

# Real Property, Probate & Trust



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## What Can (and Can't) an Architectural Control Committee Do? *Your Home Is Our Castle*

by Brian P. McLean and Terrence A. Leahy

### I. Introduction

“A man’s home is his castle.”

These words—first uttered by Clarence Darrow in defense of a black man on trial for defending his home against a mob—are now deeply rooted within each of us privileged to own a home. This bedrock belief is being uprooted, however, by cases that embody a different notion: That your home is actually *our* castle.

This transformation arises from the emergence and growth of common interest communities—condominiums and subdivisions—which create owners’ associations to maintain common areas and to constrain impactful conduct. It is through the owners’ association’s exercise of its design-review authority, imparted to it through recorded covenants, that homeowners most frequently experience this cultural shift from “my” home to “our” home.

But how much say does your neighborhood really have over what form your castle takes or how you use it? This is precisely the puzzle courts in Washington and elsewhere are trying to solve. This article describes one approach a court may take in these cases.

Design restrictions come in two basic forms: (1) simple absolute restrictions; and (2) complex discretionary restrictions.

A simple absolute restriction is one the covenants themselves expressly create. A twenty-five-foot rear yard setback is a good example.

A complex discretionary restriction is one a committee creates, through its well-informed exercise of discretion. An architectural control committee’s (hereinafter sometimes referred to as the “ACC”) decision rejecting an owner’s choice of bright orange as the exterior paint color for his home is a good example of a complex discretionary restriction.

### II. Judicial Review: Checklist

How will a Washington judge arrive at a decision in a case involving design restrictions? By asking, and finding answers to, the questions below. At least that is what cases here and elsewhere seem to suggest.

#### A. What Does the Restriction Mean?

Covenant restrictions are often unclear. Enforcing a restriction commonly requires first clarifying it.

Strict construction was once the rule in Washington. Courts consistently held that (1) a covenant will not be extended by implication, and (2) a covenant must be construed in favor of the free use of land. *White v. Wilhelm*, 34 Wn. App. 763, 772, 665 P.2d 407 (1983). Strict construction resolved all ambiguities in favor of the free use of land and rejected attempts to extend restrictions beyond their literal reach.

But with its decision in *Riss v. Angel*, 131 Wn.2d 612, 621-624, 934 P.2d 669 (1997), the Washington State Supreme Court discarded “strict construction,” replacing it with the “context rule.”

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## What Can (and Can't) an Architectural Control Committee Do?

The "context rule," used in interpreting contract ambiguities, favors first discerning the parties' intent, then construing ambiguous terms in a way that gives effect to that intent. *Hollis v. Garwall, Inc.*, 137 Wn.2d 683, 695-697, 974 P.2d 836 (1999). Under this broader context rule of construction, a court has more latitude to enforce what was meant, rather than enforcing only that which was actually said.

"Discerning the parties' intent" in a covenants case means identifying the developer's "common plan purpose." This is not always an easy task. *See, e.g., Johnson v. Mt. Baker Park Presbyterian Church*, 113 Wash. 458, 194 P. 536 (1920). What future did the developer envision for the development? Something out of "Leave It to Beaver," with two-story homes framed by tall shade trees? Or, instead, a place where daylight-basement-ramblers and sparse vegetation serve to preserve spectacular lake and mountain views?

It makes a real difference. In *Leave-It-to-Beaverville*, a restriction against "mass plantings" might be narrowly construed to preserve trees; in the view community, however, the mass plantings restriction might be broadly construed to favor and preserve views against encroaching vegetation.

### B. Is the Use Restriction Valid?

The next question a court may ask is whether the use restriction is valid. In the oft-cited case *Hidden Harbour Estates, Inc. v. Basso*, 393 So.2d 637 (Fla. Dist. Ct. App. 1981), the Florida court held that covenants recorded of record should be accorded a strong presumption of validity because a buyer presumably knows of and accepts the restrictions when he purchases his home.

### C. What Standard of Review Does the Court Apply in Reviewing a Review Committee's Decision?

In *Riss*, the Court held that a board can exercise broad authority conferred by the covenants to review and approve (or disapprove) building plans, even though the decision making criteria set forth in the covenants were vague. The Court went on to hold that, in exercising its discretion to approve or disapprove plans, the board must act reasonably and in good faith. *Riss*, 131 Wn.2d at 625.

The Court held that the authority had not, in that case, been exercised reasonably and in good faith because the board, in exercising its discretion, failed to adequately investigate the relevant facts, then based its decision upon inaccurate information and then lobbied the entire membership to ratify its decision. *Riss*, 131 Wn.2d at 628. *See also Day v. Santorsola*, 118 Wn. App. 746, 758-760, 76 P.3d 1190 (2003), *rev. denied*, 151 Wn.2d 1018 (2004). A later Washington State Supreme Court case that addressed the applicable standard of review, *Shorewood West Condominium Ass'n v. Sadri*, 140 Wn.2d 47, 992 P.2d 1008 (2000), is notable for its express decision *not* to adopt a standard for reviewing an association's decision making process. *Sadri*,

140 Wn.2d at 49-50. At any rate, application of a reasonableness test to complex discretionary ACC decisions appears to be the trend if not the majority rule. *See, e.g., Norris v. Phillips*, 626 P.2d 717, 719 (Colo. App., 1980); *Country Club of Louisiana Property Owners Ass'n, Inc. v. Dornier*, 691 So.2d 142, 150 (La. App. 1997).

The precise contours of the courts' reasonableness standard are still evolving, making it hard to set out specific elements of this "reasonableness" test. Attorney Marion Morgenstern, has elsewhere suggested that the characteristics of "reasonable" ACC decision-making are that:

- The decision be within the scope of authority delegated to the ACC;
- The decision be consistent with the covenants;
- The decision be based on adequate investigation and on adequate facts;
- The applicant owner should have an opportunity to address issues raised by affected neighbors or the ACC; and
- The decision should be rendered in writing.

*See Marion Morgenstern, ARCHITECTURAL REVIEW RESTRICTIONS AND ASSOCIATION-DECISION MAKING, WSBA 8th Annual Fall Real Estate Conference, October 2001.*

As is apparent from Ms. Morgenstern's list, the "reasonableness" standard is something of a broad umbrella, stretching to encompass many of the specific questions set forth below. And the "reasonableness" standard is applied with the benefit of 20-20 hindsight, which makes it even more important to discretely analyze each separate issue a court is likely to consider in applying this broad standard of review.

### D. Does Design Review Authority Even Exist?

Merely because written covenants impart design review authority to an owners' association does not necessarily mean that the authority to review exists. Questions that need to be considered here include:

1. Have the covenants lapsed?
2. Has the community abandoned the covenants?

A court will not enforce a covenant when it has been "habitually and substantially violated so as to create an impression that it has been abandoned." *Sandy Point Improvement Co. v. Huber*, 26 Wn. App. 317, 319, 613 P.2d 160 (1980). In practice, courts are reluctant to find that covenants have been abandoned, perhaps because such rulings may foster an undesirable hyper-vigilant stance by associations on enforcement matters, a stance driven by fear that failure to aggressively prosecute each and every violation may result in ruling that the covenants have been abandoned.

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## What Can (and Can't) an Architectural Control Committee Do?

### 3. Has the ACC ceased to exist?

A once-functioning ACC can evaporate due to lack of interest, need or volunteers. *White*, 34 Wn. App. 770-771.

### E. May the Current Members of the ACC Actually Serve?

A seemingly valid ACC may lack authority to act as a body because one or some of its members are not entitled to serve. In exploring this, a court may ask the following questions:

1. Did the members currently serving validly gain their seat on the ACC?

In *Hartstene Pointe Maintenance Association v. Diehl*, 95 Wn. App. 339, 343-344, 979 P.2d 854 (1999), the Court invalidated the action of an ACC because it did not have two Board members on the ACC, as required by its governing documents.

2. Does a member of the ACC have a conflict of interest that disqualifies the member from serving on the committee in the specific case in question?

This was a significant problem for the reviewing committee in *Day v. Santorsola*, *supra*.

### F. Does the ACC Have Subject Matter Jurisdiction?

Covenants frequently use imprecise words to describe the object or activity that will trigger the owner's duty to submit to design review and the ACC's right to approve, condition or deny the proposal. This imprecision gives rise to arguments about whether a particular object or activity actually triggered design review. Resolving this dispute often involves applying the context rule and interpreting the ambiguous term in a manner that best advances the common plan purpose(s). The inquiry is basically whether the vague word used was intended to reach the object or activity in question in the particular case.

### G. What is the Scope of the ACC's Authority?

The two main questions regarding scope of the ACC's authority are these:

1. Did the ACC approve a design that will violate a simple absolute restriction?

Absent the express creation of a right to grant variances in the covenants themselves, an ACC cannot approve a proposal that will violate a simple absolute restriction. For example, an ACC cannot grant approval to build a fence within the front yard setback where the covenants specifically prohibit fences within the front yard setback.

2. Did the ACC reject a design by applying a restriction more stringent than simple absolute restrictions in the covenants?

This is a more vexing problem. It often involves an ACC that imposes a more stringent restriction on a specific proposal than the more general simple absolute restriction in the covenants. In *Riss*, our Supreme Court held that "a homeowners association may not impose restrictions under a general consent to construction covenant which are more burdensome than provided for by specific objective restrictive covenants." *Riss*, 131 Wn.2d at 638.

Some observers first viewed the ruling in *Riss* as creating a bright line standard, flatly prohibiting an ACC from ever imposing more stringent restrictions than those simple absolute restrictions contained in the covenants. This view has given way in recent years to the view that it really depends on the intent of the declarant, as embodied in the covenants. If the declarant intended to give the ACC the power to impose more stringent restrictions, than the ACC has that power. If the declarant did not so intend, then the ACC does not possess the power. In *Piepkorn v. Adams*, 102 Wn. App. 673, 10 P.3d 428 (2000), for example, the Court upheld a front yard setback condition that an architectural control committee imposed on a proposed fence through the committee's exercise of its authority to consider the

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“harmony” of a proposed fence design. *See also* RESTATEMENT (THIRD) OF SERVITUDES § 6.9 cmt. c (2000).

### H. Did the Owner Know What to Expect?

As previously noted, courts are more willing to hold an owner to the “terms of the bargain” if that owner had a good inkling of what those terms were. There are two ways in which notice of those “terms” can be imparted to the owner. The first is actual notice: through written standards and guidelines that the ACC adopts and distributes to owners. The second is constructive notice: in the absence of written standards and guidelines, notice of these “terms” can be imparted by consistency in the outcome of prior ACC decisions on similar proposals. Therefore, the two questions a court will consider here are these:

1. Were there written standards?
2. Was the owner constructively aware of unwritten standards?

### I. Did the ACC Have Its Own Affairs in Order?

A court that has a sense that the ACC generally had its act together is slightly more likely to grant the ACC a presumption of validity when examining the specific ACC decision being challenged in the case. An answer to any one question below does not necessarily determine the outcome of a case, but positive answers obviously “help” the court gain some degree of confidence that the ACC knew what it was doing. Note that because application of a “reasonableness” standard is, by its very nature, an iterative process, some questions listed elsewhere also appear on this list.

1. Did the ACC have written standards?
2. Did owners have or know of the written standards?
3. Did the ACC have written procedures?
4. Did the written procedures create an adequate opportunity for the proponent and opponent to provide meaningful input so that the ACC’s final decision could be a fully informed decision?
5. Did the ACC act consistently on prior proposals of this type?

### J. Did the ACC Apply Its Procedures and Standards to the Case at Hand?

There is a potential downside to written standards and procedures: The ACC might forget to use them. Washington appellate courts have invalidated ACC actions that did not conform to written standards or procedures. *See, e.g., Mariners Cove Beach Club, Inc. v. Kairez*, 93 Wn. App. 886, 970 P.2d 825 (1999).

### K. Did the ACC Perform Its Function Diligently and in Good Faith?

All the preceding questions lead to this, the ultimate question under Washington’s “reasonableness” standard: Did the ACC, in this case, exercise its authority reasonably and in good faith? And the court arrives at its answer to the question by first examining a series of questions that isolate, for consideration, the various parts of the ACC decision making process that the court should consider in order to arrive at an accurate decision on whether the ACC action passes (or fails) the “reasonableness” test. Again, some of the questions here are also considered – and thus listed – in connection with other questions identified above. And, again, these questions capture factors the Court should consider – the answer to any one question is typically not determinative of the ultimate outcome.

1. Did it exclude biased persons from the ACC? *See Day*, 118 Wn. App. at 759.
2. Did its members fully inform themselves, including visiting the site? *See Riss*, 131 Wn.2d at 627, 628.
3. Did it afford interested parties a full and fair opportunity to present information for the ACC to consider? *See Riss*, 131 Wn.2d at 627
4. Did it gather all the relevant information it needed to have in order to make a fully informed decision? *See Riss*, 131 Wn.2d at 633; *Heath v. Uruga*, 106 Wn. App. 506, 519, 24 P.3d 413 (2001), *rev. denied*, 145 Wn.2d 1016 (2002).
5. Did it take steps to verify that the information it intended to rely upon was accurate? *See Riss*, 131 Wn.2d at 628.
6. Did it seek information from an “expert”? *See Heath*, 106 Wn. App. at 518, 520.
7. Did it actually consider the information it collected? *See Heath*, 106 Wn. App. at 518.
8. Did it correctly apply the standards to the facts? *See Heath*, 106 Wn. App. at 518; *Mariners Cove Beach Club, Inc.*, 93 Wn. App. at 891.
9. Does its decision advance the common plan? *Shafer v. Board of Trustees of Sandy Hook Yacht Club Estates, Inc.* 76 Wn. App. 267, 273-274, 883 P.2d 1387 (1994).
10. Is the decision consistent with ACC decisions on similar applications? *See, e.g., Beckett Ridge Ass’n-I v. Agne*, 498 N.E.2d 223, 226 (Ohio App. 1985) (upholding clothesline restriction that had been “strictly and uniformly applied”).

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### **What Can (and Can't) an Architectural Control Committee Do?**

11. If the decision is different than decisions on past similar applications, has the ACC articulated valid and reasonable justifications for distinguishing the present application from the previous ones? *See, e.g., Ladner v. Plaza Del Prado Condominium Ass'n, Inc.* 423 So.2d 927, 930 (Fla. Dist. Ct. App. 1982) (association not engaged in selective enforcement of covenant requiring approval of terrace-railing changes; prior changes made without board approval occurred while association still under developer control).
12. Is its decision in writing? *See, e.g., Snowmass Am. Corp. v. Schoenheit*, 524 P.2d 645, 648 (Colo. Ct. App. 1974) (committee gave written notice of reasons for disapproval, made suggestions to remedy defects, and allowed owner time to modify plans to obtain approval).
13. Does it set forth its findings and conclusions supporting its decision—that is, does it explain how it got from the evidence to the decision? *See, e.g., Snowmass, supra*.
14. If the decision denies approval of a proposal, does it describe why the proposal was rejected or what alternative actions might be approved? *See, e.g., Snowmass, supra*.

15. Does it afford the applicant with an opportunity to revise the proposal? *See, e.g., Snowmass, supra*.

#### **III. Conclusion**

So whose home is it, yours or ours? It's a little of both, according to the reported cases thus far.

Yes, the architectural control committee has a say in what form your castle takes. But there are limits. Limits on who can decide. Limits on what process the ACC must follow. Limits on what standards the ACC may apply in reaching its decision. And as more cases are decided, the line that distinguishes "mine" from "ours" may become ever easier to discern.

*Brian P. McLean is principal at Pacific Northwest Legal Services, LLC, a law firm that provides legal services to condominiums, homeowner and neighborhood associations, clients with appeals, and small businesses. He writes and lectures frequently on issues related to common interest ownership and is a current member of the Community Associations Institute. For more information see his website at [www.pnwls.com](http://www.pnwls.com).*

*Terrence A. Leahy, the founder of Leahy.ps, a Kirkland law firm, represents many common interest communities, as well as owners involved in disputes with their associations. He writes and lectures frequently on community association legal issues. He belongs to, and currently serves on the board of, the Washington Chapter of the Community Associations Institute.*

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#### **Editor's Note**

On page 5 of the Summer 2004 RPPT Newsletter, the gift tax exemption was erroneously listed as \$1,500,000. The correct amount of the gift tax exemption is \$1,000,000 per donor.

#### **Article Ideas?**

Please contact Ken Kilbreath if you are interested in writing an article for the newsletter or if you have ideas for article topics. Ken's phone number is (425) 455-1234 and his email is [kkilbreath@insleebest.com](mailto:kkilbreath@insleebest.com).

# Total Return Trusts

by David B. Sweeney, Smith & Zuccarini, P.S.

*"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."*

Charles Darwin, British naturalist and author of *On the Origin of the Species* on the mechanics of evolution and natural selection, 1809-82.<sup>1</sup>

## 1. What Is a Total Return Trust?

An article in the summer 2001 issue of the *Real Property, Probate and Trust Journal* defines a total return trust as "a trust that allows the trustee to invest for total return and does not define distributions to the beneficiary in terms of accounting income."<sup>2</sup>

Investing for total return means that the trustee would not have to invest half of the assets, for example, to produce a high income for the income beneficiary, and the other half to invest in growth stocks for the benefit of the remainder beneficiary. The trustee could simply do what it thought best to achieve the overall total optimal return for the portfolio. At a particular time, it might mean investing more in fixed-income obligations, and, at another time, it might mean investing more in equities.

A trust that allows the trustee to invest for total return must be a trust that does not have language in it prohibiting this type of investment approach or instructing the trustee to invest in a different way. In addition, state law must allow such an investment approach.

A trust that defines distributions to a beneficiary in terms of accounting income might provide, for example, that all (or some fixed portion) of the net income is to be distributed to a beneficiary.

When the stock market was doing well in the late 1990s, trustees perhaps would have liked to invest a larger portion of the trust assets in the stock market, but doing so might have resulted in less income to an income beneficiary. Trustees may have thought that if they could only be removed from the obligation to produce a large net income for an income beneficiary, then both trustee and beneficiaries would be much happier. Corporate trustees were under great pressure from income and remainder beneficiaries to change the investment allocation to benefit either the income beneficiary or the remainderman. No one was happy.

The result was a series of changes to the Uniform Principal and Income Act in various states, including Washington. The changes allowed trustees to adjust between principal and income or to convert from an income-only trust to a unitrust. A "unitrust" is a term that came from charitable trusts, meaning a trust that provides for an annual distribution equal to some percentage of the total value of the assets in the trust. A unitrust is, thus, one type of a total return trust. Note that a credit-shelter-type trust that provides for discretionary distributions of income and principal would be another type of total return trust, so long as the document allows the trustee to invest for total return and does not define distributions to the beneficiary in terms of accounting income.

## 2. Investing for Total Return.

RCW 11.100.020, which was enacted in 1995, provides how a trustee is to invest funds in Washington. There is nothing in the statute prohibiting a trustee from investing for total return. However, a factor set forth in the statute that should be considered

by a fiduciary in applying the total asset management approach is the probable income from the investment. A total return unitrust could contain language in it expressly authorizing the trustee to make investments without regard to the amount of income the Trustee generates. "Put positively, the trustee might be authorized to invest for the overall return produced by the trust without regard to the income produced by the assets."<sup>3</sup>

## 3. Drafting Total Return Trusts.

In a standard arrangement of Wills between a husband and wife with a credit shelter trust and a QTIP trust with the survivor as trustee, the credit shelter trust could provide that the survivor, as trustee, would pay himself or herself so much of the income and principal as he or she needs. The credit shelter trust would be considered a total return trust because distributions are not defined in terms of accounting income. So long as there are no restrictions on investments, the trustee could invest for total return. The QTIP trust cannot be a total return trust, because it defines distributions in terms of income, although it typically also allows for distributions from principal. Therefore, the trustee would not be limited to a distribution of only income, and if the trustee were the spouse, the trustee may feel no obvious conflict in trying to invest for income or growth.

However, if the trustee is not the surviving spouse, things are not as easy. If the trustee is a child by the decedent's previous marriage or a residual beneficiary of the trust, there is an immediate conflict between the spouse's desire for income and the remainder beneficiary's desire for growth. In this arrangement, if there were a mandatory distribution from both trusts of, say, at least 4 percent of the trust assets in each year, then the conflict is likely removed. However, if the surviving spouse does not need a lot of money from the credit shelter trust, such a mandatory distribution from the credit shelter trust would result in amounts being paid out of such trust that otherwise might not need to be paid out.

Whenever a unitrust amount is provided for, drastic changes in the amounts of distributions would be smoothed over if the unitrust amount were figured by averaging the value of the assets over three years. The assets could be valued over the last three years, as of the end of the year each year, and the average taken. That figure would then be multiplied by 4 percent and the result would be divided by 12 as the amount of the monthly distribution.<sup>4</sup>

## 4. The Washington Principal and Income Act of 2002.

Because of changes in the Washington Principal and Income Act (the "2002 Act"), it is possible now to have a total return unitrust without having that language in the document. The 2002 Act went into effect on January 1, 2003. It replaced the previous Principal and Income Act with a modernized version. The most interesting changes affect trusts by providing that all of the net

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## **Total Return Trusts**

income is to be distributed every year. The 2002 Act provides (a) a mechanism for adjusting the net income figure and (b) a mechanism for converting the trust to a unitrust, so that 4 percent of the value of the trust, instead of the net income, can be distributed every year.

Washington's new law is based on the Uniform Principal and Income Act, which was approved in 1997 and recommended for enactment in all states by the National Conference of Commissioners on Uniform State Laws. Other states have passed similar, but not necessarily identical, laws.

The purpose of the 2002 Act was to fit with the principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than for a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents. The 2002 Act helps the trustee who has made a prudent, modern portfolio-based investment decision that may perhaps reduce ordinary income but increase total return. For example, a trustee may manage a trust for a surviving spouse to pay all of the net income to that spouse, and then on the surviving spouse's death, the trust assets pass to children from the first spouse's prior marriage. This would create tension between the need to produce income for the surviving spouse and the need to produce growth in the value of the assets for the children. If the trust could be converted to a unitrust so that 4 percent of the value of the assets every year could be paid to the surviving spouse, then the trustee would be free to invest for total return and would be free from this tension.

### **A. Power to Adjust Between Principal and Income**

Section 104 of the 2002 Act (RCW 11.104A.020) gives a trustee the power to adjust between principal and income to the extent the trustee considers it necessary if: (a) the trustee invests and manages trust assets as a prudent investor; (b) the trust describes the amount that must be distributed by referring to the trust's income; and (c) the trustee determines that the trustee is unable to comply with the trustee's duty of impartiality, based on what is fair and reasonable to all of the beneficiaries, without making an adjustment. The trustee may not adjust income and principal if the trustee is also a beneficiary. The power to adjust income and principal would allow the trustee to distribute to the beneficiaries more than net income, or less than net income, if the trustee determines that such an adjustment would be fair to the income beneficiaries and to the remainder beneficiaries. Such an adjustment does not require the consent of the beneficiaries.

Section 104(b) of the 2002 Act (RCW 11.104A.020(b)) lists a number of factors the trustee is to consider in deciding whether to make an adjustment between principal and income. An adjustment may not be made that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax marital deduction would be allowed. An adjustment may not be made if the adjustment would benefit the trustee, directly or indirectly.

### **B. Power to Convert to a Unitrust**

Alternatively, according to section 106 of the 2002 Act (RCW 11.104A.040), the trustee can give up the power to make an adjustment between income and principal. After notifying the beneficiaries and if none of the beneficiaries object, the trustee can convert the income trust into a unitrust with an annual distribution to the income beneficiaries of 4 percent of the value of the trust.

The beneficiaries also have remedies in the 2002 Act. The parties as defined in the 2002 Act may agree to convert to a unitrust by means of a binding agreement under RCW chapter 11.96A, or the trustee may petition the court to order a conversion to a unitrust if a party objects to the conversion. A beneficiary may request a trustee to convert a trust to a unitrust and, if the trustee does not convert it, may petition the court to order the conversion. The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust. The trustee or, if the trustee declines to do so, a beneficiary may petition the court to select a payout percentage different from 4 percent.

Note that the power to adjust between income and principal is a more flexible power than the power to convert to a unitrust. Adjustments can be made differently from year to year. For example, there may come a time when a 4 percent distribution is considered too small of a distribution, if interest rates are much higher than 4 percent. A conversion to a unitrust may not be appropriate when the trust assets consist of real estate or a closely held business interest if the income thereon may be insufficient for a 4 percent mandatory distribution. Converting to a unitrust may result in assets having to be sold over time. A conversion would be appropriate in cases in which the assets are securities, perhaps increasing in value, but not producing a reasonable income.<sup>5</sup> Of course, even then, if the income is insufficient to generate a 4 percent distribution, assets may have to be sold, possibly causing a capital gains tax.

### **5. Regulations Under Internal Revenue Code § 643(b).**

The IRS has enacted regulations discussing the income tax effect of such an adjustment between income and principal or conversion to a unitrust. There has been a concern that converting an income-only trust to a unitrust would constitute a taxable sale or exchange and trigger capital gains taxes going all the way back to the original cost basis of the assets in the trust. This would not be a problem with a newly established trust, but could be a serious problem with respect to long-standing trusts. The U.S. Supreme Court case *Cottage Savings Association v. Commissioner of Internal Revenue*, 499 U.S. 554 (1991) and a Private Letter Ruling, Priv. Ltr. Rul. 200231011 (May 6, 2002), are the rationale for such a result. Because of this concern, many bank trust

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departments were using the power to adjust between income and principal rather than converting to a unitrust.

However, on December 30, 2003, the IRS issued its final regulations ("the regulations") (Definition of Income for Trust Purposes, T.D. 9102, 2004 WL 19477, at \*12 (Jan. 2, 2004)) amending the definition of income under Section 643(b) of the Internal Revenue Code. "Income" means the amount of income "of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." *Id.* at \*19. The definition of income is used as a measure of the income that must be distributed from a trust in order for the trust to qualify for certain treatment under various provisions of the Code.<sup>6</sup>

However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year.... For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple-year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. T.D. 9102, 2004 WL 19477, at \*19-\*20.

These regulations make it clear that the conversion of an income-only trust into a total return unitrust or the exercise of a trustee's power to adjust pursuant to state statute will not:

1. Cause a loss of the federal estate tax marital deduction;
2. Trigger a taxable transfer for gift tax purposes;
3. Result in a taxable sale or exchange; or
4. Undo generation-skipping transfer tax grandfathering.<sup>7</sup>

This would mean that now a QTIP trust need not provide that all income must be paid to the surviving spouse, but could provide that a unitrust amount of between 3 and 5 percent could be paid to the surviving spouse, and the trust would qualify for the marital deduction. Of course, one could always draft the trust to provide that all income would be paid to the surviving spouse, but at least between 3 and 5 percent should be paid to him or her on a yearly basis.

If state law is followed, the conversion to a unitrust does not trigger a federal tax. However, if some percentage other than a

percentage from 3 to 5 percent is used, the regulations do not provide the taxation protection. In this case, it is important to follow the procedures in the 2002 Act. The regulations state: "[a] switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding nonjudicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of Section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances." *Id.* at \*19-\*20.

The regulations also revise Internal Revenue Code section 643(a)(3) to clarify when gains from the sale or exchange of capital assets are included in distributable net income. If pursuant to the terms of the governing instrument and applicable local law, the gains are allocated to income, then they are to be included in distributable net income. Unless the document contains language to the contrary, Washington state law has an ordering statute providing that if the unitrust amount is greater than net income, then capital gains shall be allocated to income to the extent of the unitrust amount. Section 106 of the 2002 Act (RCW 11.104A.040(h)(2)) provides that distributions of a unitrust amount shall first be paid from net income, as such term is determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains. To the extent net income and net realized short-term capital gains are insufficient, the unitrust distribution shall be paid from net realized long-term capital gains. To the extent net income and capital gains are insufficient, the unitrust distribution shall be paid from principal. The effect of this ordering statute is that if there are capital gains in a unitrust, the gains would be carried out to the beneficiary so that the beneficiary would pay the capital gains tax, to the extent that the unitrust amount is in excess of ordinary income.<sup>8</sup>

Even though the definition of income has changed in the new regulations to include the unitrust amount, it does not mean that the beneficiary must pay income tax on the entire unitrust amount he or she receives. All of the existing income tax rules relating to trusts and estates still apply, and only the actual income received by the trust that passes through to the beneficiary is taxable to the beneficiary. The new regulations do not change this. The new regulations simply provide that for various purposes, distribution of a unitrust amount is considered a distribution of income so that the trust will still qualify for the marital deduction and a change to a unitrust distribution will not trigger a tax in and of itself.

### **6. What to Do Now?**

In representing a trustee or beneficiary of a trust that refers to the distribution of net income, one should be aware that the power to adjust between income and principal and the power to convert to a unitrust are now part of Washington law. In addition, one should be aware that future estate planning documents might

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## Will Repository New Statute Effective on June 10, 2004

by Rick Cunningham, Riddell Williams, P.S.

As of June 2004, RCW 11.12.265 went into effect, allowing any person who has custody or control over an original will may deposit the will under seal with the clerk of any court having jurisdiction. The purpose of the statute is to provide a safe place to hold a testator's will. It also addresses certain problems associated with retiring attorneys who have clients' original wills in their possession. The statute *does not require* all original wills to be deposited with the superior court clerk. Attorneys may continue to retain clients' original wills for safekeeping.

RCW 11.12.265 provides:

Any person who has custody or control of any original will and who has not received knowledge of the death of the testator may deliver the will for filing under seal to any court having jurisdiction. The testator may withdraw the original will so filed upon proper identification. Any other person, including an attorney in fact or guardian of the testator, may withdraw the original will so filed only upon court order after showing of good cause. Upon request and presentation of a certified copy of the testator's death certificate, the clerk shall unseal the file. This section does not preclude filing a will not under seal and does not alter any duty of a person having knowledge of the testator's death to file the will.

Under current Washington law, the superior court of every county has original subject matter jurisdiction over the probate of wills and the administration of estates. RCW 11.96A.040(1). Therefore, a Washington resident's will may be deposited with the clerk of any Washington superior court.

A deposited will is treated as a sealed document by the court clerk and can only be released to the testator without a court order. Any other person, including an attorney in fact or guardian of the testator, may seek a court order to withdraw the original will upon a showing of good cause. Upon request and presentation of a certified copy of the testator's death certificate, the will may become a matter of public record.

A will that is deposited with the court clerk can still be challenged upon the death of a testator. The fact that the court clerk holds a will in its repository is not a determination of validity. A will must still meet the statutory execution formalities and the testator must still have testamentary capacity.

The procedure for depositing a will with a superior court clerk may vary with each county. The following is the King County procedure:

In King County, a party wishing to deposit an original will of a living person must complete a *Will Repository Cover Sheet* (WRCS), which is available in the Clerk's Office or on the Clerk's Web site at [www.metrokc.gov/kcsc/forms.htm](http://www.metrokc.gov/kcsc/forms.htm). A filing fee of \$20 is required to deposit a will in the Clerk's Will Repository. An index will be maintained in the Superior Court Management Information System (SCOMIS) under the name and date of birth of the testator. Any other filing, such as of a codicil, also requires payment of the \$20 filing fee. If a will is withdrawn from the Repository, it may be deposited again with payment of the \$20 filing fee.

The testator may withdraw the will upon verification of identity. Removal of the deposited will by someone other than the testator requires a court order. A sample Motion and Order is available on the Clerk's Web site. All pleadings filed relating to the repository must be captioned "IN RE THE DEPOSITED WILL OF \_\_\_(testator)\_" and should include the date of birth of the testator.

After the death of the testator, and upon request and presentation of a certified copy of the death certificate, the will be unsealed.

The Clerk will retain deposited wills or the record of their withdrawal for 100 years.

See King County Superior Court Clerks' Alert, June 9, 2004.

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### Total Return Trusts

provide for a unitrust amount instead of a distribution of net income, or a distribution of a unitrust amount but no less than net income. This article provides helpful information on the current changes in a Trustee's and a beneficiary's powers over trust distributions.

- 1 Appearing in *Investment Outlook*, PNC Advisors, April 2004.
- 2 See Robert B. Wolf, *Estate Planning with Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design*, Real Prop. Prob. & Tr. J. 169, 172 n.1 (2001).
- 3 See John R. Price, *Price on Contemporary Estate Planning*, § 10.47.5, at 1181 (2000).

- 4 There are many examples of total return trust forms in the article cited in Footnote 2. See Wolf, *supra*, at 284, *et seq.*
- 5 Note that Section 106 of the 2002 ACT (RCW 11.104A.040(h)(1)) provides that expenses that would be deducted from the income of a trust may not be deducted from the unitrust distribution. Normally, one-half of the trustee's fees would be deducted from the income of a trust. In a unitrust distribution, paying all of the trustee's fees from the portion of the trust that is not distributed to the beneficiary would by itself make a difference in the amount of the beneficiary's distribution.
- 6 *IRS Issues Final Regs. on Definition of Trust Income*, Practical Tax Strategies, Apr. 2004, at 252.
- 7 Robert B. Wolf & Stephan R. Leimberg, *Total Return Trusts Approved by New Regs., But State Law Is Crucial*, Estate Planning, Apr. 2004 at 179.
- 8 See Example 11 in the regulations. See 2004 W.L. at \*24.

## Recent Changes to the Condominium Act

by Vincent B. DePillis, Real Property Law Group

Readers of this Newsletter may remember Chris Osborne's grim conclusion about condominium development in his Spring 2003 article summarizing the state of condominium law, and in particular the case of *One Pacific Towers Homeowners v HAL Real Estate*, 148 Wn.2d 319 ("HAL"): "After *HAL Real Estate* it will be the truly brave developer who is willing to risk unlimited personal liability to develop and sell condominium units."

In the last year and a half, the situation for developers has not improved. Litigation continues and plaintiffs now routinely sue the individual developers as well as the development entity. Anecdotal evidence suggests that insurance companies have started to balk at paying big settlements. As a result, builders and homeowners spend more time in the pointless anguish of litigation, homeowners wait longer for repairs to damaged buildings, and more builders have abandoned the condominium industry. General liability insurance continues to be hard to find and absurdly priced, and policy exclusions have become ever tighter.

### Recapping the Legislative Battle

In response to this situation, the builders, led by the Master Builder Association of King County, mounted a sustained campaign to amend the Washington Condominium Act (RCW 64.34, the "WCA"). Naturally enough, the builders' efforts were directed primarily at narrowing the scope of the implied warranties of quality created by RCW 64.34.445. These warranties have been the plaintiffs' ace in the hole. The plaintiffs' bar and homeowners responded with a tenacious and effective lobbying effort which focused that there is a large amount of shoddy construction.

In the 2001-2002 legislative session, builders and homeowners fought to a draw, but did manage produce a piece of legislation (now codified at 64.50) which is commonly and misleadingly referred to as the "Right to Cure" bill. This bill requires only that the parties talk to one another before a suit is filed. Most observers believe that the "Right to Cure" bill has had no positive effect on condominium litigation. Rather it adds a time consuming (and therefore expensive) procedural prologue to litigation, but does nothing to change the motives and substantive rights of the parties.

In the 2002-2003 session, the builders and the homeowners again fought to a complete standstill. No legislation was passed. However, the battles of '02-'03 set the stage for the 2003-2004 session, and the eventual passage of SSB 5536, the bill which is the subject of this article.

My own involvement in this issue has been primarily through RPPT's ad hoc committee on condominiums, led by David Rockwell, and manned by Gary Ackerman, Bill Reetz and me. Mr. Rockwell and Mr. Ackerman were on the committee which was responsible for the original drafting of the statute. The committee consulted extensively with Pete Middlebrooks, who might fairly be characterized as the dean of the developer side of the condominium bar, and who was also on the original drafting committee. Mr. Middlebrooks does not, however, bear any

responsibility for the positions taken by the Committee in the course of the legislative battle. As an aside, it is worth mentioning that this work was some of the most rewarding of my professional career, notwithstanding the fact that it consumed many non-billable hours.

So—has SSB 5536 changed the game? Can Mr. Osborne now safely advise his condominium builder clients to get back in the business? My personal view is that SSB 5536 has made a disastrous situation somewhat better. The game, however, has not been fundamentally altered. This conclusion comes with one caveat—if the warranty insurance provided for in this bill becomes widely available, the situation may improve significantly.

### The 2003 Political Deal

The fundamental "deal" embodied by SSB 5536 can be summarized as follows: the builders succeeded in watering down the implied warranties of quality, and shored up the protection offered by the use of limited liability entities. In exchange, the builders gave up the ability to disclaim hypothetical defects. Homeowners and builders also agreed to a toothless, but conceptually promising, warranty program. The Legislature punted the thorny issues of arbitration and third party inspection to a commission.

### The Details

#### *The HAL Fix*

The main issue with *HAL* was the definition of "Declarant." Prior to SSB 5536, Declarant included "a person **or group of persons acting in concert** who execute as declarant a declaration as defined in subsection (15) of this section, or (b) reserves or succeeds to any special declarant right under the declaration." RCW 64.34.020(13). (Emphasis added.)

The *HAL* court adopted a broad definition of the term "acting in concert" which swept in upstream owners of the development entity (a limited liability company) and saddled them with the duties and potential liabilities of a "declarant." The *HAL* court's holding exposed individual developers and investors to personal liability for construction defects without regard to any of the relatively high standards of proof previously required under Washington law to "pierce the corporate veil." From a condo production standpoint, *HAL* was a bad result—builders are much less likely to build (and investors were much less likely to provide needed equity) if they are concerned about personal liability. There was surprisingly little debate about the fact that the *HAL* case ought to be fixed—perhaps because the plaintiffs' bar did not ultimately believe that *HAL* would result in the wholesale dissolution of the principle of limited liability in the condominium field.

SSB 5536 attempts to fix the *HAL* problem by eliminating the troublesome language "group of persons acting in concert." But then, in order to make sure that the definition closes the door

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## Recent Changes to the Condominium Act

on excess creativity on the part of Developer attorneys, the definition of “declarant” is expanded to specifically include:

- any person who “exercises” a special declarant right (not just those who formally succeed to a special declarant right), and
- any person who “is the owner of a fee interest in the real property which is subjected to the declaration at the time of the recording of an instrument pursuant to RCW 64.34.316 and who directly or through one or more affiliates is materially involved in the construction marketing, or sale of units in the condominium created by the recording of the instrument.”<sup>1</sup>

This latter clause is intended prevent property owners from circumventing the purpose of the statute by signing a declaration in some capacity other than declarant (*e.g.*, ground lessor) while substantively acting like a developer/declarant.

One final change was to the definition of “dealer.” In order to prevent dealers from creating multiple subsidiaries which would each own five or fewer units (which was the structure at issue in the HAL decision), SSB 5536 defines a dealers as a person who “**together with such person’s affiliates** owns or has a right to acquire either six or more units a condominium or fifty percent or more of the units in a condominium containing more than two units.” (Emphasis added).

In at least one case, however, excessively creative plaintiffs’ attorneys have attempted to argue that by this definition every corporate parent of a “declarant” is also a “dealer.” This certainly was not an intended result, and would not make sense as a result, but it is an interpretation that should be squelched by way of a technical amendments bill (which should fix the typo in the definition of “Declarant” as well).

The other issue that has arisen with respect to the HAL fix is whether it was intended to apply to condominiums and transactions commenced prior to the effective date. Unfortunately the statute is unclear on this simple technical issue, and that litigation is ongoing with respect to the matter.

### *The Implied Warranties*

The debate over implied warranties was intense, and the statutory result uncertain. The builders wanted to say simply that a defect had to be “material” to be actionable. The homeowners responded that a “material” breach of warranty means, “a breach so significant it excuses the other party’s performance and justifies rescission of the contract... ‘serious enough to justify the other party in abandoning the contract... one that substantially defeats the purpose of the contract.’”, citing *Park Avenue Condo Owners Association v. Buchan Developments L.L.C.* 117 Wn. App. 369, 383 (2003) (“*Park Avenue*”) (Citations omitted). To most of the parties at the table, this seemed too high of a standard. There ensued a comical (in retrospect) search for the few magic words that would magically separate frivolous from meritorious

claims. Here they are:

- (7) In a judicial proceeding for breach of any of the obligations arising under this section, the plaintiff must show that the alleged breach has adversely affected **or will adversely affect** the performance of that portion of the unit or common elements alleged to be in breach. As used in this subsection, an “adverse effect” must be more than technical and must be significant to a reasonable person. To establish an adverse effect, the person alleging the breach is not required to prove that the breach renders the unit or common element uninhabitable or unfit for its intended purpose. RCW 64.34.445(7) (emphasis added).

From the builders’ standpoint, the biggest weakness in this text is the highlighted reference to future effect. This allows the plaintiffs to bring in (excessively creative?) experts to offer their opinion about future events—opinions, which in the very nature of an opinion about the future, cannot be conclusively disproved. I fear that such opinions may tend toward excessive pessimism. On the other hand, the homeowners made a convincing case that it would be unfair to stick them with a disaster waiting to happen. We will not know what this change really means until courts start to interpret it, which will not be for a few years yet. This change applies only to condos created after the effective date of SSB 5536 (July 1, 2004).

In a related amendment, SSB 5536 codified the measure of damages in these cases, as set forth in *Park Avenue*:

- Proof of breach of any obligation arising under this section is not proof of damages. Damages awarded for a breach of an obligation arising under this section are the cost of repairs. However, if it is established that the cost of such repairs is clearly disproportionate to the loss in market value caused by the breach, then damages shall be limited to the loss in market value.  
RCW 64.34.445(8).

As this does not represent a change in the law, this provision was uncontroversial. To the non-litigator it might seem that this measure of damages protects builders against the kind of overhyped damage claims we hear so much about. Defense litigators tell me that this is a vain hope—that in practice, this measure of damages principle affords no leverage to the builders.

### *Disclaimer of Future Defects*

This was the homeowners’ big win. Under the WCA prior to SSB 5536, declarants had the right to create laundry lists of future potential defects. Some practitioners doubted that the WCA was really intended to allow a laundry list disclaimer of defect, as this seemed to open up the possibility of disclaiming almost every conceivable defect. However, the case of *Marina Cove Condominium Owners Association v. Isabella Estates.*, 109 Wn.

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## **Recent Changes to the Condominium Act**

App. 230 (2001) (“*Marina Cove*”), the court upheld the laundry list disclaimer of future defects, at least conceptually. And in fact many practitioners had adopted (cribbed, more likely) a 30+ page laundry list of disclaimed defects, presented in the form of a limited warranty.

The practical value of these laundry lists was open to some question, because the defendant has to prove that the disclaimer is “entered into and become a part of the basis of the bargain,” and that the waiver did not run afoul of the unconscionability section of the WCA. RCW 64.34.080. We have no case law dealing directly with these issues.

It may be that these doubts were common among the builders. This would explain why they were not particularly aggressive in defending the ability to disclaim future defects.

So—what we are left with is the ability to disclaim existing defects, but subject to certain (relatively commonsensical) limitations:

For units intended for residential use, no disclaimer of implied warranties of quality is effective, except that a declarant or dealer may disclaim liability in writing, in type that is bold faced, capitalized, underlined, or otherwise set out from surrounding material so as to be conspicuous, and separately signed by the purchaser, for a specified defect or specified failure to comply with applicable law, if: (a) The declarant or dealer knows or has reason to know that the specific defect or failure exists at the time of disclosure; (b) the disclaimer specifically describes the defect or failure; and (c) the disclaimer includes a statement as to the effect of the defect or failure.

RCW 64.34.450.

At least we don’t have to prove “basis of the bargain” anymore.

### *Qualified Warranty – the Rationale*

This is the joker in the pack, and not easy to explain in brief. The concept is modeled in part on British Columbia’s Homeowner Protection Act, a complicated statute which took several years of intensive effort to develop. We adopted the qualified warranty concept (codified at RCW 64.35) in a matter of weeks, with almost no substantive debate. The goal was to entice (but not force) developers and insurers into a system which would (1) limit litigation; (2) provide an insured source of money to fix problems, and (3) provide incentives to build well.

RCW 64.35 sets up a voluntary alternate universe for condo defects. If the declarant provides a “qualified warranty,” the declarant cannot be sued for breach of the WCA implied warranties. RCW 64.34.205. The qualified warranty becomes the sole recourse for defect. This part of the SSB 5536 appealed to builders, and is designed to reduce litigation.

A qualified warranty must be issued by a real insurance company, not by the builder. The point was to try to provide a real

pot of money for the homeowner—not just a claim against a single asset shell, or against a general liability insurer who didn’t really intend to insure construction defects, and is really reluctant to pay for them. Homeowners really liked this aspect of the bill.

The potential public policy benefit of the qualified warranty concept is this: if the qualified warranty catches on, warranty insurers will act as quality enforcers. In B.C. this has in fact happened, and operates in two ways. First, the warranty insurers will not accept 100% risk transfer – they insist that the developer indemnify the insurer from some or all of the claim. The scope of the risk transfer is a business deal not regulated by the Province of British Columbia (or by 64.35). Obviously, if a builder has put up real security to secure its indemnity to the warranty insurer (parent corporate signatures, etc.), it has a greater incentive to build with quality—it cannot simply walk away from a single asset LLC and tender the issues to the liability insurer. Second, the warranty insurers have learned to underwrite the quality of the building. They require expert review of building envelope details, and third party course of construction inspections. They will not insure building technologies which have proven to be fundamentally defective (*e.g.*, face-sealed EIFS).

In British Columbia the qualified warranty is mandatory. Under RCW 64.35, it is voluntary on the part of the declarant. The first step, obviously, is convincing an insurer to offer the qualified warranty in Washington. A number of brokers and other parties are trying to sell this concept to insurers, but it takes time. Washington state is a tiny market in the insurance world, with a reputation (whether or not deserved) for sticking it to insurers. The second step is convincing builders that the cost benefit ratio of the qualified warranty makes sense—something we will not be able to determine until a real-life insurer starts quoting a real-life policy.

There are a number of aspects of RCW 64.35 which were designed specifically to attract insurers. For instance, contingent attorneys’ fees are forbidden. RCW 64.35.115. Mandatory binding arbitration is specifically permitted. RCW 64.35. Typical coverage exclusions are specifically permitted. RCW 64.35.410 *et seq.* The association must allow the warranty insurer to fix the problem RCW 64.35.405(3)(d).

### *Qualified Warranty – the Coverage*

RCW 64.35 defines the coverage which must be offered by a qualified warranty in considerable detail. The coverage is copied largely from British Columbia’s Homeowner Protection Act. I would characterize the coverage as more being carefully nuanced than the coverage offered under RCW 64.34.445 implied warranties, but still reasonably protective of the homeowner. It might be summarized as follows:

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- 12-month warranty for “any defect” in labor and materials in the units, including code violations.<sup>2</sup>
- 15-month warranty for “any defect” in labor and materials in the common elements, including code violations.
- 24-month warranty for defects in HVAC, building envelope, defects which render the unit unfit to live in, or code defects. See RCW 64.35.305.
- 5-year warranty for defects in the building envelope, including defects causing unintended water penetration. See RCW 64.35.310.
- 10-year warranty for defects that result in structural damage. See RCW 64.35.315.

The coverage limit for a qualified warranty is set at \$100,000 per unit (or the original purchase price if that is less), and \$150,000 per unit for common elements (or the original purchase price for all building components if that is less). Because the unit improvements usually represent a very small part of total condominium value relative to the value of the common elements, the practical limit on the exposure of the warranty insurer is \$150,000 per unit.

In the months subsequent to the enactment of 5536, feedback from potential insurance markets has indicated that insurers are concerned about the fact that there is no aggregate maximum cap on the insurers’ liability in this program. Efforts are underway now to come up with amendments to this program which will induce potential warranty insurance providers to enter the market.

### The Punted Issues: Arbitration and Third-Party Inspection

The concept of mandating third-party inspection as a way of improving quality came into the debate at the tail end of the negotiation, and was suggested by the builders. The concept was not particularly controversial, but there was no time to work out the details. Issues which surfaced include the cost of inspection, whether there are enough qualified inspectors, and what the qualifications ought to be, whether the inspectors should be allowed to limit liability, and whether the inspection should establish a presumption of compliance with the implied warranties. It was entirely appropriate to delegate this issue to a commission for additional study.

One of the thorniest issues dividing the builders and the homeowners was arbitration, which is arguably not permitted under *Marina Cove*’s interpretation of 64.34.100. Homeowners hate arbitration. They perceive it as expensive (because you have to pay an arbitrator), stacked against them, and they think that the threat of going in front of a jury will bring the big bad insurance

company to a quicker settlement. Builders wanted arbitration because they perceive it as attractive to insurers, quick (and therefore cheaper), less subject to procedural gaming. The insurers did not say one way or another whether they wanted arbitration.

Among the issues which were never resolved, despite intensive negotiation over two years were these: How do you join in an arbitration the many necessary parties—especially if they have not signed arbitration agreements? What procedural safeguards should be mandated, to ensure consumer protection? Should arbitration be mandated in all cases, permitted by contract at the time the condominium is formed, or permitted only at the time a dispute arises?

At the end of the day, the builders gave up on arbitration at least for the ’03-04 session, thinking, I suppose, the getting the *HAL* fix, and the change in the implied warranties, was better than nothing.

The commission established by SSB 5536 to study these two issues is charged with making a recommendation to the legislature this year. Time will tell whether the commission will prove more successful than the “stakeholders” and legislators in coming to consensus.

### Conclusion

Personally, I doubt that the change to the implied warranties will significantly reduce the amount of condominium litigation, for the reasons discussed above. By all accounts, however, there has been a considerable increase in the quality of condominium construction. Perhaps this will reduce the number of claims, at least over time.

The qualified warranty concept has attracted quite a bit of interest, and even enthusiasm, among many of those who have studied the problems of the condominium industry in detail. It is too soon to tell whether the incentives built into RCW 65.35 are sufficient to attract builders and insurers.

The good news, I suppose, is that the intensive efforts of the last several years have educated the Legislature, the legislative staff, and the stakeholders. I now think that it is possible, with continued effort, get to the point where Chris Osborne could entirely retract his estimate of the courage required to build condominiums. And equally important, I now think it possible that we will get to the point where it takes no more courage to buy a condominium than to buy a single-family house. I would not have said either of those things two years ago.

1 The reference to 64.34.316, having to do with the transfer of special declarant rights is an error. It was supposed to be 64.34.216, having to do with the contents of a declaration.

2 A code defect is not covered by the warranty unless it “constitutes an unreasonable health or safety risk, or has resulted in, or is likely to result in material damage the unit or common elements.”

## Recent Developments

# Probate and Trust

by Colonel F. Betz and Adriana Maestas, Perkins Coie LLP, Seattle

### ***Estate of Krappes v. Daley*, 121 Wash.App. 653 (March 2004, Div. 1)**

**Summary:** Since the creation of a joint account with right of survivorship is not an inter-vivos gift, the surviving depositor of a joint account with right of survivorship did not hold legal title to funds she removed from the account prior to the deceased depositor's death. Thus, the imposition of a constructive trust granting the surviving depositor the funds from the joint account was proper where the evidence established the deceased depositor's intent that the surviving depositor receive those funds upon his death.

**Facts:** Rudolph Krappes opened a joint bank account with a right of survivorship in 1986. He named himself and his niece, Sondra Daley, as depositors. Throughout his life Krappes deposited all of the funds held in the account and used the account to pay his living expenses. Daley did not deposit her own money into the joint account and did not make personal use of its funds. In 1991, Krappes executed a will in which he named another niece, Edwina Garten, as personal representative and sole beneficiary of his estate.

In June 2001, Krappes was admitted to the hospital, and Daley agreed to manage the Krappes' financial affairs. She obtained the checkbook for the Krappes-Daley joint account and paid Krappes' bills from that account. Daley learned that Krappes had given several signed checks in blank to the caregiver to pay for necessities. The caregiver informed Daley that a box of checks from the Krappes-Daley account was missing. Worried about the integrity and safety of the Krappes-Daley account, Daley withdrew \$95,000 from the account and deposited it into a personal account. She left \$21,000 in the Krappes-Daley account so the caregiver could use the blank checks in her possession to pay bills as necessary.

On July 5, Krappes told the caregiver that he wished to consolidate all of his money in the Krappes-Daley account so that Daley would receive the proceeds if anything were to happen to him. He also asked the caregiver to help him change his attorney-in-fact from Garten to Daley and make Daley the sole beneficiary of his will. On August 7, Krappes executed a new power of attorney designating Daley as his attorney-in-fact. A new will was drafted but never formalized.

On August 12, Daley withdrew \$18,000 from the Krappes-Daley account, since there was no need for the caregiver to write checks from the account, and the missing box of checks had not been located. Daley withdrew a total of \$113,900 from the joint Krappes-Daley account during the months of July and August.

On August 24, Krappes died of a heart attack and his existing will was admitted for probate. The personal representative of the

Krappes estate, Garten, sought return of the \$113,900 that Daley had removed from the joint account and filed an action against Daley demanding return of the funds. The complaint alleged that the funds removed from the joint account belonged to the estate and demanded their return.

The trial court held that when Krappes created the joint account with right of survivorship, he made an inter-vivos gift of the money in the joint account to Daley, and that she was therefore entitled to the funds. It also found that Daley was the intended beneficiary of the funds removed from the joint account, that Daley did not intend or attempt to convert the money to her own use, and that the estate would be unjustly enriched if awarded the funds. The trial court, therefore, imposed a constructive trust on the funds from the joint account and awarded them to Daley. The personal representative of the Krappes estate appealed, *inter alia*, (1) the decision that Daley held legal title to the funds in the joint account, and (2) the imposition of a constructive trust granting the funds from the joint-account to Daley.

**Discussion:** In Washington, under the Financial Institution Individual Account Deposit Act, a joint account with a right of survivorship is "an account in the name of two or more depositors and which provides that the funds of the deceased depositor become the property of one or more of the surviving depositors." During the lifetime of a depositor, funds in a joint account with a right of survivorship belong to the depositors "in proportion to the net funds owned by each depositor on deposit in the account unless the contract of deposit provides otherwise or there is clear and convincing evidence of contrary intent at the time the account was created." Additionally, under RCW 30.22.100, the funds of a deceased depositor in a joint account with right of survivorship become the property of the surviving depositor(s).

Together, the applicable statutes create a rebuttable presumption that joint accounts with right of survivorship do not give a non-depositing party any present interest in the account funds and do not constitute inter-vivos gifts. Washington case law supports this interpretation and also makes clear that the right of survivorship is defeated when funds owned by the joint tenant are withdrawn before the joint tenant's death. On these grounds, the Court of Appeals concluded that Daley did not hold legal title to the withdrawn funds. If Daley had never withdrawn the funds from the joint account, she would have obtained legal title to them upon Krappes' death. When she withdrew the money from the joint account, however, she also withdrew them from the operation of the account's survivorship terms. As the funds were not on deposit in the joint account at the time of Krappes' death, Krappes

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## Recent Developments

# Real Property

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

The Supreme Court has provided two recent opinions concerning the interpretation of contracts affecting real estate transactions – one in the context of a purchase and sale agreement and the other in the context of the construction of improvements on real property. In the first case, the Court adopted a structured approach to analyzing contractual liability; in the second case, a seemingly new “equitable” cause of action was created from a mash-pit analysis of contract and tort remedies.

**Keystone Land & Development v. Xerox Corp.**, 152 Wn.2d 171, 94 P.3d 945, 2004 Wash. LEXIS 537 (filed July 22, 2004), appears to be the final chapter in the dispute reported in *Keystone Land & Development v. Xerox Corporation*, 353 F.3d 1070, 2003 U.S. App. LEXIS 26462 (9<sup>th</sup> Cir. 2003) and a companion opinion, *Keystone Land & Development v. Xerox Corporation*, 353 F.3d 1093, 2003 U.S. App. LEXIS 26463 (9<sup>th</sup> Cir. 2003), which were reviewed in the Spring 2004 RPPT Newsletter.

Xerox listed property that it owned in Tukwila for sale. Offers were solicited. Keystone, a prospective purchaser, responded through its broker, Broderick, with a letter titled “offer of purchase.” At the request of Xerox’s broker, Kidder Mathews, a revised offer was submitted. Upon receipt of the revised offer, Kidder responded that “Xerox is prepared to negotiate a Purchase and Sale Agreement with Keystone Development subject to two modifications to your Proposal.” *Keystone*, 152 Wn.2d at 175. Keystone accepted those two modifications, and contended that at that point, all of the material terms of the purchase agreement had been agreed upon by itself and Xerox.

Xerox terminated negotiations with Keystone and sold the property to another purchaser. Keystone sued for damages in the United States District Court for the Western District of Washington. The trial court, and on appeal, the Ninth Circuit, concluded that the exchange of letters did not constitute a binding agreement, and dismissed the claim for a breach of the agreement to sell the property. See *Keystone Land & Development v. Xerox Corporation*, 353 F.3d 1070, 2003 U.S. App. LEXIS 26462 (9<sup>th</sup> Cir. 2003).

The Ninth Circuit, however, concluded that there might perhaps be a valid claim arising from Xerox’s alleged breach of an agreement to negotiate. In *Keystone Land & Development v. Xerox Corporation*, 353 F.3d 1093, 2003 U.S. App. LEXIS 26463 (9<sup>th</sup> Cir. 2003), the following two questions were certified to the Washington State Supreme Court:

1. Will Washington contract law recognize and enforce an agreement, whether implicit or explicit, between two or more parties to negotiate a future contract under the circumstances presented in this case?

2. If such a contract can exist, what is the property measure of damages for the breach of a contract to negotiate?

In responding to these questions, the Washington court noted that there were three similar, yet distinct, types of agreements: (1) an agreement to agree, which is not enforceable under Washington (see e.g., *Sandeman v. Sayres*, 50 Wn.2d 539, 314 P.2d 428 (1957)); (2) an agreement with open terms in which “the parties intend to be bound by the key points agreed upon with the remaining terms supplied by a court or another authoritative source” (such as lease with an option, but with not stated rent, in which case the court may imply a fair market rent), which presumably a Washington court will enforce; and (3) an agreement to negotiate, in which “parties exchange promises to conform to a specific course of conduct during negotiations, such as negotiating in good faith ... for a specific period of time.... In contract to an agreement to agree, under a contract to negotiate, no breach occurs if the parties fail to reach agreement on the substantive deal. The contract to negotiate is breached only when one party fails to conform to the specific course of conduct agreed upon.” *Keystone*, 152 Wn.2d at 176.

It was the enforceability of this third type of contract that was at issue in the questions posed by the Ninth Circuit. The Court noted that in prior opinions, such as *Badgett v. Security State Bank*, 116 Wn.2d 563, 807 P.2d 356 (1991), there were statements that indicated that parties could obligate themselves to negotiate in good faith:

Our holding in *Badgett* supports a conclusion that, under Washington contract law, a specific course of conduct agreed upon for future negotiations is enforceable when it is contained in an existing substantive contract. However, *Badgett* does not answer the question of whether an enforceable obligation to negotiate in accordance with an agreed upon course of conduct can exist independently from an existing substantive contract. *Id.*, p 177.

The Court stated that as a preliminary matter, it was necessary to determine whether a contract to negotiate actually existed between Keystone and Xerox.

We conclude that it is unnecessary to decide whether Washington will ever enforce a contract to negotiate in order to answer the first certified question. The exchange of letters with which we are presented does not constitute a contract to negotiate. The parties did not exchange promises to conform to a specific course of conduct during

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## Recent Developments: Real Property

negotiations, such as negotiating in good faith, exclusively with each other, or for a specific period of time.... There was never an agreement as to how the parties were required to proceed. *Id.*, at p. 179-180.

Although not answering the question posed, the Court did hold out the prospect that a properly structured contract to negotiate may be enforced in Washington. As a condition to enforcement, however, the agreement must:

1. Contain mutual undertakings to negotiate;
2. Specify a specific standard of conduct to be observed by the parties in the negotiation (apparently a standard of "good faith" will be sufficient); and
3. Have a temporal scope during which the negotiations are to take place.

Not addressed, however, was the remedy if one party breaches its obligations under this agreement.

In some respects, the Court's not so subtle message to the Ninth Circuit that perhaps it should have spent a bit more time analyzing the facts before certifying the questions was reminiscent of the position of former Justice Frank Hale, who consistently resisted responding to any question certified from a federal court:

Because of the abiding spirit of mutual respect and comity long existing the state and federal judiciary here, I would hope that we had the power to answer the certified question, but I am convinced that constitutional limitations, running to the very jurisdiction of this court, forbid our doing so.

Justice Hale, in dissent in *In re Elliot*, 74 Wn.2d 600 (1968); see also dissent in *Thiry v. Atlantic Monthly*, 74 Wn.2d 679 (1968)

***Fortune View Condominium Ass'c. v. Fortune Star Development***, 151 Wn.2d 534, 90 P.3d 1062, 2004 Wash. LEXIS 363 (filed May 27, 2004), represents a much less rigorous examination of contract issues surrounding the purchase of siding material installed on the exterior of a condominium building. The opinion continues the tendency of Washington courts to mix the principles of tort and contract law to reach a desired result.

Urban Development contracted with Fortune Star Development to construct a residential condominium. Urban contracted with a subcontractor for the installation of siding on the project. The subcontractor purchased a Dryvit siding system from Evergreen Building Products, LLC, which was a distribution for the system, manufactured by Dryvit Systems, Inc. The siding cracked and leaked soon after installation. The homeowners association sued the Fortune Star, which in turn sued Urban. Urban sued various subcontractors, as well as Evergreen and Dryvit.

Even though Urban did not have direct contractual privity with either Evergreen or Dryvit, Urban claimed it had the right to recover implied and express warranties made by these companies. Specifically, Urban pointed to a brochure published by Dryvit that stated "Dryvit offers a five-year limited warranty on Dryvit materials. Contact Dryvit Systems, Inc., for further details." *Fortune View*, 151 Wn.2d at 537.

The trial court dismissed the claims against Evergreen and Dryvit on summary judgment. The Court of Appeals held that (i) Urban was not entitled to the benefits of implied warranties for the sale of goods under the UCC because of the lack of privity of contract; (ii) Urban was not entitled to rely on any of the express warranties made to the siding subcontractor, because Urban was not a third-party beneficiary; and (iii) factual issues remained as to whether Urban was entitled to the express warranties made in Dryvit's advertising that required reinstatement of Urban's claims for breach of express warranty and implied indemnity. Dryvit appealed the Court of Appeal's ruling that a breach of express warranties in advertising can support a claim for implied indemnity.

The Court reviewed the history of claims for implied indemnity, which were established by *Central Washington Refrigeration v. Barbee*, 133 Wn.2d 509, 946 P.2d 760 (1997). The claim was described as a hybrid tort-contract claim which existed as a separate "equitable cause of action" which "arises when one party incurs a liability the other party should discharge by virtue of the nature of the relationship between the two parties." *Barbee*, 133 Wn.2d at 539.

Although *Barbee* involved a direct contract between the disputing parties, the Court rejected the notion that a contractual relationship had to exist in order to support the claim. "*Barbee* specifically identifies implied indemnity as a separate equitable remedy, not an implied contractual remedy." *Fortune View*, 151 Wn.2d at 540. In affirming the Court of Appeals, the Court held:

Express warranties, including those made through advertising, provide a sufficient basis for an implied indemnity claim. Accordingly, we affirm the Court of Appeals' decision reinstating Urban Development's claim for implied indemnity based on breach of express warranties. *Fortune View*, 151 Wn.2d at p. 541-542.

There was a vigorous, and better reasoned dissent by Justice Madsen, which asserted that the majority interpretation of *Barbee* was flawed. The dissent argued that there does not exist an independent cause of action for "implied indemnity" absent an underlying contract or the existence of a claim in tort. In this case, Urban had no valid contract claims and never asserted that Evergreen or Dryvit had committed a tort. The dissent also questioned whether creating this type of relief was appropriate in

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### **Recent Developments: Real Property**

a situation in which the subcontract, which was the beneficiary of product warranties and had a direct contractual relationship with Urban, had settled its liability and was not longer in the action.

The reasoning in *Fortune Star* is a significant expansion of liability for contracts involving multiple levels of parties. The opinion appears to affirm that an entirely new cause of action exists in Washington – the equitable claim for implied indemnity - that will support a claim from a remote purchaser based on a breach of an express warranty that appears in any published form. This raises the prospect that remote parties supplying materials to a construction project may have liability that extends beyond that of their purchaser, who at least has the opportunity to limit its liability through contract. The Court noted that if Dryvit wanted to avoid the result of the opinion, it could simply stop making brochures with warranties, which is in fact the likely outcome for any thoughtful manufacturer of construction products.

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### **Recent Developments: Probate and Trust**

still owned the funds and legal title passed to his estate. Although Daley had a right as a joint tenant to withdraw the funds, they did not belong to her. The appeals court accordingly reversed the trial court's determination that the joint account created by Krappes constituted an inter-vivos gift or created an ownership interest in Daley.

The Court of Appeals then proceeded to consider the propriety of the constructive trust imposed by the trial court. In Washington, a constructive trust may be imposed where, for any reason, the legal title to property is placed in one person under such circumstances as to make it inequitable for him to enjoy the beneficial interest. The Court of Appeals noted that other courts have imposed constructive trusts when clear, cogent and convincing evidence establishes the decedent's intent that the legal title holder was not the intended beneficiary. In this case, the court held that the evidence established Krappes' undisputed intent that the funds go to Daley upon his death. Krappes opened up a joint account with right of survivorship in his and Daley's names, told the caregiver on several occasions that Daley should manage the funds in the Krappes-Daley account because the money was "going to her anyway," and he intended that Daley have the funds in the joint account when he died. Additionally, the personal representative testified that Krappes told her he anticipated giving Daley a separate monetary gift. Since Daley, rather than the estate, was the intended beneficiary of the funds, the court determined that the estate would be unjustly enriched if awarded the funds. On these grounds, it affirmed the imposition of the constructive trust awarding the funds removed from the joint account to Daley.

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(206) 343-7220 fax  
breetz@landam.com

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Stokes Lawrence, P.S.  
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Seattle, WA 98104-3179  
(206) 626-6000  
(206) 464-1496 fax  
llb@stokeslaw.com

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Lukins & Annis, P.S.  
717 West Sprague Ave., Suite 1600  
Spokane, WA 99201-0466  
(509) 455-9555  
(509) 363-2500 fax  
tculbertson@lukins.com

#### **Alfred M. Falk, Probate & Trust Council Director**

Harlowe & Hitt LLP  
One Tacoma Avenue North, Suite 300  
Tacoma, WA 98403  
(Legislative committee)  
(253) 284-4413  
(253) 284-4429 fax  
amfalk@harlowehitt.com

#### **Stephen R. Crossland, Real Property Council Director**

Crossland Law Office  
P.O. Box 566  
Cashmere, WA 98815-0566  
(509) 782-4418  
(509) 782-4298 fax  
steve@crosslandlaw.net

#### **EX OFFICIO MEMBERS**

#### **Kenneth M. Kilbreath, Newsletter Editor**

Inslee, Best, Doezie & Ryder, P.S.  
777 108th Avenue NE, Suite 1900  
Bellevue, WA 98004-5144  
(425) 455-1234  
(425) 635-7720 fax  
kkilbreath@insleebest.com

#### **Charles E. Shigley, Assistant Newsletter Editor**

Preston Gates Ellis LLP  
925 Fourth Avenue, Suite 2900  
Seattle, WA 98104  
(206) 623-7580  
(206) 623-7022 fax  
cshigley@prestongates.com

#### **Douglas C. Lawrence, Web Editor**

Stokes Lawrence, P.S.  
800 Fifth Ave., Suite 4000  
Seattle, WA 98104-3179  
206-626-6000  
206-464-1496 fax  
dcl@stokeslaw.com

#### **Jean McCoy, Assistant Web Editor**

Landerholm Law Firm  
P.O. Box 1086  
915 Broadway  
Vancouver, WA 98666  
360-696-3312  
360-696-2122 fax  
jeanm@landerholm.com