risks associated with applying for permits. If the risk is allocated to

lessee and it cannot secure a permit for its intended use, then it is still bound by the lease.

- If the lessee has limited knowledge, but treats this knowledge as sufficient, then the risk of failure to obtain needed permits may be deemed allocated to the lessee by operation of law. Thus, the lessee would be wise to investigate land use issues as part of its due diligence process before executing the lease.

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settlers.⁸ In many instances, this would be all of the assets in the trust. Therefore, the settlors could “run up” debts and the settlors’ creditors could reach all or part of the trust’s assets to satisfy these obligations. Another way of looking at the situation is that the settlors, indirectly, have retained the ability to reach the assets of the trust through incurring debts.

This indirect retention of the use of the assets in the trust prevents the settlors’ transfers to the trust from being completed gifts for federal gift tax purposes.⁹ Further, such indirect retention would result in the trust assets being included in the settlors’ gross estates under I.R.C. sections 2036 and 2038.¹⁰

II. Alaska's Statutory Change Provides a Solution

In 1997, the Alaska Legislature changed Alaska law to authorize the use of SSDS Trusts. The new legislation provided, in effect, that under Alaska law a settlor may create an irrevocable trust, transfer assets to it, be a discretionary beneficiary of such trust, and yet, the settlor’s creditors cannot reach the assets in such a trust.¹¹

From a transfer tax standpoint, since the settlor’s creditors cannot reach the assets in the trust, the settlor’s ability to incur debt does not give the settlor “dominion and control” over the trust assets. Accordingly, the settlor’s transfers to a SSDS Trust are completed gifts. The IRS has agreed.¹² Further, proponents of SSDS Trusts contend that none of the inclusion provisions of the federal estate tax apply to the assets in an Alaska SSDS Trust. Their position is that the settlor has not retained the enjoyment or income from the assets (I.R.C. § 2036), nor does the settlor possess at death the power to alter, amend, revoke, or terminate the transfer (I.R.C. § 2038). Therefore, the trust assets should be excluded from the settlor’s gross estate.¹³

As a result, the clients in our example, described above, may create an Alaska SSDS Trust, make annual exclusion and other gifts to the trust,¹⁴ be included in the class of discretionary beneficiaries to whom an independent trustee may make distributions, and a strong position exists that such assets will not be included in their gross estates at their deaths. If the clients need funds in the future, due to an unexpected financial downturn, the trust assets are available.

III. How a SSDS Trust Is Structured and Funded

Often, settlors first form a family limited partnership or family limited liability company.¹⁵ These entities are funded with investment assets such as interests in closely-held businesses, real estate, and marketable securities. The clients may desire that they, or family members, be the general partners or managers. Then, the clients give the limited partnership or non-managerial interests to the SSDS Trust. In this way, the clients, or their family members, retain the ability to manage the assets and to decide when distributions will be made to the trust. The gifting of the non-managerial interests qualifies for valuation discount.

A “rule of thumb” has developed concerning the portion of a client’s assets that should be transferred to a SSDS Trust. This “rule” limits such assets to no more than one-third (conservative) to one-half (aggressive) of the client’s net worth. The rationale for this “rule” is that a settlor would not give away assets which the settlor knew with some certainty that he or she would need in the future, unless the settlor also knew that he or she could get the assets back. That is, the transfer of too large a proportion of the settlor’s assets to an SSDS Trust invites a court finding that an agreement exists between the settlor and the trustee.¹⁶

IV. Trust-Owned Life Insurance

SSDS Trusts have also become a vehicle for the ownership of life insurance on the settlors’ lives. For example, assume the clients desire to purchase a second-to-die life insurance policy that will develop substantial cash value and will benefit from the income tax-free inside buildup of this type of asset. However, again, clients may desire the ability to access the value of such policy if they have a financial reversal. If the policy is owned by an SSDS Trust, the independent trustee may borrow from the insurance company, or even cash-in the policy, in order to make discretionary distributions which are needed by the settlors. The fact that the settlors are discretionary beneficiaries of the trust does not appear to be enough to conclude that they have retained “incidents of ownership” in the policy.¹⁷ However, careful choices of trustees and drafting are necessary in order to ensure that such incidents of ownership are not attributable to the clients.

A. The Dispositive Plan

A typical SSDS Trust will provide that the independent trustee has absolute discretion to make distributions to a class of beneficiaries, which includes the settlors and their descendants. Such absolute discretion is provided in order to avoid an exception to the Alaska spendthrift rule for any portion of a trust’s income or principal that must be distributed to the settlor.¹⁸ Further, absolute discretion avoids contentions that a beneficiary (or the beneficiary’s creditors) can force a trustee to make distributions pursuant to an ascertainable standard stated in the trust instrument.¹⁹ For example, a creditor could argue that maintenance or support includes the payment of the beneficiary’s creditors. Alternatively, a creditor could argue that a trustee is required, pursuant to the ascertainable standard, to distribute assets to an insolvent beneficiary. Then the creditor could attempt to attach the distributions.

Often, an SSDS Trust will contain a perpetual trust dispositive plan after the deaths of the settlors.²⁰ A perpetual trust dispositive plan is designed to provide the following advantages for the non-settlor beneficiaries: (1) asset protection for descendants; (2) elimination of transfer tax upon the portion of the assets held in a GST-exempt trust; (3) management; (4) an estate plan which is already in place; and (5) probate avoidance.²¹

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B. Choice of Trustees

At least one trustee of an SSDS Trust should be an independent trustee. This independent trustee has all trust distribution powers under the absolute discretion standard. In order to preserve the independence of the trustee, there must not be any agreement between the independent trustee and the settlor regarding distributions. The existence of such an agreement would allow the settlor's creditors to reach the trust assets because the settlor would have a right to the distribution of the assets.²² The result would be inclusion of the assets in the settlor's gross estate.²³ Such an agreement could be written, verbal, or implied through a pattern of distributions.²⁴ It would be more likely that a court might imply an agreement between the trustee and settlor if the independent trustee had a relationship with the settlor. Such relationships would include being a close relative, close friend, or employee. Since the transfer tax advantages depend on the premise that the settlor's creditors cannot reach the assets in the trust, it is very important to structure the choice of trustees to minimize the risk that an implied agreement will be found.

In addition to an independent trustee, some clients desire that a family trustee be appointed who will have some or all of the administrative responsibilities for the trust. These are not tax-sensitive duties and should not affect the creditor protection foundation.²⁵ However, if the trust owns life insurance policies that insure the life of a family trustee, then the managerial duties relating to such policies must be reserved to the independent trustee in order to avoid inclusion of the proceeds in the family trustee's gross estate.

The state where a potential trustee resides must be considered. A creditor can obtain jurisdiction over the trust in that state. Then its courts will first decide conflict of laws issues, and a judgment from such state's courts will be entitled to full faith and credit in Alaska. Also, if the trustee resides in a state that has an income tax, that state may assert its tax against the trust.²⁶

C. Future Amendments

The newness of SSDS Trusts and the ambiguous state of the law has encouraged drafters to build flexibility into the trust instrument. The independent trustee, or an independent trust protector, is often given the authority to amend the trust instrument in order to adjust for future tax law changes.²⁷ A trust protector may be given the power to eliminate the settlor as a discretionary beneficiary of the trust and to change the choice of trustee.²⁸ The goal of such provisions is to allow future adjustments so that the trust assets will not be included in the settlor's gross estate if the tax law is interpreted or changed in a manner, which indicates that such inclusion is likely.

V. Conclusion

Part II of this article, which will appear in the Winter 2003 edition of this Newsletter, will discuss the following subjects:

- Use of SSDA Trusts by Nonresidents.
- Subsequent Alaska Legislation Facilitating the Use of SSDS Trusts.
- Failure of SSDS Trusts.
- Why There Is Not More Authority.
- Guidance for Planners – Evaluating Your Client's Tolerance for Ambiguity and the Downside of SSDS Trusts.

1 Alaska's statute was passed in April 1997. Delaware immediately followed suit and enacted its version in July 1997. In 2000, both Nevada and Rhode Island passed statutes designed to implement SSDS Trusts.

In this article, an "SSDS Trust" means an irrevocable trust that authorizes an independent trustee, in such trustee's absolute discretion, to make distributions to a class of beneficiaries, which includes the settlors.

2 In this article, a "perpetual trust" means an irrevocable trust created in a jurisdiction that has abolished the rule against perpetuities, and therefore, the trust can continue as long as it has assets. Many SSDS Trusts are also designed as perpetual trusts.

3 The general factual information in this article concerning Alaska SSDS and perpetual trusts is based upon anecdotal, as opposed to scientific, research by the author. The author surveyed institutions which and individuals who had indicated an interest in acting as trustees for nonresident trusts. Also contacted were Alaska estate planning attorneys likely to be involved with creation of SSDS Trusts for Alaska residents or in assisting non-Alaska attorneys in forming such trusts.

4 The numerical counts stated in this article refer to the number of trust instruments. Each trust instrument may create one or more separate subtrusts.

5 Alaska Statute 34.40.110(b)(2) allows the settlor to retain a power to veto a distribution from the trust or a testamentary special power of appointment. Either approach makes the gift incomplete.

6 Giordani and Osborne, "Alaska Asset Protection Trusts: Will They Work?" included in Osborne and Schurig, "Asset Protection: Domestic and International Law and Tactics," Special Pamphlet to 1997-4 Supplement (Clark Boardman and Callaghan, 1995); Osborne, "Asset Protection and Jurisdiction Selection: Clearing Up Your Sinus Headaches," 33rd U. of Miami Heckerling Inst. on Est. Plan. (1999); Hogan, "Once More Unto The Breach: Planning for a Conflict of Laws With Alaska and Delaware Self-Settled Spendthrift Trusts," *Probate & Property*, Mar./Apr. 2000.

7 For example, assume that your clients' gifts total \$1,000,000 and that they are both 50 years of age. Further, assume that these assets grow at a net rate of 5 percent per year and that the second to die of your clients lives to age 84. The gifted assets will grow to \$5,454,648. Subtracting out the \$1,000,000 initially gifted to the SSDS Trust leaves growth of \$4,454,648. Assume this growth is taxed at a federal estate tax rate of 45 percent, producing taxes of \$2,454,592. This is the tax amount that would have occurred 34 years from now if your clients had not gifted the \$1,000,000 to the SSDS Trust. Using the same 5 percent rate, avoiding this tax produces a present value savings of approximately \$449,000.

8 Prior to 1997, almost all states had such authority.

9 Reg. § 25.2511-2(b) provides that a gift is complete if the donor "has so parted with dominion and control as to leave in him no power to change its

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Alaska's Five-Year Experience...

- disposition, whether for his own benefit or for the benefit of another ...”
This test is not satisfied by SSDS Trusts in most states.
- 10 I.R.C. § 2036 would probably apply since the settlors have retained the enjoyment of, and income from, the property by their ability to incur debt that their creditors may satisfy from trust assets. I.R.C. § 2038 would apply because the ability to relegate creditors to the trust assets allows the settlors to revoke the transfer of assets to the trust.
- 11 Alaska Statutes 34.40.110; 13.36.310.
- 12 See PLR 9837007 (involving an Alaska resident); *See also*, Rev. Rul. 77-378, 1977-2 C.B. 347.
- 13 For a comprehensive discussion of these issues, including the relevant authorities, see Blattmachr and Zaritsky, “North to Alaska-Estate Planning Under the New Alaska Trust Act,” 32nd U. of Miami Heckerling Inst. on Est. Plan. (1998); Pennell, *Estate Planning*, Vol. II, ‘ 7.3.4.2 (Aspen, 6th ed.); Manley, “Estate Planning and Asset Protection Using Self-Settled Alaska Trusts,” 33rd U. of Miami Heckerling Inst. on Est. Plan. (1999), Spec. Sess.; and Shaftel, “Newest Developments in Alaska Law Encourage Use of Alaska Trusts,” *Estate Planning*, Feb. 1999, Vol. 26/No. 2. Note that in P.L.R. 9837007, cited above, the Internal Revenue Service declined to rule on whether the Alaska settlor’s trust was includable in her estate.
- 14 Gifts to a fully discretionary trust cannot be “split,” under I.R.C. § 2513, with a spouse who is a discretionary beneficiary. *See* Handler and Chen, “Fresh Thinking About Gift Splitting,” *Trusts & Estates*, Jan. 2002; Benjamin, “When Should the Option to Split Gifts be Chosen?” *Estate Planning*, Jan./Feb. 1995.
- 15 Alaska’s limited partnership and limited liability company statutes have both been amended so as to maximize qualification for valuation discounts. *See* Alaska Statutes 32.11.110, *et seq.*, and 10.050.010, *et seq.*
- 16 The consequences of such an agreement are discussed in Section IV.B. of this Article.
- 17 *See* Reg. § 20.2042-1(c) and PLR 9434028.
- 18 *See* Alaska Statute 34.40.110(b)(3).
- 19 Restatement (Second) of Trusts § 155, comment b (1959); Rothschild, “Protecting the Estate From In-Laws and Other Predators,” 35th U. of Miami Heckerling Inst. on Est. Plan., pp. 17-21 through 17-23 (2001).
- 20 In 1997, Alaska took a first step for abolition of its rule against perpetuities. This abolishment was perfected in 2000 by amendments designed to avoid the “Delaware Tax Trap.” *See* Alaska Statute 34.27.051-100 and Greer, “The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities,” *Estate Planning*, Feb. 2001, Vol. 28/No. 2. Alaska is one of only several states that have both successfully abolished the “rule” in a manner that avoids this tax trap, and also does not have a state income tax.
- 21 These planning concepts have been thoroughly analyzed and discussed by Frederick R. Keydel and Harvey B. Wallace II in “Trust Drafting for the Unforeseeable,” presented at a workshop and later incorporated by Ronald D. Aucutt into “Structuring Trust Arrangements for Flexibility,” 35th U. of Miami Heckerling Inst. on Est. Plan. (2001).
- 22 *See* Alaska Statutes 34.40.110(b)(3).
- 23 *See* Reg. § 20.2036-1(a) (finding “retention” under I.R.C. section 2036 if such an agreement exists).
- 24 Cases involving I.R.C. § 2036 and an implied understanding of settlor access are discussed in Boxx, “Gray’s Ghost,” 85 Iowa L.R. 1195, at 1244-51 (2000).
- 25 Pennell, *Estate Planning*, Vol. II, § 7.3.3, p. 320 (Aspen, 6th ed.).
- 26 Coleman, “State Fiduciary Income Tax Issues,” ALI-ABA Advanced Estate Planning Techniques (2002); Gutierrez, “The State Income Taxation of Multi-Jurisdictional Trusts-The New Playing Field,” 36th U. of Miami Heckerling Inst. on Est. Plan. (2002).
- 27 Such flexibility and suggested provisions are discussed in McBryde and Keydel, “Back to the Future for the Estate Planner: Building Flexibility in Estate Planning Documents,” 30th U. of Miami Heckerling Inst. on Est. Plan. (1996).
- 28 *See* Dodge, 50-5th T.M., “Transfers With Retained Interests and Powers,” p. A-78.

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Back to the Basics

Best Practices For Drafting Charitable Bequests

by Felicia Value, La Conner, Washington

(Ms. Value wishes to thank Mr. Elliot Johnson, Esq. and Mr. Michael Cunningham, CPA, for their help with this article.)

You may not be one of the elite planned giving experts Washington is so fortunate to have, but you regularly assist clients with their estate plans. A common client scenario is that of the single older individual who has named the various generations of his family as successive beneficiaries under his will. Because you are a thorough and conscientious practitioner, you ask, as always, whether the client would like to name a charitable organization as the ultimate contingent beneficiary. Impressed by your comment that he might as well pick his own fall-back beneficiary, rather than letting the laws of intestate succession decide for him, your client ponders some causes which he believes in and then decides to name his church and a nationally-known animal welfare organization as contingent residuary beneficiaries of his estate.

Are you done? Do you simply plug in the names that the client has given you and call it good? No. Because in drafting charitable bequests, best practices require that you establish your client's intent and in so doing, dodge potential estate tax disasters.

I. Playing the Name Game

While many clients try to do good by naming charities in their wills, without proper legal assistance, some, when they fail to use the proper legal names of the charities or proper bequest language, create problems that will only later appear. It is up to you to make certain that your philanthropic clients' desires and wishes will be properly carried out.

First, you must identify the correct legal name of the charitable organization. Do not assume that your client has provided you with the correct name. Many national charitable organizations have names that sound the same, and some charities have legal names that are different from their popular names. Ask your client to give you literature or a mailing from the charity or phone the charity yourself and ask for material to be sent to you. You may also access the charity's website for the pertinent information. In conducting such research, I have two goals: (1) to make certain that the charitable organization that I am naming in the client's will is the one my client actually wants to name; and (2) to make certain that I am designating the charity in the will by its correct legal name so that there will be no confusion later. For example, I had a client who wanted to make a gift to "Meals on Wheels" in Whatcom County. The proper name for the beneficiary turned out to be "The Northwest Regional Council." It took some phone calls to identify the core charity.

In addition to the charitable beneficiary's name, it is good practice to include in the will some other identifying information, such as the charitable organization's current business address. Perhaps the best way to pin down a charitable beneficiary's identity is to include in the will its tax identification number

(EIN). Resources for finding charities' tax identification numbers are mentioned later in this article.

II. Remembering the Tax Angle

Besides accurately expressing your client's intent, there is another reason to be a stickler for properly naming a charitable beneficiary. In so doing, you may avoid potential estate tax problems. Generally speaking, your client's best tax advantages will come from naming a 501(c)(3) entity – that is, a charity that has been approved by the IRS as qualifying for exemption from federal income taxation. A gift to a 501(c)(3) charitable organization will be entitled to a charitable estate tax deduction in the amount of the full fair market value of the gift.

Be alert to the fact that some organizations, such as Planned Parenthood, have a political action branch, which is not a 501(c)(3) organization, and a non-political branch, which is a 501(c)(3) organization. If your client has a taxable estate, specifying the proper name or branch of an organization could make the difference between zero estate taxes and big estate taxes. IRS Publication 78 lists all charities registered with the IRS as tax-exempt 501(c)(3) organizations. You can find Publication 78 at your local library or request it from the IRS by calling (800) 829-1040. You can also find it at the IRS website, <http://www.irs.gov> by going to the "Search For" box and typing in "Publication 78". This publication may be downloaded and searched online.

There can be exceptions to the rule that naming a 501(c)(3) entity is best, and the interacting tax rules can become complex. Perhaps your client wants to give some real property to Western Washington University. The University has established the Western Washington University Foundation to receive charitable gifts. The Foundation is listed with the IRS as a 501(c)(3) organization, but Western Washington University is not. In this instance, this distinction may not matter. In terms of tax consequences to the donor, gifts to a public university are treated the same way as gifts to a 501(c)(3) foundation. Moreover, if your client gives her real property to the Foundation, the Foundation may have to pay real estate taxes on the property. If instead Western Washington University is named as the donee of real property, no real estate taxes will be due because Western Washington University is a public institution that is exempt from payment of real estate taxes. In this case, naming the entity that's *not* the 501(c)(3) organization might be best for the donor and the beneficiary.

Your client also should consider where the charitable beneficiary will direct the gift. If the gift is given to the University, it may become part of the general fund when it is sold, thus serving as an offset to legislative funding. If it is instead given to the Foundation, it can become part of the permanent endowment.

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Back to the Basics ...

There are still other rules that can come into play depending on the use the University could make of the property, and whether it will be kept or sold. Thus, you may find that best practices dictate that you initiate a dialogue with the charitable beneficiary to discuss your client's charitable intent as well as the charity's needs.

As a rule, I like to contact a charity's planned giving department and talk to someone in the know. The professionals in the planned giving department should be able to advise you on how to properly name the organization in a client's will and if there are any restrictions or tax considerations for the particular types of gifts that your client is considering. It is also a good opportunity to ask for the organization's tax identification number. Many planned giving departments have sample bequest language that they will send to you. You may glean more options for your client by reviewing such material. For example, you may discover a campaign for capital improvements that the client might favor, a recognition system for gifts over a certain amount, or a memorial program. Be advised that planned giving officers almost always ask you to identify the donor who you are representing. I always decline to say unless my client has specifically given me permission to reveal his identity.

III. Expressing Your Client's Charitable Intent

You are now confident that you have identified the charitable beneficiary that your client wants to benefit and have structured the gift in the best tax-saving manner. You still have one more important task – to ask your client to specify the purpose, or the place, for the gift's intended use. I recently worked on a large estate of which an international environmental organization was the sole beneficiary. The decedent was a Washington resident, and her surviving spouse explained that the decedent had wanted her gift used in Washington. Unfortunately, there was no such specification in the will. The gift went to the charitable organization's national office. A portion was eventually returned to the Washington branch, but the decedent's intent was frustrated, time and money were wasted, and the surviving spouse was needlessly burdened.

Ask your client whether the gift may be used by the designated charity "wherever need is greatest" or if it is her intent that it be restricted in some manner. I have had clients specify that their gifts must be used in Washington, in Skagit County, and in the town of La Conner. Others have specified that their gifts must be used to buy toys for Children's Hospital in Seattle, to provide scholarships for older women returning to school, or to pay for a new roof for the client's church. Charities generally prefer unrestricted gifts, but you should at least make certain the gift is going to the right branch of the charity.

Be wary if your client wants to give specific property with a specific use in mind. The charity may not want the gift or may use

it for something that your client did not intend. More than once I have called a museum or university for a client who wished to make a bequest of art, only to be told that the art was not wanted and that it would be sold, not kept. You may be told that a proposed gift of books or a music collection to a local library will be more of a burden than a blessing.

Be especially careful when a client wants to give real property to an environmental organization on the assumption that the organization will keep the property and never develop it. Most environmental groups with which I have dealt keep ownership only of truly exceptional real property. More often, when they receive real property as a bequest they will sell it and use the proceeds to further their work elsewhere. If that is acceptable to your client, gift away – but if your client has definite ideas about the property's use, you will need to get the charity involved in the process of structuring the gift.

Ask the charitable organization to view the property and then discuss prospective uses of it with your client. Even if the organization agrees to accept the gift and not develop it, it is a good idea to add a clause in the client's will that directs an alternative gift in case things change. For example, you may state that if the named charity cannot or will not accept the gift and promise to keep it undeveloped, the charity shall select as an alternate beneficiary an organization which will hold the property in accordance with your client's terms and conditions. National environmental organizations are constantly working with the Department of Natural Resources, city, county and state parks departments, and Washington's many land trusts to preserve undeveloped land.

IV. Doing the Research

In searching for the names, addresses, and tax identification numbers of charitable organizations, there are a number of good websites now accessible. An excellent local resource is LEAVE A LEGACY® of Western Washington (<http://www.leavelegacy.org>). This organization, which promotes planned giving, includes more than 550 nonprofits in Western Washington. LEAVE A LEGACY® of Western Washington offers tips to lawyers, certified public accountants, financial planners and potential donors. Also helpful are <http://www.guidestar.org> (hosted by Philanthropic Research, Inc.) and <http://www.give.org> (hosted by the Better Business Bureau Wise Giving Alliance). These websites offer a wealth of information, including the percentage of each donation that is used by each charity for administration versus charitable work, financial reports, and links to many charities' websites.

It is worth the time and effort to do follow best practices in this aspect of estate planning. You get to help clients do good and help a huge variety of causes do their work. It's a true win/win situation.

Recent Developments

Real Property

by Scott B. Osborne, Preston Gates & Ellis LLP, Seattle

WASHINGTON COURT OF APPEALS

Too much water continues to cause litigation in Washington courts. The Court of Appeals had two recent opportunities to consider claims to recover property damage suffered from the effects of excessive runoff water.

Rabie v. City of Federal Way, 2002 Wn.App., LEXIS 503 (March 25, 2002), involved a claim of property damage arising from surface water runoff. Rabie bought three acres in the City of Federal Way in 1989. The property was located on Puget Sound beneath a steep bluff. At the time the property was purchased, Rabie received an engineering evaluation that noted unstable soil conditions affecting the property as a result of water runoff from bluff. Rabie filed applications for development permits in 1990. The City determined that there were wetlands on the property and, as a result, installation of the proposed drainage system necessary to stabilize the soils condition on the property was prohibited. The development permits were denied.

In 1999, Rabie sued the owners of the bluff property and the City of Federal Way, alleging that surface water runoff caused damage to Rabie's property. The owners of the bluff had installed drainage systems to stabilize their properties and the City maintained a French drain along a street that collected storm water that would otherwise flow onto Rabie's property.

In response to motions for summary judgment, Rabie presented evidence that the drainage systems maintained by the defendants increased the flow of surface water, but did not establish where the water would have flowed naturally. The trial court dismissed the claims against the property owners and the City. On appeal, Rabie contended that an issue of material fact existed as to whether the defendants unnaturally channeled water onto his land.

The Court of Appeals rejected the City's argument that the public duty doctrine shielded it from liability. A municipality may be liable for damages if it "artificially channels, collects or thrusts water onto an adjoining landowner's property." Similarly, the upland property owners, who under the common enemy doctrine may dispose of unwanted surface water without incurring liability, would be liable if they (1) blocked the water's natural drainage, (2) collected and discharged water in greater quantities or in a different manner than naturally occurring, or (3) exercised their rights under the common enemy doctrine without due care to avoid damage to the downstream owner.

The Court noted that the "flow of surface water along natural drains may be hastened or incidentally increased by artificial means, so long as the water is not ultimately diverted from its natural flow onto the property of another" and "mere increases in

volume or velocity of surface water drained into a natural watercourse are not actionable." The evidence presented by Rabie established that the drainpipes and French drain deposited water significantly above Rabie's property. The surface water then entered a natural watercourse that flowed onto Rabie's property. No evidence was presented that the drains deposited water in volumes that exceeded the capacity of the natural watercourse. Furthermore, Rabie's own expert conceded that the drains installed by the upland owners were necessary and reasonable. The fact that the upland owners would not cooperate with Rabie to replace pre-existing drains with tight-line drains emptying directly into Puget Sound did not create a question of material fact surrounding the reasonableness of the landowners' actions in exercising their right to dispose of unwanted surface water.

Whether the respondents [upland owners] will today cooperate with his [Rabie's] described remedial efforts does not establish any lack of good faith. The question of good faith goes to the installation or modification of those systems in the past. No other evidence was present regarding respondents' lack of good faith. No question of material fact has been raised on this issue.

The Court affirmed the summary dismissals of the claims based upon a lack of evidence establishing any exception to the common enemy doctrine. In discussing the shortcomings of the evidence presented by the plaintiff to oppose the motion for summary judgment, the Court provided a thorough analysis of the facts necessary to overcome the common enemy doctrine defense.

Smith v. City of Kelso, 112 Wn.App. 277, 48 P.3d 372, 2002 Wn.App. LEXIS 1441 (June 21, 2002), involved a claim for damages asserted in 1998 by owners of 150 homes damaged by landslides following three years of heavy rainfall. The plaintiffs asserted that the City of Kelso was responsible for damages for negligently approving the plats for the subdivisions in which the homes were located, or in the alternative, negligently issuing building permits for the homes. The plats were approved and the homes were built at various times during the 1970's. The City received various engineering studies concerning the plats. One study prepared in 1973 rated the soil stability of the area and found certain areas to be unstable. In 1979, another City engineer expressed concern over the soil stability of portions of the plats.

The City moved for summary judgment to dismiss the claims. The trial court denied the motion, finding that the homeowners had established that the City knew of the potential

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Recent Developments: Real Property

instability prior to the approval of the plat in which the homeowners were located or the issuance of the building permits for the homeowners' houses.

In order to establish a claim for negligence, the homeowners had to (1) establish a duty owed by the City to the homeowners, (2) prove a breach of the duty and (3) prove that the breach of the duty was the proximate cause of the harm suffered by the homeowners. In the case of a negligence claim against a municipality, the plaintiffs had to further establish that the duty was owed to an individual rather than the public in general to overcome the public duty doctrine. The Court of Appeals concluded that the homeowners failed to meet this last requirement and dismissed all of the homeowners' claims.

The plaintiffs based their claims on the City's failure to enforce (1) a municipal ordinance that required the City engineer to prepare minimum standards for construction based in part on soil conditions of the area in which a proposed plat was to be located and (2) a provision of the Uniform Building Code that required a developer to submit a soils investigation prior to obtaining a building permit.

The Court of Appeals reviewed prior Washington decisions in which liability was imposed on municipalities based on a failure to enforce an ordinance or regulation. Commenting on the prior case law, the Court observed:

In each case [in which negligence liability had been imposed based on a failure to enforce] the statute or ordinance regulated public conduct ... And a statute or ordinance then obligated a government agency to take specific action to correct a violation of the law. Here, KMC 13.04.516 obligates the city engineer to prepare design and construction standards, but it does not regulate public conduct; it requires nothing of developers or homeowners. Thus, the ordinance sets no requirements that the City can enforce against a developer or homeowner; a developer or homeowner cannot violate this ordinance. Because of this, the City cannot fail to enforce anything.

Similarly, in the case of the alleged failure to enforce the UBC provision dealing with soils investigations, the UBC did not require that the City take any specific action if the investigation was not performed. Furthermore, the UBC provision applied only if the construction occurred on fills or slopes for permanent fills greater than a 2-to-1 ratio. The plaintiffs presented no evidence that either condition was present for any of the damaged homes.

The second prong of the Court's analysis – was there an affirmative duty to take specific action in light of the violation – seemed to replace the normal requirement that in order to overcome the public duty doctrine, it is necessary to establish that the governmental action is intended to benefit not just the general public, but a specific class of individuals. Perhaps the Court was attempting to point out that in an action based on a failure to

enforce an ordinance, the municipality must intend that the enforcement of the requirement be for the express or implied benefit of specific individuals or a class of individuals, as opposed to the general public. If there was no requirement of enforcement, then the ordinance could not be construed to be intended for the benefit of any particular individual or class of individuals.

Easement rights, like any right in real property, can be extinguished through adverse possession. *Cole v. Laverty*, 112 Wn.App. 180, 2002 Wn.App. LEXIS 1433 (June 20, 2002), points out the difficulty in proving the necessary elements of adverse possession to terminate an easement.

In 2000, Cole purchased property that had an appurtenant easement "for driveway purposes and for the location and maintenance of water pipe lines and public utility connections on, over and across the South sixteen (16) feet of the North half of the North half of Lot One." Laverty owned the burdened property. In 1983, Laverty erected a fence with locked gates across the easement and placed two bathtubs, which were filled with dirt to act as planters, across one end of the easement. This action was taken to prevent "people from coming and going across the south 16 feet of [their] property." Water pipes were located in the easement area, and the pipes were never disturbed.

After Cole bought his property, he demanded the use of the easement for driveway purposes. When Laverty refused, Cole commenced a quiet title action. Laverty claimed that the easement had been extinguished through adverse possession. On a motion for summary judgment, the trial court terminated the easement with respect to driveway purposes, but quieted title as to the maintenance of utilities within the easement area.

The Court of Appeals reversed as to the termination of the driveway easement. The Court noted the difficulty of establishing the possession of the easement area in an adverse manner, since the owner of the servient estate was already in possession of the property.

Hostile use is difficult to prove. The servient estate owner has the right to use his or her land for any purpose that does not interfere with the enjoyment of the easement...

Mere nonuse, no matter how long, will not extinguish an easement... if an easement has been created and no occasion has arisen for its use, the owner of the servient estate may fence the land and that use will not be considered adverse until (1) the need for the right of way arises, (2) the owner of the dominant estate demands that the easement be opened, and (3) the owner of the servient estate refuses to do so [citing *Edmonds v. Williams*, 54 Wn.App. 632, 774 P.2d 442 (1990)].

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Recent Developments

Probate and Trust

by Alice M. McCarty, Graham & Dunn, P.C., Seattle, and Kelli M. Johnson, Seattle University law student, J.D. expected 2004

SUPREME COURT OF THE STATE OF WASHINGTON

Stokes v. Polley, 145 Wn.2d 341 (2001)

Summary: “Equity” in property is a monetary award, not a property interest. Where a dissolution decree awards one party a one-half interest in the equity of real property, that person does not acquire an ownership interest in or title to the real property. In addition, the statute of limitations will bar enforcement of a monetary award when 19 years has elapsed since the dissolution decree was entered.

Facts: In 1976, Scott Polley (“Polley”) acquired by real estate contract approximately 20 acres of property in Chelan County. He married Colleen Stokes (“Stokes”) in 1977, and they separated in May 1979. On March 29, 1980, Stokes obtained a dissolution decree presented by her attorney in a default proceeding

in Chelan County Superior Court. The decree directed that the community property of the parties be divided as follows: (a) one-half of the equity in the 20 acres of property located in Union Valley, Chelan County, Washington, to petitioner; and (b) one-half of the equity in the 20 acres of property located in Union Valley, Chelan County, Washington, to the respondent. The decree did not include a legal description of the 20 acres of real property referenced therein nor did it divide the couple’s separate property.

In 1986, Polley paid off the purchase contract and received a statutory warranty fulfillment deed. On January 7, 1993, Polley

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Recent Developments: Real Property

... What the record does not show is whether Mr. Cole’s predecessors ever used the easement right of way. The Cole property had alternative access on its southern border. If the owners of the Cole property had desired use of the easement across the Laverty property before or after 1983, any evidence of that desire is conspicuously absent from the record.

The case was remanded for trial to determine the extent of use, if any, by Cole’s predecessors in title.

Two other recent cases merit brief mention. Because the outcome of these cases is so dependent upon the specific facts, that the value of the cases as precedent is somewhat doubtful.

In *Van Blaricom v. Kronenberg*, 50 P.3d 266, 2002 Wn.App. LEXIS 1686 (July 15, 2002), an attorney had real property of the defendant attached after commencing a lawsuit without notice to the defendant and without showing any extraordinary circumstances. This occurred in 1996. The attachment followed the procedure outlined in RCW 6.25.070. The attachments were released, but the defendant in the action sued the lawyer, claiming damages for a civil rights violation under 42 U.S.C. §1983. *Tri-State Development v. Johnston*, 169 F.3d 528 (9th Cir. 1998) declared the procedure authorized by RCW 6.25.070 to be

unconstitutional. The trial court dismissed the claim on summary judgment, but the Court of Appeals reinstated the action. The Court noted, however, that in order to prove damages, it would be necessary to prove that the attorney “knew or should have known Washington’s *ex parte* prejudgment writ of attachment procedure for real property was unconstitutional.”

Josephinium Associates v. Kahli, 111 Wn.App. 617, 45 P.3d 627, 2002 Wn.App. LEXIS 783 (May 6, 2002), held that a claim of discrimination can be used as a defense to a residential unlawful detainer action. The case involved a rental arrangement in a low-income facility that offered several different rent subsidy plans. Kahli, the tenant, tendered the amount of rent that she believed was due under a subsidy plan for which she believed she was qualified. The landlord asserted that Kahli did not qualify for the amount of rent reduction that she claimed.

Where a tenant does not pay the agreed rent, the tenant’s defense must constitute an excuse for that breach. While discrimination is extremely unlikely to be such a defense, it is not a logical impossibility. This is one of those unlikely cases; if true, Kahli’s defense excused her nonpayment, because had the Josephinium not discriminated against her, Kahli would have occupied a 30 percent unit, and would have owed no more rent than she tendered.

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Recent Developments: Probate and Trust

sold the real property contract to Ken and Lori Rector who were the owners of the property at the time this lawsuit was commenced.

On December 31, 1998, Stokes filed a complaint to quiet title and partition the real property. She claimed the dissolution decree awarded her a one-half ownership interest in the real property, not merely a monetary award.

Discussion: The Court applied *de novo* review because this case involves interpreting a dissolution decree on review of a summary judgment order. The record demonstrated that the Chelan County real property was Polley's separate property. The dissolution decree purported to divide all of the community property of Polley and Stokes. The decree divided "equity" in Polley's real property. Thus, the Court concluded that the trial court characterized the "equity" of the real property as community property and divided the equity in half.

At the time of the decree, the ordinary meaning of "equity" in property was the fair market value of the property over its debts. Although the decree was silent as to the characterization of the real property and to whom it should be distributed, when the disposition of a spouse's separate property is not made in decree, it remains the separate property of that spouse after the decree. Thus, the Court concluded that the real property remained Polley's separate property. Stokes was awarded one-half of the equity, which was meant as a monetary award, not as an award of title or ownership.

Actions on a judgment or decree must be brought within 10 years. RCW 4.16.020(2). The time period begins to run the date the decree is entered. RCW 6.17.020(1). Therefore, the statute of limitations ran out in 1990. Stokes was therefore barred from enforcing her monetary award.

WASHINGTON COURT OF APPEALS

Marriage of Chumbley, 110 Wn.App. 871, (Div. II 2002)

Summary: When a company provides a married employee with stock options as part of the employee's employment benefits, those options are an asset of the community. The community has an interest in the value of the stock options and the resulting stock. Exercising the options with separate funds does not extinguish the community interest.

Facts: In 1984, Gerald Chumbley ("Chumbley") and Patricia Beckmann ("Beckmann") were married. During their marriage, Chumbley worked in residential construction and Beckmann worked as a research scientist. Beckmann earned a Ph.D. in biochemistry and pharmacology in 1985 and obtained a job at Immunex Corporation in 1988.

During the marriage, the parties accumulated substantial assets. In 1991, Beckmann inherited a significant amount of money from her father. She kept the money in a separate account, which contained \$520,914 at the time of trial. Also, Immunex granted Beckmann stock options as part of her employment. During the marriage, Beckmann exercised these options on three occasions: in December 1992, with a loan from Immunex; in May 1993, with money from Beckmann's separate account; and again, in June 1993, with money from the sale of some of the stock purchased. Beckmann would have lost the options if she had not exercised them.

In 2000, Chumbley and Beckmann dissolved their marriage. At trial, they disputed whether the stock options Beckmann exercised in May 1993 were community or separate property. The trial court concluded that the stock purchased in May 1993 with money from her separate account was Beckmann's separate property. Beckmann paid \$38,391 from her separate account for

that stock. At the time of trial, the stock was worth approximately \$549,780.

The trial court recognized that the option exercised to purchase the stock was community property. To compensate Chumbley for this, the trial court characterized the value of the option when it was exercised as community property and awarded that amount (\$50,816) to Chumbley. This amount was the difference between the market value of the stock and the cost to Beckmann, less taxes, when she exercised the options.

Chumbley appealed the trial court's decision.

Discussion: The parties agree that all of the Immunex stock options were community property, but they disagree as to the character of the stock Beckmann acquired with separate funds. The Appeals Court reviewed whether employee stock options acquired with separate funds are separate or community property. Assets acquired during marriage are presumed to be community property under RCW 26.16.030. An asset assumes its character as community or separate stock when it is acquired. *In re Marriage of Zahm*, 138 Wn.2d 213, 223 (1999).

First, the Court reviewed *In re Marriage of Sedlock*, 69 Wn.App. 484 (1993) and *In re Marriage of Harrington*, 85 Wn.App. 613 (1997). In both cases, the parties acquired stock by exercising a community option with separate funds after the marriage was dissolved. The Court held that the stock options exercised with separate funds resulted in a community asset.

The Court applied the analysis of *Sedlock* and *Harrington* and determined that the trial court correctly found that the options were community property and the value of the option when exercised was a community asset. However, the Court ruled that the trial court erred when it reasoned that "a community property

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Recent Developments: Probate and Trust

asset can become a separate property asset if separate funds are used to acquire that community property asset.” Instead, the Court ruled that the community had an interest not only in the value of the stock options, but also in the resulting stock. Therefore, exercising the options did not extinguish the community interest.

Second, the Court considered the proper distribution of the increase in value of the stock. It agreed with the *Sedlock* court that the use of separate funds “had nothing to do with the increases in value of the stock at issue.” *Sedlock*, 69 Wn.App. at 508. The community owned the right to purchase stock at a fixed price and market forces increased the value of the both the stock options and the stock. As a result, the Court held that the stock purchased in May 1993 was community property and that Beckman had a lien claim for the amount of her separate contribution.

The Court of Appeals remanded the case back to the trial court to redistribute the property with the May 1993 stock considered community property.

In re Estate Garwood, 109 Wn.App. 811 (Div. II 2002)

Summary: RCW 11.54.010 requires the surviving spouse, if there is one, to first petition for an award in lieu of homestead, before the decedent’s adult child, who is not the surviving spouse’s child, may petition to divide the award. The Court does not address whether an adult child can petition to divide an award or whether the statute is constitutional.

Facts: Kathleen Promisel Garwood (“Garwood”) died on April 21, 2000, survived by the following heirs: her second husband, Robert Garwood (“Robert”); her daughter from a previous marriage, Shonda Promisel (“Shonda”); and her adopted son, Keith Promisel (“Keith”). In her handwritten will, Garwood left the remainder of any amount owed her under her settlement agreement with her first husband to Shonda and Keith equally. She left all other assets to Robert, her surviving spouse. There was no money owed on the settlement, so Shonda and Keith received nothing under their mother’s will.

The Court granted Shonda a \$40,000 award in lieu of homestead. Robert did not petition for a homestead award and objected to Shonda’s award.

Discussion: The Court reviewed *de novo* the meaning of RCW 11.54.010 to determine the legislature’s intent. The Court held that the language of the entire statute does not appear to allow a decedent’s adult child to petition the court for an award from the decedent’s estate unless such child is a minor. In addition, the Court looked to RCW 11.54.020, which allows the basic award to be divided between a surviving spouse and the decedent’s children, who are not the children of the surviving spouse. The Court determined that the surviving spouse’s petition for the award was a condition precedent to the petition of a decedent’s child. Therefore, the Court concluded that the plain meaning of RCW 11.54.010 was sufficient to find that the statute did not grant adult children a right to a portion of the award or an independent award, absent the surviving spouse first petitioning for an award.

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PROBATE & TRUST COUNCIL REPORT

*by Lora L. Brown, Stokes Lawrence, P.S., Seattle
Director - Probate & Trust Council*

As we near a change of season, our Section begins its new fiscal year. We also welcome new members of the WSBA to our Section. The Section's leadership will convene in late September for its annual retreat. At the meeting, the executive committee will analyze the results of the recent membership survey and focus on ways to better serve our members. We will dissect the question of how to involve more of you with the Section itself – whether through participating on the executive committee, involvement with legislative matters, writing for the newsletter, speaking at a CLE in the coming year, or joining and becoming active in the new Section listserve.

I want to encourage new Bar and Sections members to make yourselves known to us. Being involved with our Section introduced me to many leading lawyers in my practice area as well as to new ideas and practice tips. I can say easily that over the past decade of my practice, some of my most treasured professional relationships have come through my involvement with our Section.

Enticing involvement in anything, let alone volunteer work, is never easy. The payoff for serving our Section may not initially seem tangible, at least not tangible in the usual sense with which we are familiar when we track the hours of our work day. When I recently agreed to return to the executive committee, I considered the amount of time and energy I would be committing to my new role as director of the Probate and Trust Council. The motto I often turn to when feeling a bit put off by some deadline I agreed to meet sits next to my computer. “We make a living by what we get; we make a life by what we give.” (Winston Churchill.) It's because of that sentiment, and my prior experience with the Section, that I agreed to serve again.

Added to my busy practice is the recent addition of a toddler daughter from Bulgaria. Talley is just wonderful, but I have never been so tired in my life! And even with the year-plus of preparation, planning and waiting, at times I feel so completely out of my element. This new stage of my life reminds me at times of the first few years of practicing law – the transition from “book” law to “real” law. Swimming in deep water, completely unaware of how

much I didn't know that I didn't know! As trust law continues to change and tax acts come and go, these professional challenges continue.

In very concrete ways, our Section is here to help you make sense of your practice (especially for newer attorneys). The Section will assist you in creating and maintaining relationships with experts and other lawyers who may be working on issues similar to those before you, keep you posted on legislative changes, and introduce you to resources that can make your practice more successful and rewarding.

If our Section is to continue to successfully pursue these lofty but attainable goals, we need the involvement of our members who will devote time and energy to helping us do just that. We are fortunate to have the commitment of a number of fine individuals who give tirelessly to our Section, namely members of our Probate and Trust Council (Barbara C. Sherland, outgoing Section Chair; Thomas M. Culbertson, Section Chair-Elect; Charles W. Riley, Jr.; Alfred M. Falk; James A. Flaggert; and Alan H. Kane), Website Editor Douglas C. Lawrence, and Newsletter Editor Beth McCaw. Numerous other members present materials at Section-sponsored CLEs, serve on legislative committees and prepare articles or updates for our newsletter.

I want to thank Barbara Sherland for the endless amounts of time and energy that she devoted to our Section over the past four years as Probate and Trust Council Director and Section Chair. Barbara has contributed to our Section for many years, and she has inspired me to serve in similar roles.

So I ask, why should you join us? The hours that Section work requires are those you might otherwise use to exercise, sleep, spend with family, or maybe watch the Mariners. And yet, it is precisely this investment of time and energy that will eventually lead to real returns in your life, in your practice, and in your legal community. As the new Section year begins, I hope you will join me and make a commitment to become involved with our Section. Contact any member of the executive committee (we are listed in this Newsletter and on the Section's website) to let us know who you are. We look forward to working with you.

REAL PROPERTY COUNCIL REPORT

*by William H. Reetz, LandAmerica Financial Group, Seattle
Director – Real Property Council*

For several reasons, this issue's report will be short and sweet. First and foremost, I am woefully late. Summers seem full of time and opportunity at the outset. Then vacations are taken and files requiring immediate attention appear on your desk – but they were not your files the previous day. Each year seems to bring the unexpected, whether it is illness or employee changes. You have all been there. So I sit here post-Labor Day making New Year-type resolutions to make sure next summer flows more evenly than this past one.

Second, for the executive committee, the period between the Mid-year (Annual) Meeting and the fall retreat is largely time away from Section business. No proposed legislation affecting real property has passed my desk as yet. I did receive word that legislation dealing with predatory lending practices will receive attention this upcoming session. Several bills were introduced last session but died without action. One bill in particular had serious implications for foreclosures. I intend to propose a special subcommittee to follow these bills and work with the sponsors to resolve real property issues.

You will recall discussion in previous Newsletters of a joint task force whose purpose was to develop a legislative solution to the reconveyance mess that clouds title to many, many properties.

The task force began as a collaborative effort between the title industry and our Section but later grew to include lender, escrow and foreclosure representatives. As the number of representative groups grew, so did the agenda. An effort was made to address problems associated with foreclosures conducted by non-resident trustees. We also looked at the creation of financial responsibilities for trustees that are not otherwise regulated (e.g. WSBA, Insurance Commissioner, Department of Financial Institutions regulate attorneys, title companies and registered escrow agents). This proved to be a much more complex task than originally perceived. I see the scope of the task force returning to the reconveyance problem in the coming year, and the trustee issue being addressed separately.

This fall's real property seminar will focus on selected real estate issues in financially distressed times. We have seen many major projects affected, or even put on hold, by the state of the economy. Please take a careful look at the seminar brochure when it comes out. The program will be very interesting.

Last, but not least, I offer my apologies to Michael Barrett who serves as our Assistant Newsletter Editor for the inadvertent misspelling of his name in the last Newsletter.

HOW TO REACH US

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CLE Credits for Pro Bono Work?

Limited License to Practice with No MCLE Requirements?

Yes, it's possible!

Regulation 103(g) of the Washington State Board of Continuing Legal Education allows WSBA members to earn up to six (6) hours of credit annually for providing pro bono direct representation under the auspices of a qualified legal services provider.

APR 8(e) creates a limited license status of Emeritus for attorneys otherwise retired from the practice of law, to practice pro bono legal services through a qualified legal services organization.

For further information contact Sharlene Steele, WSBA Access to Justice Liaison, at 206-727-8262 or sharlene@wsba.org.

INFORMATION FOR YOUR CLIENTS

Did you know that easy-to-understand pamphlets on a wide variety of legal topics are available from the WSBA? For a very low cost, you can provide your clients with helpful information. Pamphlets cover a wide range of topics:

- Alternatives to Court
- Bankruptcy
- Buying and Selling Real Estate
- Consulting a Lawyer
- Criminal Law
- Dissolution
- Elder Law
- Landlord/Tenant Rights
- Lawyers' Fund for Client Protection
- Legal Fees
- Marriage
- Parenting Act
- Probate
- Revocable Living Trust
- Signing Documents
- Trusts
- Wills

Each topic is sold separately. Pamphlets are \$9 for 25, \$15 for 50, \$20 for 75, and \$25 for 100. Pricing for larger quantities is available on request.

Additionally, copies of *The Law Book*, a special supplement to the King County Journal newspapers, are available. The 12-page tabloid includes articles by WSBA members on a wide range of topics. The cost is \$20 for 100 copies.

To place your order or for more information, please contact the WSBA Service Center at 800-945-WSBA or 206-443-WSBA. Sales tax is applicable to all in-state orders.

Speak Out!

Wanted: Lawyers to volunteer to speak to schools and community groups on a variety of topics. For more information about the WSBA speakers bureau call Amy O'Donnell at 206-727-8213.



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We're here to serve you! The mission of the WSBA Service Center is to respond promptly to questions and requests for information from our members and the public.

Call us Monday through Friday, from 8:00 a.m. to 5:00 p.m., or e-mail us at *questions@wsba.org*.

Assistance is only a phone call or an e-mail away.

Join Today!

The officers of the Real Property, Probate & Trust Section urge you to become an active member of this important section. All members of the Washington State Bar Association are eligible. Simply fill out the form below and mail with a check for \$15 to: **Real Property, Probate & Trust Section, Attn: Section Liaison, Washington State Bar Association, 2101 Fourth Avenue, Suite 400, Seattle, WA 98121-2330**

RPPT SECTION MEMBERSHIP FORM

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- Please enroll me as an active member of the Real Property, Probate & Trust Section. My \$15 annual dues are enclosed.
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