

# Real Property, Probate & Trust



Vol. 32, Number 2

Published by the Real Property, Probate & Trust Section of the Washington State Bar Association

Spring 2005

## Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation

by David Goodnight, James Lynch, & Greg Tolbert

### I. Introduction

According to some authorities, the meek are scheduled to inherit the earth. Given real property conveyancing practices, their title may be subject to a mineral reservation. This may explain why the WSBA has a combined section newsletter for probate and real property. Maybe not.

We begin with a quiz. Assume you own 100 acres and have decided to sell the property. You have found a purchaser and negotiated a purchase and sale agreement. Pursuant to that agreement, you shall sell your interest in the property; *provided*, however, that you shall retain all of the mineral rights in said property. At closing, purchaser records the deed that provides, in relevant part, that:

Grantor conveys and warrants to Grantee the real property described on Exhibit A; *provided*, however, that Grantor reserves all oil, gas, and other minerals.

As Grantor, what did you reserve?

- (a) All oil, gas, and all other minerals;
- (b) Oil, gas, and hopefully something else, but I don't know for certain;
- (c) I have no idea – I copied this language from another deed; or
- (d) Only oil and gas.

If you answered (a) and make a living providing real property legal counsel, kindly keep reading as this article may prevent an unwelcome situation. Despite the seemingly unambiguous clarity of six short words (“all oil, gas, and other minerals”), in the American legal system, this phrase has a rather complicated (some say tortured, some say worse) meaning.

This article is divided into four sections. The first section briefly explains the usual purpose of a mineral reservation<sup>1</sup> and provides a brief background regarding severed minerals. The second section, occasionally in utter disregard of the first section, provides a brief overview of the judicial approach to resolving disputes pertaining to severed minerals. The third section, cognizant of potential conflicts between mineral and surface owners and judicial treatment of severed minerals, details issues to consider and practical tips in drafting a mineral reservation, including a checklist. The final section identifies additional helpful resources.

This article is not designed to be encyclopedic or historic. There is plenty of scholarship on this subject; rather, our focus is to identify a potential herd of cats and provide some practical, common-sense, cat-herding tips to cope with the situation.

*continued on next page*

### TABLE OF CONTENTS

Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation	1	Nominations for Executive Committee Membership	22
An Overview of the Charitable Income Tax Deduction	7	Midyear Meeting News	22
Ethical Issues in Nonjudicial Deed of Trust Foreclosures: <i>Cox v. Helenius</i> , Revisited	11	Recent Developments: Probate and Trust	23
Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians	17	Recent Developments: Real Property	25
		How to Reach Us	28

*continued from previous page*

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

### **II. A Brief Background on Severed Minerals**

#### **A. Why Are There Severed Minerals?**

Let's be clear. Generally speaking, folks who reserve some or all minerals in a real property transaction do so for one reason. Simply stated, in their view, they have not been paid sufficiently to part with said minerals. Which, of course, presents a rather simple solution for folks who object to mineral reservations as part of a real property transaction. But, that is a different article.

#### **B. What Are Severed Minerals?**

The phrase "severed minerals" refers to minerals that have been separated from ownership of the surface estate.<sup>2</sup> There are a variety of reasons and methods to make the severance<sup>3</sup> but, generally speaking, severed minerals commonly are created in one of two ways:<sup>4</sup> (1) the real property owner conveys the real property but reserves some or all minerals (a mineral reservation); or (2) the real property owner conveys some or all minerals to someone else but retains the balance of the property (a mineral grant). In either case, the general intent is evident. One of the parties valued the minerals more than the other. It is also obvious that the separate ownership of the minerals and the surface may set the table for conflict.

The language used to document a mineral reservation may be as general as set forth above or as detailed as the parties believe to be prudent in view of the property at issue, the circumstances surrounding the transaction, the common law, their risk profile, and their budget (or tolerance) for legal counsel. The practical reality is that there is no single "right way" to draft a mineral reservation (unless, of course, your client is the State of Washington and, in that case, you should study RCW 79.11.210).

Where a mineral reservation specifically addresses a particular mineral (*e.g.*, gold), that should be the end of the issue and courts should resist the temptation to re-write the mineral reservation (*i.e.*, the deal between the parties) to comport with their private notions of "fairness," and leave the property ownership structure as contracted. Problems arise, however, due to the fact that many mineral reservations do not expressly state whether particular substances have been reserved. Rather, many "general mineral reservations" typically include an express reservation of "coal, oil, and gas" along with a reservation of "all other minerals" or "and other valuable minerals." In that situation, if the surface owner(s) and mineral owner(s) cannot resolve what was intended by the phrase "all other minerals," unless one of the parties abandons their position, the parties must resort to third party resolution.<sup>5</sup>

#### **C. What Creates the Friction with General Mineral Reservations?**

In our view, general mineral reservations create friction (at the time of creation or, more commonly, down the road) for two reasons. First, incredible as it may seem, some people choose to spend their time doing something other than reading deeds and mineral reservations and then seem to be shocked that they purchased something less than the entire "bundle of sticks" they may have assumed to be the property. Further, when the mineral reservation at issue is a general mineral reservation, this creates an opportunity for the surface owner (or their counsel) to argue (based on "canons of construction," assumed unfairness, the potential for a mineral jackpot, or whatever) that the mineral reservation is ambiguous and, properly interpreted, does not include the particular target mineral.

Second, surface owners appear to be reluctant to make their peace with the idea that, absent language to the contrary in the mineral reservation, in the severed mineral context, the mineral owner receives both the mineral estate and the implied right to make reasonable use of the surface to explore and mine/produce the mineral(s).<sup>6</sup> Further, the mineral owner has no legal obligation to compensate the surface owner for reasonable surface damage resulting from mineral exploration and development. The whole point of reserving the minerals is to find and monetize them and that necessarily entails surface impact.

Understanding the reason for the friction should inform people of what to do in drafting the mineral reservation.

### **III. The Courts and Severed Minerals**

#### **A. Defining "Minerals" in a General Mineral Reservation**

In what may strike the untrained eye as a rather horrendous case of definitional abuse, courts have concluded that the phrase "all minerals" does not, in fact, mean all minerals; rather, the phrase is considered to be ambiguous and, therefore, requires judicial interpretation.<sup>7</sup> The product of said judicial interpretation? Now, get this. What is the one thing that a general mineral reservation of "all minerals" does not mean? That's right. "All minerals" does not mean "all minerals." Courts occasionally use a few more words to say this:

Under Washington law, 'all minerals of any nature whatsoever upon or in [the] land,' does not mean what it appears to say. It is capable of more than one interpretation.

A reservation of 'all minerals ...' is therefore ambiguous. *Kunkel v. Meridian Oil, Inc.*, 114 Wn.2d 896, 902, 792 P.2d, 1254, 1259 (1990).

*continued on next page*

## Real Property, Probate and Trust Section 2004-2005

### Executive Committee

William Reetz, Chair  
Thomas M. Culbertson, Past Chair  
Lora L. Brown, Chair Elect & Treasurer  
Robert P. Beschel, Emeritus

### Council Members

#### Probate and Trust

Alfred M. Falk, Director  
Alan H. Kane  
Jennifer L. King  
N. Elizabeth (Beth) McCaw  
Mary Anne Vance

#### Real Property

Stephen R. Crossland, Director  
Michael A. Barrett  
Vincent B. DePillis  
Jody M. McCormick  
Virginia M. Pedreira

### Newsletter

Kenneth M. Kilbreath, Editor  
Charles E. Shigley, Assistant Editor

### Website

Douglas C. Lawrence, Web Editor  
Jean McCoy, Assistant Web Editor

### Editorial Board

#### Probate and Trust

Darcy L. Boddy  
Richard (Rick) T. Cunningham  
Claudia A. Gowan  
Nancy L. Livingston  
Ryan D. Rein  
Laura Herpers Zeman

#### Real Property

Brian J. Danzig  
Elizabeth E. Ehrhart  
Aleana W. Harris  
Sean Holland  
Joseph P. McCarthy  
Laura L. McClellan  
Allen R. Sakai

### WSBA Liaison

Toni Doane

### Desktop Publisher

Ken Yu/Quicksilver

*This is a publication of a section of the Washington State Bar Association. All opinions and comments in this publication represent the views of the authors and do not necessarily have the endorsement of the Association nor its officers or agents.*

Washington State Bar Association • Real Property,  
Probate & Trust Section • 2101 Fourth Avenue,  
Suite 400 • Seattle, WA 98121-2330

Printed on recycled paper



*continued from previous page*

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

To further complicate things, courts across the country have not developed a uniform approach in determining what minerals are included in a general mineral reservation.

### **B. The Stated Judicial Analysis Pertaining to General Mineral Reservations<sup>8</sup>**

Concluding that the term “all minerals,” or “all valuable minerals,” or “all other minerals whatsoever” is ambiguous is, of course, only half the battle. Courts must then define – usually in a context where one party will end up a winner and the other a loser – what the term “minerals” means.

In interpreting general mineral reservations, courts repeatedly hold that the term “minerals” has no universal definition. Unfortunately, words do not necessarily mean what they say. Rather, what is considered to be included in a general mineral reservation must be derived from the parties’ intent (which, by the way, may date back to a mineral severance that occurred several decades or more earlier), in each particular case at the time of conveyance which will be evidenced by the context of the underlying transaction, surrounding circumstances, local custom, what was considered to be valuable minerals at the time, and, if available, parole evidence. This analysis, quite obviously to experienced counsel, does not bode well for a liberal interpretation of the term “all minerals.”

Not to worry. Counsel who can withstand cries to “make the reservation shorter” have a very simple solution to minimize judicial interpretation. To wit, avoid general mineral reservations and instead, labor to make the reservation as specific as possible to reduce the risk of judicial interpretation.

### **C. What Courts Really May Be Thinking**

Now, it is possible that courts apply the various canons of construction mentioned above<sup>9</sup> on a Sisyphean search for intent in a general mineral reservation. It is also possible, however, that a court might simply be tinkering with a general mineral reservation to arrive at a result that seems fair, seems reasonable, or seems to make sense at that moment to that particular judge. And, again, this sort of inquiry is not going to be helpful to the mineral owner.

The surface owner no doubt will make the judge keenly aware that a liberal interpretation of a general mineral reservation would – in the surface owner’s view – afford the mineral estate a windfall and unduly burden the surface estate.

It seems fairly obvious, even to life’s most casual observers, that much of what constitutes interpretation of a general mineral reservation is a pretty transparent effort to minimize the effect of the dominant mineral estate rule and impact to the surface owner.<sup>10</sup> Accordingly, when drafting a mineral reservation, counsel should consider this potential.

### **D. Effect of Land Use Regulations on the Mineral Reservation**

An increasingly important consideration for mineral owners is the effect of land use regulations and zoning on their property rights. Recently, the Washington Supreme Court considered whether land use regulations may, by implication, extinguish mineral reservations, thus relieving the surface landowner from liability associated with mineral removal. *See Saddle Mountain Minerals, L.L.C., v. Joshi*, 152 Wash.2d 242, 95 P.3d 1236 (2004). In *Saddle Mountain*, the surface landowner constructed a residential housing development on property containing a mineral reservation. During development, the landowner graded the site, and in doing so, exported sand and gravel material (substances included in the mineral reservation) to fill a railroad right-of-way adjacent to the property. The mineral owner commenced suit against the landowner for trespass and conversion, seeking compensation for sand and gravel removed from the property. Landowner

*continued on next page*

*continued from previous page*

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

defended by arguing that local zoning ordinances prevented mining activities on the property, and that the mineral right had been extinguished by a “regulatory taking.”

The Court, in considering the regulatory taking argument, concluded that in the absence of a “final government decision” regarding the application of the zoning ordinance to the mineral right, such a regulatory taking could not be implied. Ultimately, the Court ordered the surface landowner to pay compensation to the mineral owner for landowners’ removal of sand and gravel from the property.

*Saddle Mountain* confirms the potential value (and uncertainty) associated with mineral reservations in urban areas, or areas undergoing residential development. In the face of restrictive zoning or land use regulation, surface landowners cannot simply assume mineral reservations have no effect on the surface estate; rather, surface landowners should carefully assess the potential affects of mineral reservations on land development, and seek to resolve conflicts with mineral owners before engaging in substantial surface development activities.

### **IV. Issues to Consider in Drafting a Mineral Reservation**

First the good news. Generally speaking, there is no single correct way to draft a mineral reservation. Rather, a mineral reservation can be drafted in any number of ways to memorialize the underlying transaction as well as address the issues that typically create conflict between the mineral and surface estates. Now, the bad news. That means that, to minimize potential conflicts, the person holding the pencil needs to think about and address a variety of issues.

This section first briefly identifies some potential issues that may arise in severed mineral situations and then provides a checklist of matters to consider in drafting a mineral reservation.

#### **A. Potential Issues**

In addition to the obvious issue of what minerals are included in a mineral reservation, severed mineral estates may involve a variety of issues including:

- Access
- Subsidence
- Mining methods (including strip mining)
- Use of surface resources (*e.g.*, timber, water, etc.)
- Exploration activities
- Mining operations
- Surface pollution

#### **B. Mineral Reservation Drafting Checklist**

To begin, if you represent the party who will become the mineral owner, regardless of the purported exigency to “save some trees,” “save some time,” or “soften the reservation,” a general mineral reservation is not likely to be very useful to your

client. Rather, Washington case law indicates that mineral reservations should be clearly drafted by specifically describing the mineral(s) to be reserved. Such reservations also should contain the terms necessary to permit exploration and the removal of minerals. In addition, you should also be mindful that Washington courts will construe ambiguous reservations against the grantor, and that increasingly, courts appear likely to construe mineral reservations narrowly to protect surface uses and values. The importance and value of potential mineral resources will vary from land transaction to land transaction; however, the more important the mineral resource, the more important it will be to negotiate and develop a well-crafted reservation that will withstand judicial scrutiny.

The parties should consider the following issues when negotiating and drafting a mineral reservation:

- (1) **MINERAL RESERVATION OR MINERAL ROYALTY.** One approach to creating a split estate is a mineral reservation in which there is a reservation of some or all specified minerals. Another approach is a royalty reservation whereby the royalty owner is entitled to a specified royalty in the event of mineral consumption or conveyance by the fee owner. One important distinction between the two is that, unlike a mineral reservation, a mineral royalty reservation is typically passive in nature and the surface owner decides whether to consume or convey the minerals subject to the obligation to pay a royalty.<sup>11</sup>
- (2) **SCOPE OF THE MINERAL RESERVATION.** This issue is a tough nut to crack. On one hand, a person could take their chances with a “general mineral reservation” – *i.e.*, all oil, gas, and other minerals. But, given both judicial erosion of the dominant mineral estate doctrine<sup>12</sup> as well as the judicial appetite to re-write agreements – in the interest of perceived fairness, of course – such an approach should not instill much confidence in the assumed breadth of the mineral estate. At the other end of the spectrum, assuming the drafter had sufficient paper and free time, she could list every conceivable mineral substance that might have value now or in the future. In between these approaches, the parties could make an informed business decision as to how the surface and mineral estates are split. Given that, in the event of a disagreement between the parties, courts likely will be more sympathetic to surface owners, counsel for the mineral estate owner should take care to draft the minerals to be severed as specifically (and, if appropriate, comprehensively) as possible. Examples of such minerals include hydrocarbons (*e.g.*, oil, gas, coal, coal seam gas, etc.); hard minerals (*e.g.*, gold, silver, copper, etc.);

*continued on next page*

continued from previous page

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

geothermal resources;<sup>13</sup> and commodity minerals (e.g., sand, rock, gravel,<sup>14</sup> limestone, diamonds, peat, clays, kayolin, etc.). Absent an unambiguous statement of the intended mineral reservation, courts may examine the intent of the parties to discern the appropriate scope of the reservation.

- (3) **DURATION OF RESERVATION.** The duration of the reservation may be for a defined time period, or it may be perpetual in nature. Reservations may or may not be extinguished by future land use regulations. Courts will not imply a regulatory taking affected by land use regulations; such a taking requires a “final government action” in the form of a ruling that a mineral owner cannot mine or remove minerals.
- (4) **ACCESS.** Misunderstandings over surface access can create conflict. The issue entails who gets access to and use of the surface estate, under what conditions, for how long, and at what, if any, cost. The mineral estate has the implied right to enter upon the surface to explore for, mine/produce, and remove minerals. Legal citations aside, this is just common sense. If the mineral owner is precluded from using the surface, the mineral estate would be worthless. Finally, unless agreed to the contrary, there is no obligation to pay for access. That said, given the potential for surface conflict, the better practice is to draft the mineral reservation to describe the type and manner of access available to implement the right, such as the right of ingress and egress onto or from the property.
- (5) **OPERATIONAL RIGHTS.** To decrease potential friction down the road, the mineral reservation should address the right to conduct exploration activities on the property (including geophysical, geological, and other studies); the right to develop, mine/produce, and remove minerals; the right to store minerals on the property; and the right to use the premises for transportation or processing of minerals extracted from the land.
- (6) **SURFACE RIGHTS AND USES.** The parties should consider the scope of surface uses needed to implement the mineral reservation. For example, mineral extraction and removal may require the construction, maintenance, and removal of roads, buildings, and other facilities on the surface. Grantors may also need to remove timber or use water from the premises. Mineral reservations should expressly reserve all surface uses and resources necessary to effectuate the reservation. The mineral owner is obligated to pay for actual damages.
- (7) **EXTRACTION METHODS.** Another opportunity to decrease potential conflict and manage expectations is to be particularly explicit regarding the manner of mineral extraction, particularly if potential extraction methods may result in significant surface damage or destruction. Examples of common extraction methods include strip mining (typically used in coal operations); open-pit mining (used in coal operations and other hard rock operations), underground mining (used in coal operations and other hard rock operations), drilling both exploration and development holes (oil and gas operations). Extraction methods may implicate other important issues, such as surface rights and uses, and subjacent support.
- (8) **SUBJACENT & LATERAL SUPPORT; LIABILITY ISSUES.** The mineral owner may possess liability to the surface owner for failing to provide subjacent and lateral support,<sup>15</sup> for surface damage, and for interference with surface wells. To address potential liability, the mineral owner could seek express waivers concerning the need to provide subjacent and lateral support, and the need to protect wells through the reservation.
- (9) **SURFACE DAMAGE.** Finally, conducting mineral exploration and/or extraction operations may damage or destroy the surface estate. The mineral reservation is a good place to address whether the surface owner is entitled to surface damage compensation and, if so, the amount. The mineral owner, of course, will want to preclude the surface owner’s ability, if any, to delay mineral exploration and development while the parties haggle over compensation.
- (10) **RECORDING.** Mineral reservations should, of course be recorded in the applicable county recording office.

### **V. Selected Additional Resources**

The following materials may provide additional helpful insight regarding the scope of mineral reservations.

#### **A. General Materials**

- ANNOT. *Clay, sand, or gravel as “minerals” within deed, lease, or license.* 95 ALR2d 843.
- ANNOT. *What are “minerals” within deed, lease, or license.* 17 ALR 156, supplemented 86 ALR 983.
- ANNOT. *Oil and gas as “minerals” within deed, lease, or license.* 37 ALR2d 1440.
- ANNOT. *Grant, reservation, or lease of minerals and mining rights as including, without expressly providing,*

continued on next page

continued from previous page

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

*the right to remove the minerals by surface mining.* 70 ALR3d 383.

- ANNOT. *Conveyance or reservation of minerals as including minerals recoverable only by open pit mining.* 1 ALR2d 784.
- Emery, *What Surface Is Mineral and What Mineral Is Surface*, 12 OKLA. L. REV. 499 (1959).
- Hayes, *Now Is It A Mineral? The Supreme Court Takes Another Look and Sand and Gravel*, 41 ROCKY MOUNTAIN MINERAL LAW FOUNDATION JOURNAL No. 2 pp 297-307 (2004).
- Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH. L. REV. 1 (1993).
- Laue, *Interpretation of 'Other Minerals' In A Grant or Reservation of A Mineral Interest*, 71 CORNELL L. REV. 618 (March 1986).
- Reeves, *The Meaning of the Word "Minerals"*, 54 N.D. L. REV. 419 (1978).
- Rocky Mountain Mineral Law Foundation, *Severed Minerals, Split Estates, Rights of Access, and Surface Use in Mineral Extraction Operations*, MINERAL LAW SERIES Vol. 2005, No. 1 (Feb. 2005) [extensive materials].
- 53A AM. JUR. 2D *Mines and Minerals* §§ 176 – 186, 201 – 206 (1996).
- Washington State Bar Association, WASHINGTON REAL PROPERTY DESKBOOK §§ 17.1 – 17.7 (3d ed. 1997).

### **B. Washington Cases**

- *Saddle Mountain Minerals, L.L.C. v. Joshi*, 116 Wn. App. 198, 65 P.3d 366 (2003)
- *Harrison v. County of Stevens*, 115 Wn. App. 126, 61 P.3d 1202 (2003)
- *Kunkel v. Meridian Oil, Inc.*, 114 Wn.2d 896, 792 P.2d 1254 (1990)
- *Weyerhaeuser Company v. Burlington Northern, Inc.*, 15 Wn. App. 314, 549 P.2d 54 (1976)
- *Puget Mill Co. v. Duecy*, 1 Wn.2d 421, 96 P.2d 571 (1939)
- *Peters v. Bellingham Coal Mines*, 173 Wash. 123, 21 P.2d 1024 (1933)

### **C. Washington Statutes**

- RCW 79.11.210: State of Washington Mineral Reservation

- RCW 78.22.060: Dormant Mineral Statute. *See also*, 7A Uniform Laws Annotated, *Uniform Dormant Mineral Interests Act* (2002).
- RCW 78.60.040: Geothermal Resources Deemed *Sui Generis*

*David Goodnight is a partner at Stoel Rives LLP in Seattle, Washington.*

*James Lynch is an attorney at Stoel Rives LLP in Seattle, Washington.*

*Greg Tolbert is Senior Corporate Counsel at Weyerhaeuser Company in Federal Way, Washington.*

- 1 For simplicity, we use the phrase "mineral reservation" but the same analysis, of course, applies to mineral grants.
- 2 The concept of divided surface and mineral estates has existed for hundreds of years. *See, e.g.*, The Case of Mines, 75 Eng. Rep. 472 (Ex. 1567) (addressing royal mining privilege). In the western US, a great deal of split estates were created by the federal government. *See e.g.*, Coal Lands Acts of 1909 and 1910; Agricultural Entry Act of 1914; Stock Raising Homestead Act of 1916, etc. Split estates – as well as real and potential conflicts – are not an insignificant issue. The US BLM alone manages 438,000,000 acres of federal split estate minerals.
- 3 A mineral interest separate from the surface estate may be created through variety of methods including grant, reservation, exception, court decree, oil and gas lease, etc.
- 4 Washington, like all states, recognizes a property owner's right to split estates as well as to create multiple mineral estates (*e.g.*, coal to A, oil and gas to B, etc.).
- 5 The case law (and saloon stories) from other jurisdictions document additional approaches to conflict resolution but these appear to be disfavored in polite company.
- 6 The reasonable use doctrine allows the mineral owner to use a reasonable amount of the surface to develop the mineral estate. The rationale for the doctrine is that, without such surface use, the severed minerals would have no value. An increasing number of jurisdictions modify the reasonable use doctrine to require the mineral owner to accommodate existing surface uses.
- 7 Under Washington law, the term "minerals" in a general mineral reservation is deemed to be ambiguous. *Kunkel v. Meridian Oil, Inc.*, 114 Wn.2d 896, 792 P.2d 1254 (1990); *Weyerhaeuser Co. v. Burlington Northern, Inc.*, 15 Wn. App. 314, 549 P.2d 54 (1976); *Puget Mill Co. v. Duecy*, 1 Wn.2d 421, 96 P.2d 571 (1939).
- 8 Unlike some jurisdictions with more extensive mineral exploration and development, Washington common law is a bit skinny. *Saddle Mountain Minerals, L.L.C. v. Joshi*, 116 Wn. App. 198, 65 P.3d 366 (2003) ("In Washington, the law in the state courts construing mineral grants and reservations is embryonic at best.") citing 1 WASH. STATE BAR ASS'N, Real Property Deskbook §17.4, at 17-16.
- 9 Courts also may employ other canons of construction – *e.g.*, *ejusdem generis* (under this rule, more specific terms such as "oil" and "gas" define and limit the general term "and other minerals"); surface destruction test (*i.e.*, if such mineral mining would destroy the surface, it was not intended to be included as "all minerals"); presence of mineral knowledge (*i.e.*, at the time of severance, did the parties have knowledge of the presence of such mineral); economic production test (*i.e.*, was the mineral capable of economic production at the time of severance); etc.
- 10 Question whether that judicial charity is warranted given that knowledgeable surface owners presumably discount the purchase price of the property because of the mineral reservation. To now narrowly interpret the general mineral reservation could very well result in a windfall to the surface owner.
- 11 In part, because of the passive nature of a mineral royalty reservation, a mineral royalty reservation should address both consumption by the surface owner as well as conveyance/development of the minerals. A mineral royalty reservation, however, need not address surface access and related issues.
- 12 The general common law rule has been that the mineral estate is the dominant estate. Accordingly, the mineral owner has the right to use so much of the surface as may reasonably be necessary to enjoy the mineral estate and to interfere with the

*continued on next page*

# An Overview of the Charitable Income Tax Deduction

by Ryan D. Rein, Short Cressman & Burgess PLLC

## I. Introduction

The primary goal of most individuals and corporations that make charitable contributions is to further charitable activities of the donee organization. Although generosity is the primary goal, a secondary goal is to make the contribution in a cost-effective manner by taking advantage of the charitable income tax deduction.

Congress enacted the first charitable income tax deduction in 1917 to encourage private philanthropy. The deduction is, in effect, a subsidy to charitable organizations. As a result, there are a myriad of rules that must be satisfied in order to qualify for a charitable income tax deduction. The current provision that allows individuals and corporations to take charitable income tax deductions is in Section 170 of the Internal Revenue Code (the "Code").

This article provides an overview of the rules in order to assist practitioners in advising their clients regarding the charitable income tax deduction under Section 170 of the Code.

## II. Basic Elements of a Charitable Contribution

Section 170(a) allows individuals and corporations to deduct "charitable contributions" paid during the year. A charitable contribution generally consists of four elements: (1) a payment (2) of money or property (3) to a permissible charitable donee (4) with charitable intent (i.e., without receiving adequate consideration in return).

### A. Payment or Transfer

The first element of a charitable contribution requires that the donor part with dominion and control of the money or

*continued from previous page*

## **Defining the Scope of a General Mineral Reservation in Washington & Practical Tips for Drafting a Mineral Reservation**

surface owner's use of it. The rationale is that without surface use, the mineral estate would be worthless. Today, however, informed by 400 years of conflict between mineral owners and surface owners, it is not uncommon for courts to require that the severed mineral owner's surface use be "reasonable" and/or "accommodate" the surface owner. "Reasonable use" is a matter of perspective. For some surface owners, any surface use by the mineral owner is unreasonable. Similarly, for some mineral owners, any accommodation of the surface estate is unreasonable. Courts, for their part, add essentially useless 'tests' such as "reasonable use," "due regard" for the surface owner's interests, etc.

13 Geothermal resources (think Mount St. Helens) must be specifically reserved, otherwise they go with the surface. See RCW 78.60.040.

14 Unless specifically reserved to the mineral estate, common sand, rock, and gravel belong to the surface owner. The rationale for excluding common sand, rock, and gravel in a general mineral reservation is that such substances do not have extraordinary value and their extraction generally entails surface destruction.

15 The Washington Supreme Court has held that a surface landowner is entitled to subjacent support unless the surface owner waives such support by some clearly expressed contractual term *Peters v. Bellingham coal Mines*, 173 Wash. 123, 21 P.2d 1024 (1933); *Saddle Mountain Minerals, L.L.C., v. Joshi*, 152 Wash.2d 242, 95 P.3d 1236 (2004).

property contributed. The actual payment or transfer is an essential element of a charitable donation. For example, the Tax Court has held that contributions made to an account in the name of the charitable organization, but controlled by the donor, were incomplete.<sup>1</sup> Furthermore, conditional gifts are not complete until the condition lapses, unless the condition is so remote as to be negligible.<sup>2</sup>

*Example.* Donor transfers land to the City of Seattle for as long as the land is used by the City for a public park. If, on the date of the gift, the City of Seattle plans to use the land for a park, and the possibility that the City will not use the land for a public park is so remote as to be negligible, Donor is entitled to a deduction under Section 170 for his charitable contribution.

### B. Money or Property Contributed

The second element of a charitable contribution requires a payment of money or property. While a contribution of cash to a charity clearly constitutes a deductible payment, a promise to pay cash in the future is not deductible. For example, delivery of a promissory note is not deductible because they are treated as a promise to pay in the future. By contrast, a charitable contribution made by credit card is deductible as of the date the charge is made to the card because the donor immediately becomes indebted to the donor's credit card company.<sup>3</sup>

Gifts of property, other than cash or cash equivalents, are deductible as payments so long as the donor parts with dominion and control over the property. In the case of stock, contribution occurs when the stock is delivered to the charitable donee or its agent.<sup>4</sup> A contribution of real property is complete when the donor delivers a deed to the charity transferring the real property to the charity.

If the donor retains ownership rights, the contribution of the property will be nondeductible. For example, the donor of a patent may not retain any rights in the patent. If a donation agreement states that a transfer to the donee of the donor's interests in a patent is subject to a right retained by the taxpayer to manufacture or use any product covered by the patent, the taxpayer has transferred a nondeductible partial interest in the patent.<sup>5</sup>

Similarly, a donor that assigns royalties to a charitable organization must, nevertheless, include the royalties in his or her gross income, unless the source of the royalties (i.e., the patent or copyright) is also assigned to the charitable organization. If the royalties are included in the donor's adjusted gross income, he or she should receive an offsetting charitable deduction for the amount of the royalties actually paid to charity. It is possible, however, that the donor's personal deduction limitations will prevent him or her from offsetting the entire amount of the royalty income with a charitable deduction.

*continued on next page*

continued from previous page

## An Overview of the Charitable Income Tax Deduction

The performance of services is not a payment of “property,” and therefore is not deductible.<sup>6</sup> It is not always clear whether a contribution is of services or of property. For example, a newspaper that prints free advertisements for a charitable organization is not entitled to a deduction because the advertisement constitutes services.<sup>7</sup> By contrast, the charitable contribution by a film maker of his films is deductible because the films had an identifiable value and were property.<sup>8</sup>

### C. Permissible Charitable Recipients

In order to qualify for a charitable deduction under Section 170(a), a donor must make a payment of money or property to a qualified charitable recipient. The list of the five permissible recipients is contained in Section 170(c) of the Code: (1) federal, state and local governmental entities; (2) certain charitable organizations; (3) war veterans organizations; (4) fraternal associations if the gift is used for charitable purposes; and (5) certain cemetery companies.

The second category, *charitable organizations*, are commonly referred to as Section 501(c)(3) organizations. It is not uncommon for donors to believe that the terms “nonprofit organization” is synonymous with “tax-exempt organization.” The term “nonprofit,” however, merely reflects that the corporation was formed under a state nonprofit corporation statute. Tax-exempt status must be applied for from the Internal Revenue Service.

An organization formed after October 9, 1969, must file Form 1023 (Application for Recognition of Exemption) in order to qualify for tax exemption under Section 501(c)(3) of the Code and to be affirmatively recognized by the Service to receive tax deductible contributions under Section 170(c)(2) of the Code (unless the organization is a church or has annual gross receipts under \$5,000).<sup>9</sup>

Donors have a duty to determine whether an organization may receive tax deductible contributions. The Service publishes a list of organizations that the Service has determined to be entitled to receive tax deductible contributions under Section 170(c). Publication 78, Cumulative List of Organizations is described in Section 170(c) of the Internal Revenue Code of 1986. It is available on the IRS’s website ([www.irs.gov](http://www.irs.gov)).

Charitable contributions directly to *individuals* do not qualify for an income tax deduction because individuals do not fall into any of the five categories listed in Section 170(c). Furthermore, in some instances, the Service will deny a charitable deduction where a contribution is made to a qualified charitable recipient, but is earmarked for an individual. For example, a deduction was disallowed where a donor made a contribution to a college for the education of the donor’s grandson.<sup>10</sup> Also, no deduction was allowed where a contribution to a university was earmarked for a teacher to engage in research.<sup>11</sup> Provided that the charitable organization had discretion to apply the donation in accordance with its exempt purpose, a charitable gift normally will be

deductible despite the donor’s desire that it benefit a specific individual.

Contributions to *foreign organizations* are not deductible under Section 170, except as permitted under a specific treaty between the U.S. and certain foreign countries. In order to qualify as a charitable organization under Section 170(c)(2) that can receive tax deductible contributions, an organization must be “created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States.”<sup>12</sup> Furthermore, a contribution to a domestic charitable organization may be nondeductible if the contribution is earmarked for a foreign organization.

### III. Charitable Intent (Receipt of Consideration)

Generally, a gift is not a “charitable contribution” unless it is a voluntary transfer of money or property *without adequate consideration*. If a donor receives a benefit in return for a transfer to a charitable organization, the transfer may be deductible as a charitable contribution, but only to the extent (1) the amount transferred exceeds the fair market value of the benefit received, and (2) only if the excess amount was transferred with the intent of making a gift (a “dual character” transfer).<sup>13</sup> In other words, the donor must establish that it knew, at the time of the transfer, that the value of what it gave was greater than the value of what it received.

#### A. Payments Related to Fundraising Activities

Charitable organizations often hold fundraising events such as banquets, golf tournaments, and shows in order to solicit contributions. Donors purchase tickets to the fundraising events to not only benefit the organizations, but also to obtain the right to attend the events. Also, charitable organizations often give donors token items such as books, videos, mugs, or special privileges in return for contributions. Because the donor receives a benefit from attending an event or receiving a token item in exchange, the impact on the charitable contribution deduction must be examined.

The burden is on the donor to show that all or part of the payment is a charitable contribution or gift.<sup>14</sup> No part of a payment that a donor makes to, or for the use of, a charitable organization that is in consideration for goods or services is a “contribution or gift” under Section 170(c) unless the donor: (i) intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) makes a payment in an amount that exceeds the fair market value of the goods or services.

For example, a symphony association sponsors a performance as part of a fundraising effort to solicit contributions for a new symphony hall. Admission prices for the gala are \$100. The established admission charges for comparable symphony

continued on next page

continued from previous page

## **An Overview of the Charitable Income Tax Deduction**

performances are \$40. This information is reflected in all promotional materials. Donor purchases two tickets for \$200. The value of his tickets is \$80. Under the two-part test, Donor's payment of \$200 exceeds the \$80 benefit that the Donor received. Also, based on the promotional materials, it appears that the Donor intended to make a gift in excess of the usual cost of admission. Thus, Donor is entitled to a charitable contribution deduction of \$120 (\$200 – \$80).

### **B. Bargain Sales (and Contributions of Encumbered Real Estate)**

A bargain sale occurs where a donor transfers property to a charitable organization in exchange for consideration that is less than the fair market value of the property. A bargain sale is treated in part as a charitable contribution and in part as a sale or exchange of property. The part of the bargain sale that is treated as a contribution is equal to the excess of the fair market value of the property over the purchase price paid by the charity. The sale portion of a bargain sale is governed by the general rules pertaining to property dispositions, under which gain or loss is determined with reference to the difference between the amount realized and the adjusted basis of the property. In determining the amount of the gain, the donor's basis in the property must be apportioned between the gift portion and the sale portion.<sup>15</sup> Thus, the donor will not be able to reduce the tax liability by applying his/her entire cost basis against the sale portion.

Some donors are surprised to learn that contribution of mortgaged real estate to a charitable organization constitutes a bargain sale. The donor is treated as receiving consideration upon the contribution in an amount equal to the amount of the indebtedness.<sup>16</sup> A contribution of encumbered property is treated as a bargain sale even if the indebtedness is nonrecourse or the donee does not agree to assume the debt. *Id.* Thus, a charitable contribution of encumbered real estate may trigger income taxes.

### **IV. Gifts of Partial Interests**

As a general rule, a charitable contribution of a partial interest in property does not qualify for a charitable income tax deduction.<sup>17</sup> This is true whether the contribution is made outright or in trust. A partial interest in property is an interest in property that consists of less than the donor's entire interest. The contribution of the right to use property constitutes a partial interest.<sup>18</sup>

*Example.* Donor is an individual that owns a 10-story office building. He donates the rent-free use of the top floor of the building to a charitable organization. Since Donor's contribution consists of a partial interest (use of the space), he is not entitled to a charitable contributions deduction for the contribution of such partial interest.<sup>19</sup>

Discussed below, however, are a number of exceptions to the general prohibition against deducting contributions of partial interests.

A charitable contribution of a partial interest in property is deductible if it consists of the donor's *entire interest* in the property.<sup>20</sup>

*Example.* Dad leaves Boeing stock under his Will to Son for life with the remainder passing to Granddaughter upon Son's death. Granddaughter makes a charitable contribution of her remainder interest in the Boeing stock to a charitable organization. A deduction is allowed for the present value of Granddaughter's remainder interest in the securities, because it consists of Granddaughter's entire interest in the property.

A deduction is not allowed, however, if the property in which the partial interest exists was divided for the purpose of circumventing the rules under Section 170(f)(3).

A donor may take a deduction for an outright contribution of an *undivided portion* of the donor's entire interest in property.<sup>21</sup> The undivided portion must consist of a fraction or percentage of every interest or right owned by the donor. The charitable organization must have the right to possession, dominion, and control of the property.

*Example.* Donor owns a 100-acre ranch. Donor contributes an undivided 50% interest in the ranch to a charitable organization. Donor and the charitable organization share the income from the ranch, and the charitable organization has a right to possession, dominion, and control of the property appropriate to its 50% interest. Donor's contribution of an undivided portion of his entire interest in the land is deductible.

A donor may take a deduction for an outright contribution of a *remainder interest in a personal residence or farm*, even though it is not the donor's entire interest in the property.<sup>22</sup> The term "personal residence" includes any property used by the taxpayer as a personal residence and is not limited to the donor's principal residence.<sup>23</sup> Thus, a donor's vacation home may be a personal residence. The term "farm" means any land used by the donor or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

A donor may deduct the value of a *qualified conservation contribution*, which is defined as the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.<sup>24</sup> The amount of the deduction is determined by comparing the value of the real property before

continued on next page

continued from previous page

## An Overview of the Charitable Income Tax Deduction

and after the granting of the easement. The decrease in value resulting from the easement is deductible.

Generally, **contributions to charity in trust** are not deductible for income tax purposes unless the donor transfers his or her entire interest in the property and there are no non-charitable beneficiaries.<sup>25</sup> However, the contribution of a remainder interest in trust will qualify for a deduction so long as the trust qualifies as a "charitable remainder annuity trust," a "charitable remainder unitrust," or a "pooled income fund." A discussion of charitable remainder trusts and pooled income funds is beyond the scope of this article.

### V. Amount of Deduction and Percentage Limitations

A donor's deduction for charitable contribution is limited based on the character of the property contributed. For example, a charitable deduction for the contribution of appreciated real property may be limited to the donor's cost basis in the property (if it is contributed to a private foundation) or may be the fair market value of the property (if contributed to a public charity). Furthermore, there are percentage limitations based on the donor's adjusted gross income. The purpose of the following grid is to summarize both the deduction limitations and percentage limitations.

	Contributions to Privately Supported Foundations		Contribution to Publicly Supported Charities	
	AGI Limit	Deduction Amount	AGI Limit	Deduction Amount
Cash/Cash Equivalents	30%	FMV	50%	FMV
Appreciated Publicly Traded Stock	20%	FMV	30%	FMV
Other Long-term Gain Property such as real estate	20%	Basis	30%	FMV
Ordinary Income Property such as inventory or short-term property	30%	Basis	50%	Basis
Tangible Personal Property (unrelated to exempt function) such as art	30%	Basis	50%	Basis
Tangible Personal Property (related to exempt function)	30%	Basis	50%	FMV

**FMV:** The fair market value of the property contributed.

**Basis:** Short for "cost basis." Technically, it is the fair market value of the property contributed reduced by the amount that would have been long term gain.

Note, however, that if the basis of the property exceeds its fair market value, the deduction will be limited to fair market value.

### VI. Accountability

A charitable organization must file Form 8282 with the Service to report the disposition of donated property if the disposition occurs within two years of its receipt. The purpose of the reporting requirement is to facilitate accurate valuation by the original donors. For example, a sale of donated real estate by a donee shortly after its contribution for substantially less than the amount claimed as a deduction by the donor may indicate that the donor overvalued the property.

The reporting obligation only applies in the case of a sale or other disposition of "charitable contribution property" within two years of its contribution. The term "charitable contribution property" is defined as any property for which a deduction was claimed under Section 170 where the claimed value of the property exceeded \$5,000.<sup>26</sup> Cash and certain publicly traded securities are excluded from the definition of charitable contribution property.

### VII. Conclusion

By remaining mindful of the rules governing charitable income tax deductions, practitioners can help clients leverage their charitable giving and avoid pitfalls. This benefits both the taxpayer and the charities.

- 1 Burwell v. Commissioner, 89 T.C. 580 (1987)
- 2 Treas. Reg. § 1.170A-1(e)
- 3 Rev. Rul. 78-38
- 4 Treas. Reg. § 1.170A-1(b)
- 5 See Rev. Rul. 2003-28
- 6 Treas. Reg. § 1.170A-1(g)
- 7 Rev. Rul. 57-462
- 8 *Holmes v. Commissioner*, 57 T.C. 430 (1971)
- 9 I.R.C. § 508(a)
- 10 *Cooper v. Commissioner*, 264 F.2d 889 (4th Cir. 1959)
- 11 Rev. Rul. 61-66.
- 12 I.R.C. § 170(c)(2)(A)
- 13 See *American Bar Endowment* at 118 (the taxpayer must "at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.")
- 14 Treas. Reg. § 1.170A-1(h)(1)
- 15 I.R.C. § 1011(b)
- 16 Treas. Reg. § 1.1011-2(a)(3)
- 17 I.R.C. § 170(f)
- 18 Treas. Reg. § 1.170A-7
- 19 Treas. Reg. § 1.170A-7(d), Ex. 1
- 20 Treas. Reg. § 1.170A-7(a)(2)(i)
- 21 I.R.C. § 170(f)(3)(B)(ii)
- 22 I.R.C. § 170(f)(3)(B)(i)
- 23 Treas. Reg. § 1.170A-7(b)(3).
- 24 Treas. Reg. § 1.170A-14
- 25 I.R.C. § 1.170A-6(a)(1)
- 26 I.R.C. § 6050L

# Ethical Issues in Nonjudicial Deed of Trust Foreclosures: *Cox v. Helenius*, Revisited

by G. Michael Zeno, Jr.

Twenty years ago, in the case of *Cox v. Helenius*, 103 Wn.2d 383, 693 P.2d 683 (1985), the Washington Supreme Court held that (1) a deed of trust trustee owes fiduciary duties to both the grantor and the beneficiary, and (2) even though Washington's Deed of Trust Act (RCW 61.24) permits the beneficiary's attorney to serve as trustee, ethical considerations may preclude the attorney from doing so. These holdings shocked many attorneys accustomed to conducting nonjudicial foreclosures for lenders. This article examines the logic of *Cox*, how the WSBA interpreted the case in Informal Ethics Opinion 87-1, how subsequent cases have treated the issues raised by *Cox*, and whether *Cox* should be overruled.

## I. The Case

Cox agreed to pay the Contractor \$9,985 to supply and install a pool. Payments were to be made over time, with the deferred payment obligation secured by a deed of trust.

Pipes installed by the Contractor collapsed, causing damage. Cox stopped paying on the note and sued the Contractor. The Contractor commenced a nonjudicial foreclosure of the deed of trust at about the same time. The service and filing of Cox's complaint was completed after the Contractor had given notice of default but before it had served and filed the notice of trustee's sale. The Contractor's attorney, Helenius, was also the trustee under the deed of trust.

In response to the notice of sale, Cox amended the complaint to request that the trustee's sale be enjoined. However, Cox took no further action to enjoin the sale. Cox's attorney apparently assumed that the sale was not going to take place. The opinion hints that Helenius somehow lulled Cox's attorney into complacency, but does not describe any particular instances of deception by Helenius.

The house was purchased at the foreclosure sale by a dealer in distressed properties for \$11,784, one dollar more than the Contractor's credit bid. The house was worth \$200,000 to \$300,000.

The court held that the foreclosure was invalid, because there was an action pending on the obligation secured by the deed of trust (*i.e.*, Cox's suit), contrary to RCW 61.24.030(4). That section of the statute has since been amended to specify that the action must have been commenced by the beneficiary.

The controversial portion of the opinion, section II, consists of five short paragraphs. The first three paragraphs assert that the trustee owes a fiduciary duty to both the grantor and the beneficiary. The court acknowledges that the duty to the grantor has limits:

Washington courts do not require a trustee to make sure that a grantor is protecting his or her own interest... We agree ... that a trustee's management responsibilities under a deed of trust are less extensive than those of trustees in other fiduciary settings... The trustee of a deed of trust is not

required to obtain the best possible price for the trust property.

*Cox*, 103 Wn.2d at 389, 693 P.2d at 686-87.

At the same time, the court repeats several times that the trustee owes a duty to the grantor:

Because the deed of trust foreclosure process is conducted without review or confirmation by a court, the fiduciary duty imposed upon the trustee is exceedingly high ... a trustee of a deed of trust is a fiduciary for both the mortgagee and the mortgagor and must act impartially between them.... [T]he trustee must 'take reasonable and appropriate steps to avoid sacrifice of the debtor's property and his interest.'

*Cox*, 103 Wn.2d at 388-89, 693 P.2d at 686-87.

The fifth and last paragraph of Section II suggests that attorney trustees have additional constraints, deriving from the Code of Professional Conduct, though it does not describe those constraints in any detail. The court then states: "Where an actual conflict of interest arises, the person serving as trustee and [attorney for the] beneficiary should prevent a breach [of the Code of Professional Conduct] by transferring one role to another person." *Cox*, 103 Wn.2d at 390, 693 P.2d at 687.

## II. Questions Raised by Cox

*Cox* seems to require the trustee of a deed of trust to strike a balance between the interests of the grantor and the beneficiary. This need to behave with some degree of impartiality is imposed on all trustees, whether or not they happen to be attorneys, and raises practical questions.

*Postponement.* How should the trustee handle requests by the grantor to postpone the sale? Suppose it appears likely (based on documentation, interviews with third party funding sources, and so forth) that a week's continuance would allow the grantor to obtain enough money to cure the default. Does *Cox*'s statement that the trustee should "take reasonable and appropriate steps to avoid sacrifice of the debtor's property and interest" require a continuance? Does the trustee have a duty to investigate before accepting or rejecting a grantor's request for a continuance?

*Grace.* Does the trustee's duty to the grantor require the trustee to show the grantor some grace, by excusing *de minimus* deviations from strict performance? For example, if the grantor tenders \$10 less than the full amount required to cure the default, may the trustee accept it as the equivalent of full performance? Should the trustee do so?

*Price—Procedural Requirements.* What, if anything, is the trustee required to do to encourage bidding? Where there are several legal newspapers in a county, some obscure weeklies, other wide-circulation dailies, is the trustee required to publish in

*continued on next page*

continued from previous page

## **Ethical Issues in Nonjudicial Deed of Trust Foreclosures: Cox v. Helenius, Revisited**

the wide-circulation daily, even though the publication cost will be higher? If an interested party asks the trustee for a copy of the title report prior to sale, must the trustee provide one? If so, may the trustee charge the requestor a fee?

**Price—Substantive Requirements.** *Cox* says that the trustee is not required to obtain the best possible price. At the same time, the Court was undoubtedly troubled by the fact that the Coxes' house, worth \$200,000 or \$300,000, was sold for less than \$12,000 at the foreclosure auction. When the price paid for the property at the sale is obviously too low, does the trustee have a duty to protect the grantor—for example, by continuing the sale until a fairer price is obtained?

**Strict Compliance with Statutory Procedures.** Does the trustee breach a duty to the grantor by failing to strictly follow the foreclosure procedures set forth in RCW 61.24?

**Candor.** If the trustee is aware of possible problems with the foreclosure, does he or she have a duty to inform the grantor?

**Conflicts of Interest.** *Cox* raises additional questions when the trustee is an attorney. First, *Cox* implies that the Code of Professional Responsibility does not prohibit a beneficiary's attorney from serving as the foreclosing trustee in all cases, but only when "an actual conflict of interest" arises. How is the attorney-trustee to judge when an "actual" conflict has occurred? Does a request for a postponement trigger an actual conflict? Does litigation between the parties necessarily constitute an actual conflict? What about a bankruptcy filing? Second, if the beneficiary selects an attorney to serve as trustee, is the beneficiary necessarily that attorney's client? Can an attorney-trustee avoid conflicts of interest by declaring that he or she is serving as an independent trustee rather than as attorney for the beneficiary? Does the fact that a beneficiary has separate counsel mean that the trustee is not also the beneficiary's attorney?

### **III. Informal Ethics Opinion 87-1**

The year after *Cox v. Helenius* was decided, a lender's attorney wrote the WSBA, asking for guidance about the ethical implications of the case. By this time the relevant ethical code was the Rules of Professional Conduct, rather than the Code of Professional Responsibility referred to in *Cox*. This inquiry led to the publication of Informal Opinion 87-1. An Informal Opinion is provided for the education of the Bar and reflects the opinion of the Rules of Professional Conduct Committee, but does not reflect the official position of the WSBA.

The Informal Opinion accepted the premise from *Cox* that the foreclosing trustee owes a duty to the grantor of the deed of trust. It observed that under RPC 1.7(b), a lawyer may not represent a client if the representation would be "materially limited" by the lawyer's duty to a "third person." Although the Informal Opinion does not say so, presumably the material

limitation by a lawyer's duty to a third person is equivalent to the "actual conflict of interest" forbidden by *Cox*.

The Informal Opinion gave the following answers to some of the questions posed above:

1. "[I]f the grantor requests a delay which reasonably appears to the trustee to be nonfrivolous, but the beneficiary refuses to agree to a postponement, then a conflict may exist..." (emphasis added).
2. Where the grantor files bankruptcy and the beneficiary would like relief from stay to pursue the foreclosure, a conflict may or may not exist.
3. A lawyer "who represents neither grantor nor trustee" and who exercises independent judgment may serve as trustee, even if the grantor and beneficiary give conflicting instructions.

To summarize what the Informal Opinion did and did not do:

1. It did reiterate the holding of *Cox* that the trustee owes a duty to the grantor. It also reiterated the holding of *Cox* that the existence of such duty could create an impermissible conflict of interest, preventing the attorney for the beneficiary from serving as trustee. It located the basis for the conflict in RPC 1.7(b).
2. It identified two, but only two, circumstances in which a conflict might exist. It did not say that a conflict would definitely exist in those circumstances.
3. It did not give any guidance to the trustee on what choices to make when conflicting duties arose.
4. It recognized the possibility, suggested in *Cox*, that an attorney could serve as trustee without having either the grantor or the beneficiary as client. It did not, however, address how the attorney-trustee could achieve the status of attorney-without-client, and thereby avoid conflicts of interest.

### **IV. Subsequent Cases**

In each of the following cases, the grantor claimed that the trustee had breached the fiduciary duties referred to in *Cox*. In each case the grantor lost.

In *Cascade Manor Associates v. Witherspoon Kelley, Davenport & Toole, P.S.*, 69 Wn. App. 923, 850 P.2d 1380 (1993), the lender commenced a nonjudicial foreclosure, then abandoned it and brought a lawsuit to have a receiver appointed to collect rents. The lender prevailed in the motion to have a receiver appointed and received some rents, but the borrower at first withheld back rents. In a subsequent motion the lender obtained these back rents as well. The borrower appealed. While

*continued on next page*

continued from previous page

### **Ethical Issues in Nonjudicial Deed of Trust Foreclosures: Cox v. Helenius, Revisited**

the appeal was pending, the lender recommenced the nonjudicial foreclosure. Although the borrower's counsel received the notice of trustee's sale, he apparently assumed the sale would not take place—just as the debtor's attorney in *Cox* had done. The lender purchased the property at the sale with a credit bid. The borrower later brought suit to set aside the sale.

Michael Currin, an attorney at the defendant Witherspoon firm, acted as attorney for the lender before the foreclosure began, represented the lender in the contentious litigation, and served as foreclosing trustee under the deed of trust. The borrower argued that he had breached his fiduciary duty by doing so. The court rejected this argument as follows:

Likewise, there is no basis to conclude that Currin breached his fiduciary duties as trustee by acting as both the trustee and Bancorp's attorney. Contrary to Cascade's assertion, *Cox v. Helenius*, does not prohibit a trustee from also acting as the attorney for the beneficiary. Instead, Cox noted that, although the attorney's dual role could have "precipitated" a breach of fiduciary duties if a conflict of interest arose, such a breach could be prevented if "the person serving as trustee and beneficiary ... transferr[ed] one role to another person." While a trustee acting as counsel for one of the involved parties could avoid any risk of conflict when litigation arises by arranging for a substitute trustee, neither Cox nor any other authority requires the trustee to do so. Indeed, Cox noted that a trustee is not required to ensure that the grantor is protecting his or her own interest. Consequently, we hold that the trial court erred by concluding that Witherspoon, through Currin, breached its fiduciary duties to Cascade.

*Cascade Manor*, 69 Wn. App. at 934-35, 850 P.2d at 1386. (citations omitted).

The *Cascade Manor* case implies that whatever the attorney-trustee's duties to the grantor may be, these duties do not preclude the attorney-trustee from representing the beneficiary in contentious litigation against the grantor over rents from the property. Apparently, in striking a balance between his duties to the grantor and his duties to the beneficiary, the trustee need not accord any weight to the grantor's desire to retain rents from the property.

In *Meyers Way Development Co. v. University Savings Bank*, 80 Wn. App. 655, 910 P.2d 1308 (1996), the attorney-trustee had not previously served as the lender's attorney, and the lender had separate counsel. This attorney-without-client status protected the trustee from violating the RPCs, but did not insulate him from the borrower's claim that he had breached the fiduciary duties owed to the grantor. The court's discussion of the borrowers'

claims against the trustee and its reasons for rejecting each of them are quoted below, with footnotes omitted:

[The Borrowers] argue that the indemnity agreement was a breach of [the Trustee's] fiduciary duty, *per se*, as a matter of law, because the effect was to allow [the Trustee] to violate the grantors' rights with impunity, knowing he would be indemnified by the Bank.

A trustee of a deed of trust acts as the fiduciary for both the creditor and debtor on a deed of trust, so must act impartially between them. Because a deed of trust foreclosure is a nonjudicial proceeding, the trustee's fiduciary duty to the debtor is 'exceedingly high.' Despite this high duty, the *Cox* court recognized that a trustee need not guarantee that the debtor is protecting his or her own interests. Neither does the high fiduciary duty prevent a trustee from serving simultaneously as the creditor's attorney, agent, employee or subsidiary. The trustee serving in such a dual role must transfer one role to another party if serving in this capacity causes an actual conflict of interest with the debtor.

In the instant case, [Borrowers] assert four breaches of fiduciary duty: (1) the indemnity agreement itself; (2) [the Trustee's] failure to tell the borrowers what he told the bank—that the notice of default was fatally defective; (3) [the Trustee's] failure to exercise independent judgment in setting the sale to occur forty-five days after dismissal of the first bad faith bankruptcy; and (4) [the Trustee's] failure to investigate [Borrowers'] claim of cure.

We first address the indemnity agreement between [the Trustee] and the Bank. We agree with the trial court that the indemnity agreement was not *per se* a breach of fiduciary duty and adopt the trial court's ruling that, by its nature, an indemnity agreement between a deed of trust beneficiary and the trustee foreclosing on the deed of trust requires heightened judicial scrutiny of any claims of breach of fiduciary duty, given the 'exceedingly high' fiduciary duty owed by a trustee to the debtor.

Even if by the indemnity agreement [the Trustee] became the equivalent of the Bank's attorney, agent or employee, as claimed by the appellants, *Cox* does not prevent [the Trustee] from serving in both of these roles. Only an actual conflict of interest can precipitate a breach of fiduciary duty. The indemnity agreement does not include any provisions requiring [the Trustee] to adopt the Bank's position without regard to the rights of the borrowers. If the agreement in question had contained such provisions, we would, of course, agree with the appellants' position. But

continued on next page

continued from previous page

### ***Ethical Issues in Nonjudicial Deed of Trust Foreclosures: Cox v. Helenius, Revisited***

this agreement merely required the Bank to indemnify the trustee from any claims arising from his services, including any claims asserted by the grantors that the trustee had breached his fiduciary duty to them.

Whether or not the record supports the Bank's claim that this agreement was justified by the litigious nature of the grantors, the very nature of a trustee's role leaves the trustee vulnerable to claims arising from the foreclosure process. A completed foreclosure is bound to result in an unhappy grantor, and often a grantor who may perceive, as in this case, breaches of fiduciary duty which ultimately prove not to have been breaches. Still, litigation is expensive, time-consuming, and emotionally draining. We believe that to prohibit indemnity agreements such as the one in this case would make it difficult to find qualified people willing to serve as trustees, frustrating one of the purposes of the deed of trust act—keeping the nonjudicial foreclosure process efficient and inexpensive. The heightened judicial scrutiny standard will deter the abuse of the protections offered to trustees by such agreements, when their existence becomes known, either by voluntary disclosure or, as apparently was the case here, through the discovery process when litigation ensues.

Second, [the Trustee] did not breach his duty by failing to disclose his initial belief that the notices filed by the earlier trustee were fatally defective. [the Trustee's] belief derived from his misunderstanding of the nature of the initial defaults. The notices named only nonmonetary defaults and set forth the requisite nonmonetary cures. The notices stated that cure could also be made by paying the note in full (a rather obvious means of curing any default). [The Trustee] initially feared that this alternative recital of cure made the notices defective, a position he withdrew after realizing that the Bank claimed no monetary defaults on the loan, at the time of the notices.

A trustee's fiduciary duty does not require that he or she report erroneous conclusions to both parties, or, having reported to one party and learning of the error, report the initial mistake to the other party. As a matter of law, [the Trustee] was not required to make sure that the borrowers were vigilantly guarding their rights. By informing the Bank of his initial opinion and recommending a postponement, [the Trustee] acted in a manner consistent with his duty to the borrowers. We disagree with the appellants that *Cox* dictates a different result. There, in dicta, the Supreme Court opined that the trustee should have notified the grantor's attorney that, in the trustee's (legally correct) opinion, the filing of a lawsuit requesting

that a sale be restrained does not in and of itself restrain the sale—the grantor must request the court to issue a restraining order and the order must be issued, before the sale is restrained. This is a far cry from suggesting that the trustee must report legally incorrect opinions initially held and promptly withdrawn.

Third, there is no evidence that [the Trustee], by setting a new sale date forty-five days after the dismissal of the borrowers' first bankruptcy action, failed to exercise independent judgment. Moreover, this act was in compliance with RCW 61.24.130(4) (relating specifically to sale dates after bankruptcy actions are dismissed). In the words of the trial court, 'The shortened notice following a finding of bad faith bankruptcy cannot seriously be criticized.'

Finally, the trustee properly declined to investigate Borrowers' claim to have cured the nonmonetary defaults. By the time Borrowers made the claim, significant monetary default existed. It would be fruitless to require trustees to investigate claims of cured nonmonetary defaults where the result would be moot, given the existence of monetary default.

In sum, on these undisputed facts, applying heightened judicial scrutiny, we conclude as a matter of law that the trustee committed no breach of fiduciary duty.

*Meyers*, 80 Wn. App. at 665-69, 910 P.2d at 1315-17. (citations omitted).

Clearly, the trustee in *Meyers* occupied an awkward position between two warring parties. It also seems fairly clear that there was no overreaching or inequitable conduct by the trustee, which made it hard for the court to find any breach of fiduciary duty to the grantor.

In *Country Express Stores v. Sims*, 87 Wn. App. 741, 943 P.2d 374 (1997), the lender's attorney represented the lender against the debtor in contentious bankruptcy proceedings and served initially as the foreclosing trustee. At the debtor's request, the attorney-trustee resigned the day before the sale and a new attorney-trustee was appointed, who conducted the sale as scheduled. At the sale and prior to the sale, the borrower made a request that the trustee marshal assets. The trustee appointed at the last minute refused this request. It appears the trustee did not make any inquiry in evaluating the debtor's request, other than to talk to the lender's attorney.

The grantor then attempted to set aside the sale, alleging that the trustee had improperly "chilled" the bidding, had unfairly refused to marshal assets, and that the last-minute trustee came too late to exercise independent judgment on the marshalling

continued on next page

continued from previous page

## **Ethical Issues in Nonjudicial Deed of Trust Foreclosures: Cox v. Helenius, Revisited**

issue. The court found no evidence of “chilling” and held that the debtor had waived the marshalling issue by failing to bring an action to enjoin the sale earlier.

In *Steward v. Good*, 51 Wn. App. 509, 754 P.2d 150 (1988), a third party (Good) purchased a condominium at a foreclosure sale for \$4870; the opinion suggests that the condominium was worth more than \$60,000. Furthermore, the trustee had recorded the notice of sale late—approximately 30 days before the sale—but had mailed it to the grantor in a timely fashion. The court refused to overturn the sale on the basis of the low price, and observed that the grantors had not introduced evidence about the amount of their equity in the property. The court went on to hold that the grantors had waived the right to object to the procedural defect.

*Koegel v. Prudential Mutual Savings*, 51 Wn. App. 108, 752 P.2d 385 (1988) held that the grantor had waived procedural defects in the nonjudicial foreclosure by failing to seek injunctive relief prior to the sale.

In *Plein v. Lackey*, 149 Wn.2d 214, 67 P.3d 1061 (2003), the Washington Supreme Court reiterated the “waiver doctrine” articulated in *Koegel*, *Steward*, and *Country Express Stores*—the doctrine that where the grounds for objecting to foreclosure are evident prior to the sale, the grantor must seek to restrain the sale as provided in RCW 61.24.130. At first blush, it appears that the “waiver doctrine” is inconsistent with *Cox*. However, Plein distinguished *Cox* in footnote 5 on two grounds: (1) that the inadequacy of the price, one of the bases for the holding in *Cox*, would not have been known prior to the sale, and (2) because there was an action pending on the obligation prior to the giving of the notice of sale, the foreclosure was void.

To summarize the post-*Cox* case law on the trustee’s duty to the grantor: Every published decision to consider the issue has rejected the grantor’s claim that the trustee breached his or her fiduciary duty. The following conduct by the trustee has been allowed: (1) simultaneously acting as attorney for the beneficiary in contentious litigation in state court (*Cascade Manor*), and bankruptcy court (*Country Express Stores*); (2) proceeding with the sale despite known procedural errors (*Steward* and *Koegel*); (3) requiring an indemnity from the beneficiary (*Myers*); and (4) failing to inform the grantor about possible defects in the notices given by the predecessor trustee (*Myers*).

Certain potential grantor claims have not been addressed in any reported cases: (a) a claim that the trustee should have continued the sale to allow cure, and (b) a claim that the sale price was grossly inadequate (raised in *Steward*, but the facts were unclear).

### **V. A Critique of *Cox v. Helenius***

The *Cox* court conceived of a deed of trust trustee as an impartial fiduciary, balancing the interests of the grantor and the beneficiary, much as the trustee of a family trust might be required to balance the interests of the income beneficiaries and the remaindermen. Trust law recognizes such a duty of impartiality with respect to beneficiaries with conflicting interests. See e.g., *Johnson v. Cooper (In re Estate of Cooper)*, 81 Wn. App. 79, 913 P.2d 393 (1996).

But conceiving of the deed of trust trustee as an impartial fiduciary requires the court to articulate standards of impartiality case by case, a laborious process that involves considerable societal expense in the form of litigation costs. Furthermore, such common law standards are unavoidably imprecise, saddling borrowers and lenders with a frustrating residuum of uncertainty. Subsequent Washington cases have instinctively avoided going down the road where *Cox* points. In every case where the grantor has asked the court to put some weight on the grantor’s side of the balance of interests, the court has refused.

It makes more sense to conceive of the deed of trust trustee as an agent of the beneficiary, without fiduciary duties to the grantor. This has numerous advantages:

1. It is consistent with RCW 61.24, which permits the beneficiary to replace the trustee. Also, as noted in the *Cox* opinion, the statute was amended in 1975 to permit an agent of the beneficiary to serve as trustee.
2. *Cox* articulated an “efficient and inexpensive” foreclosure process as one of the public policies behind the Deed of Trust Act. This policy serves the ultimate policy of encouraging real estate-secured lending. Requiring the trustee to balance competing interests introduces uncertainty into the foreclosure process and frustrates this policy. A lender needs to know that he or she will be able to foreclose the deed of trust in the event of default, insisting on strict compliance with the loan documents. The fiduciary duty to the grantor articulated in *Cox* raises the possibility that foreclosure will be stalled or barred if proceeding with the foreclosure would sufficiently harm the debtor. If subsequent cases had not reduced this duty to a vapor, lenders might now be using to real estate contracts or mortgages.

There are further objections to the notion that a deed of trust trustee owes fiduciary duties to the grantor:

1. It is not necessary. Two-party security instruments—mortgages and real estate contracts—have been used and enforced for centuries. In these instruments no one plays the role of “trustee,” with putative duties to the

continued on next page

continued from previous page

### **Ethical Issues in Nonjudicial Deed of Trust Foreclosures: Cox v. Helenius, Revisited**

borrower. Furthermore, the fact that no case after *Cox* has found a violation of duty by the trustee suggests that the existing system works without the need to conceive such a duty.

2. The fact that the person who forecloses the deed of trust is called a "trustee" does not require the court to import the duties and concepts of trust law into the law of real estate security. The court should recognize that the term "trustee" is an anachronism and a misnomer.
3. Even if the term "trustee" required the importation of trust law concepts, the trustee of a trust does not owe fiduciary duties to the grantor. Fiduciary duties are owed to the beneficiaries. Once the grantor conveys the trust corpus to the trustee, the grantor loses any right to control it or benefit from it, unless the trust is revocable or the grantor is also a beneficiary.
4. It is not necessary to posit any fiduciary duties in order to recognize that the trustee owes general duties of fair dealing to the grantor. While an agent owes a duty of loyalty to his or her principal, the agent must act within the general duties that constrain his or her dealings with third parties. For example, an agent cannot excuse assault, murder, or fraud even if these acts would serve the principal's interests. Similarly, an attorney must be candid with the court and fair in his dealings with the opposing party and counsel, per RPC 3.3 and 3.4.
5. Doing away with the notion that the trustee owes fiduciary duties to the grantor would eliminate the professional ethical concerns raised by *Cox* and Informal Opinion 87-1. As a practical matter, these professional

ethical concerns are typically avoided by appointing a successor trustee, who occupies the position of attorney-without-client and thus escapes the conflict of interest that burdens the attorney for the beneficiary. Practitioners know that the successor trustee-without-client does the beneficiary's bidding, and therefore that the appointment of a successor trustee in lieu of the beneficiary's attorney is an empty formality. Empty formalities are better avoided.

#### **VI. Conclusion**

Courts are still quoting *Cox v. Helenius's* language about the high fiduciary duty owed by the trustee to the grantor, but ignoring this duty in practice. *Cox v. Helenius* should be overruled, both in the interest of intellectual honesty and in order to remove the legal cloud that lingers over nonjudicial deed of trust foreclosures. However, until this occurs, attorneys asked to serve as foreclosing trustee should take reasonable precautions, including the following:

1. If you are the attorney for the beneficiary serving as trustee and an "actual conflict of interest" arises, resign and have the beneficiary appoint a successor. If the grantor asks you to resign or questions your impartiality, resign. If the grantor sues, resign.
2. If you are not the beneficiary's attorney and are asked to serve as successor trustee, enter into a written agreement with the beneficiary in which the beneficiary agrees to indemnify you and which clearly states that you are an independent trustee, bound to exercise independent judgment.

## **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, Washington State Bar Association,  
2101 Fourth Avenue, Suite 400, Seattle, WA 98121-2330**

### RPPT SECTION MEMBERSHIP FORM

Name \_\_\_\_\_

Firm \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ Zip \_\_\_\_\_

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

I am not a member of the Washington State Bar, but I want to receive your informational newsletter. My \$15 is enclosed.

*Current membership year: October 1, 2004 – September 30, 2005*

Send this form with check to: \_\_\_\_\_

*office use only*

Real Property, Probate & Trust Section  
Washington State Bar Association  
2101 Fourth Avenue, Suite 400  
Seattle, WA 98121-2330

Date \_\_\_\_\_

Check # \_\_\_\_\_

Total \$ \_\_\_\_\_

# Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians A Proposed New Court Rule

by Steve Crossland, Crossland Law Offices

In 2001 the Washington State Supreme Court passed General Rules 24 and 25. General Rule 24 (GR 24) created a definition of the practice of law. General Rule 25 (GR 25) created the Practice of Law Board (POLB). The POLB was charged with two primary functions. First, to investigate instances of alleged unauthorized practice of law by non lawyers. Second, to make recommendations to the State Supreme Court regarding instances in which nonlawyers may be authorized to engage in the practice of law and under what circumstances and to what degree. The source for this effort originally was the regulation of the unauthorized practice of law. However, GR 25 also has as one of its purposes addressing the very large issue of access to justice. As we all know, and as was underscored by the State Supreme Court's "Civil Legal Needs Study," there is a tremendous unmet need for legal services in our state.

The POLB is a board appointed by the State Supreme Court and funded by the Washington State Bar Association. The POLB was created and held its first meeting in August of 2002. The POLB consists of 13 members. There are 4 non lawyers and 9 lawyers. Since its inception it has considered 76 complaints, found 16 instances of unauthorized practice of law, made 8 referrals to the prosecuting attorney's offices for criminal prosecution, dismissed 20 cases and issued 7 advisory opinions.

GR 24 and GR 25 are unique in the legal system in the United States. Since their adoption several states have elected to adopt similar rules. The ABA considered adopting a model rule similar to Washington's but found the diversity among the circumstances in the various states to be too great to allow for a uniform rule.

Since October 2004, the POLB has been in process of creating a new Admission to Practice Rule to address the charge of GR 25 to consider making recommendations to the State Supreme Court for instances in which nonlawyers may engage in the practice of law. It is anticipated that the proposed rule will be ready for public comment in March. The rule establishes a mechanism by which non-lawyers would be authorized and regulated to deliver legal services in certain limited practice areas of the law. The rule will only create the mechanism. Consideration of areas of authorization would come at a later date. The rule establishes minimum requirements that any applicant would need to meet in order to be certified to "practice." The Rule also establishes an examination process that would demonstrate proficiency in the area being sought to be authorized.

The process is not unlike the process a law school graduate must follow in order to be authorized to practice law. It is proposed that the authorized non lawyer would be held to the same standard of care and ethical standards of lawyers.

The process of authorization will be overseen by a commission called the Nonlawyer Practice Commission (NPC). This would be a body of lawyers and nonlawyers who would establish and manage the process of authorizing and regulating non lawyers. The commission would make recommendations to the State

Supreme Court regarding limited practice areas in which nonlawyers would be authorized to practice. A non-lawyer could be authorized to "practice" in more than one area provided they have met the certification requirement for each "practice area." The certification process would also require the applicant to pass a written test that would demonstrate proficiency in the practice area for which certification is sought. It is anticipated that the NPC and the functioning of the regulation process would be self sufficient and supported by licensing fees.

Before any limited practice area would be considered for authorization certain threshold criteria would need to be met. These criteria were established in GR 25 and are as follows:

#### **(4) Recommendations to the Supreme Court Regarding the Provision of Legal and Law-Related Services by Non-Lawyers.**

On request of the Supreme Court or any person or organization, or on its own initiative, the Board may recommend that non-lawyers be authorized to engage in certain defined activities that otherwise constitute the practice of law as defined in GR 24. In forwarding a recommendation that non-lawyers be authorized to engage in certain legal or law-related activities that constitute the practice of law as defined in GR 24, the Board shall determine whether regulation under authority of the Supreme Court (including the establishment of minimum and uniform standards of competency, conduct, and continuing education) is necessary to protect the public interest. Any recommendation that non-lawyers be authorized to engage in the limited provision of legal or law-related services shall be accompanied by a determination:

- (A) that access to affordable and reliable legal and law-related services consistent with protection of the public will be enhanced by permitting non-lawyers to engage in the defined activities set forth in the recommendation;
- (B) that the defined activities outlined in the recommendation can be reasonably and competently provided by skilled and trained non-lawyers;
- (C) if the public interest requires regulation under authority of the Supreme Court, such regulation is tailored to promote access to affordable legal and law-related services while ensuring that those whose important rights are at stake can reasonably rely on the quality, skill and ability of those non-lawyers who will provide such services;
- (D) that, to the extent that the activities authorized will involve the handling of client trust funds, provision has been made to ensure that such funds are handled

*continued on next page*

*continued from previous page*

## **Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians A Proposed New Court Rule**

in a manner consistent with RPC 1.14 and APR 12.1, including the requirement that such funds be placed in interest bearing accounts, with interest paid to the Legal Foundation of Washington; and

- (E) that the costs of regulation, if any, can be effectively underwritten within the context of the proposed regulatory regime.

Recommendations to authorize non-lawyers to engage in the limited practice of law pursuant to this section shall be forwarded to the Washington State Board of Governors for consideration and comment before transmission to the Supreme Court. Upon approval of such recommendations by the Supreme Court pursuant to the procedures set out in GR 9, those who meet the requirements and comply with applicable regulatory and licensing provisions shall

be deemed to be engaged in the authorized practice of law.

The process of selecting practice areas for authorization would begin with either the NPC selecting an area that seems appropriate or by having a constituency recommend consideration of a practice area to the NPC. Although the regulations for the NPC have not yet been created it is anticipated that the NPC would seek input from the public and various sections of the WSBA before making a recommendation as to the nature and scope of practice to be authorized. Once a proposal has been formulated the NPC's recommendation it would be forwarded to the Board of Governors (BOG) of the WSBA. If the BOG approves the recommendation it would then be forwarded to the State Supreme Court for consideration.

The latest version of the proposed rule is set forth below.

---

### *Draft 3 11 05*

## **New Admission to Practice Rule \_\_\_\_\_ : Limited Practice Rule for Legal Technicians**

- A) **Purpose.** The purpose of this rule is to authorize certain persons who are not lawyers licensed to practice in the State of Washington to render assistance or advice in defined areas of law and to prescribe the conditions of and limitations upon the provision of such services.
- B) **Definitions.** Unless the context clearly indicates otherwise, terms used in this rule shall have the following meanings:
- 1) "Approved and reviewed by a lawyer" means that a lawyer has supervised the legal work and documented that supervision by the lawyer's signature and bar number.
  - 2) "Board" when used alone means the Practice of Law Board.
  - 3) "Commission" when used alone means the Nonlawyer Practice Commission which is authorized and directed to carry out the functions established by this rule.
  - 4) "Lawyer" means a person licensed to practice law in the State of Washington.
  - 5) "Legal Technician" means a nonlawyer authorized to engage in the limited practice of law as specified by this rule and related rules.
  - 6) "Paralegal" shall mean is a person, qualified by education, training or work experience who is employed or retained by a lawyer, law office, corporation, governmental agency or other entity and who performs specifically delegated substantive legal work for which a lawyer is responsible.
  - 7) "RPC" means the Rules of Professional Conduct.
  - 8) "Substantive legal work" shall mean work performed by a person that requires knowledge of legal concepts and is customarily, but not necessarily, performed by a lawyer.
  - 9) "Supervised" means a lawyer directs, approves and has responsibility for work performed by the legal technician.
  - 10) Words of authority:
    - a) "May" means "has discretion to," "has a right to," or "is permitted to."

*continued on next page*

*continued from previous page*

### **Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians A Proposed New Court Rule**

- b) "Must" or "shall" mean "is required to."
- c) "Should" means recommended but not required.

**C) Certification Requirements.** An applicant for certification as a legal technician shall:

- 1) Age. Be at least 18 years of age.
- 2) Moral Character. Be of good moral character.
- 3) Education. Have graduated from a paralegal/legal assistant program that is:
  - a) Approved by the American Bar Association;
  - b) An associate degree program approved by the Commission that consists of a minimum of 90 quarter hours (900 clock hours or 60 semester hours) of which at least 45 quarter hours (450 clock hours or 30 semester hours) are substantive legal courses;
  - c) A bachelor's degree program in paralegal/legal assistant studies;
  - d) A post-baccalaureate certificate program in paralegal/legal assistant studies, approved by the Commission; or
  - e) A paralegal/legal assistant program that consists of a minimum of 90 quarter hours (900 clock hours or 60 semester hours) of which at least 45 quarter hours (450 clock hours or 30 semester hours) are substantive legal courses.
- 4) Experience. Possess the following substantive legal experience as a paralegal/legal assistant under the supervision of a lawyer:
  - a) Those with an associates degree from an American Bar Association accredited institution or who hold a bachelor's degree need a minimum of 2 years experience; or
  - b) Those who are graduates of any other program set out in sub-section (3) need 3 years experience.
- 5) Pro Bono Service Requirement. Complete at least 20 hours of pro bono service to a legal services organization approved by the Commission within the two years prior to taking the legal technician examination.

- 6) Examination. Satisfactorily complete an examination which shall, at a minimum, cover the rules of professional conduct applicable to legal technicians, rules of ethics, procedural rules and substantive law issues related to one or more discrete areas of practice.

- 7) Oath. Execute under oath and file with the Commission 2 copies of his/her application, in such form as may be required by the Commission. In the event of the failure or refusal of an applicant to furnish any information or proof, or to answer any interrogatories of the Commission pertinent to the pending application, the Commission may deny the application.

- 8) Examination Fee. Pay, upon the filing of the application, the examination fee as established by the Commission.

**D) Scope of Practice Authorized by Limited Practice Rule.** The legal technician may undertake the following in the defined area(s) of law for which the legal technician has been certified:

- 1) Interview pro se litigants to obtain relevant facts, and explain the relevancy of such information to the pro se litigant;
- 2) Inform the pro se litigant of applicable procedures, including deadlines, documents which must be filed, and the anticipated conduct of the court hearing;
- 3) Inform the pro se litigant of applicable procedures for proper service of process for motion papers, and proper filing procedures;
- 4) Provide the pro se litigant with self-help materials prepared by a lawyer or approved by the Commission, which contain information as to statutory requirements, case law basis for the litigant's claim, and venue and jurisdiction requirements;
- 5) Review pleadings or exhibits presented by the pro se litigants from the opposing side, and explain the documents;
- 6) Select and complete forms that have been approved by the State of Washington, either through a governmental agency or by the Administrative Office

*continued on next page*

*continued from previous page*

### **Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians A Proposed New Court Rule**

of the Courts or the content of which is specified by statute; federal forms; forms prepared by a lawyer; or forms approved by the Commission; and advise the pro se litigant of the significance of the selected forms to the litigant's case;

- 7) Perform legal research and draft legal letters and pleadings, if the work is reviewed and approved by a lawyer.
- 8) Advise the pro se litigant as to other documents which may be necessary (such as exhibits, witness declarations, or party declarations), and explain how such additional documents or pleadings may affect the litigant's case;
- 9) Assist the pro se litigant in obtaining necessary documents, such as birth, death, or marriage certificates.

**E) Conditions Under Which a Legal Technician May Provide Services.** A legal technician may render services authorized by this rule only under the following conditions and with the following limitations:

- 1) Be certified pursuant to these rules;
- 2) Have a staffed office for the acceptance of service in the State of Washington;
- 3) Personally perform the services for the client. The legal technician shall not supervise a non-certified individual to perform the services in the legal technician's place. Nothing in this prohibition shall prevent a person who is not certified from performing translation services; and
- 4) Prior to the performance of the services, the legal technician shall enter into a written contract that includes the following provisions:
  - (a) An explanation of the services to be performed, including a conspicuous statement that the legal technician may not appear or represent the client in court;
  - (b) Identification of all compensation and costs to be charged to the client for the services to be performed;

- (c) A statement that documents submitted by the client to the legal technician may not be retained by the legal technician for any purpose, including payment of compensation or costs;
- (d) A statement that the legal technician is not a lawyer and may only perform limited legal services. This statement shall be on the face of the contract in twelve-point bold type print;
- (e) A statement that while information provided by the client will be treated as confidential, the information is not subject to the attorney-client privilege or any other privilege;
- (f) A statement that the client has the right to rescind the contract at any time and receive a full refund of unearned fees. This statement shall be conspicuously set forth in the contract; and
- (g) Such other conditions as the Commission may require.

- 5) A legal technician may not provide services to a client who requires assistance exceeding the scope of practice authorized by this rule, and shall inform the client that the client requires the services of a lawyer.
- 6) A legal technician must sign all pleadings completed by the legal technician and include his/her certificate number.

**F) Prohibited Acts.** In the course of dealing with clients or prospective clients, a legal technician shall not:

- 1) Make any statement that the legal technician can or will obtain special favors from or has special influence with any court or governmental agency;
- 2) Retain any compensation for services not performed;
- 3) Refuse to return documents supplied by, prepared by, or paid for by the client upon the request of the client. These documents must be returned upon request even if there is a fee dispute between the legal technician and the client; or
- 4) Represent or advertise, in connection with the provision of services, other titles or credentials that could cause a client to believe that the legal technician possesses professional skills beyond those authorized

*continued on next page*

continued from previous page

### **Meeting Unmet Need for Legal Services with Non-Lawyer Legal Technicians A Proposed New Court Rule**

by the certificate for which the legal technician is approved.

RPCs conflict with these rules, in which case these rules shall apply.

**G) Continuing Certification Requirements.**

3) All funds that come into a legal technician's possession are subject to RPC 1.14.

1) Continuing Education. Each certified legal technician must complete a minimum number of credit hours of approved or accredited education as prescribed by Commission regulations, during each calendar year in courses certified by the Commission to be appropriate for study by legal technicians pursuant to this rule; provided that the legal technician shall not be required to comply with this subsection during the calendar year in which he or she is initially certified.

In order for this rule to be adopted it will first be presented for approval to the Board of Governors of the Washington State Bar Association. Once approval from the Board of Governors has been granted it will then be presented to the Washington State Supreme Court. In the typical rule making process the Supreme Court would generally publish the rule for public comment before it would be considered for adoption.

**H) Financial Responsibilities**

If this rule is adopted it will be a significant change from the way legal services are delivered in our state and most likely other states. However, the rule is designed to enhance the deliver of legal services to the consumer where a need not now being met and to be provided by qualified and regulated service providers. This rule has been created to meet the purpose as established by the State Supreme Court in GR 25(a):

1) Financial Responsibility. Each certified legal technician shall show proof of ability to respond in damages resulting from his/her acts or omissions in the performance of services permitted by this rule. The proof of financial responsibility shall be in such form and in such amount as the Commission may by regulation prescribe.

“To promote expanded access to affordable and reliable legal and law-related services, expand public confidence in the administration of justice, make recommendations regarding the circumstances under which nonlawyers may be involved in the delivery of certain types of legal and law-related services...”

2) Annual Fee. Each certified legal technician must pay the annual fee established by the Commission.

**(I) Existing Law Unchanged.** This rule shall in no way expand, narrow or affect existing law in the following areas as they apply to both lawyers and legal technicians practicing in the State of Washington:

- 1) The fiduciary relationship between a certified legal technician and his/her customers or clients;
- 2) Conflicts of interest that may arise between the certified legal technician and a client or customer; and
- 3) The lack of authority of a legal technician to give legal advice without being licensed to practice law other than an authorized under this rule.

**(J) Professional Responsibility.**

- 1) Legal technicians shall be held to the standard of care of a lawyer.
- 2) Legal technicians shall be held to the same ethical standards as a lawyer, except to the extent that the

<b>Save the Date</b>
<b>2005 Real Property Probate and Trust MIDYEAR MEETING AND CLE</b>
<b>June 10-12 Davenport Hotel Spokane, Washington</b>

## Nominations for Executive Committee Membership

Pursuant to the Bylaws of the Real Property, Probate & Trust Section, the Nominating Committee, currently composed of Mark W. Roberts of Preston Gates & Ellis LLP (Seattle); Barbara C. Sherland of Stoel Rives LLP (Seattle); Tom Culbertson of Lukins & Annis, P.S. (Spokane), and Serena S. Carlsen of Stoel Rives LLP (Seattle), has recommended the nomination and election of the following persons to the offices indicated for the 2005-2006 term of the Real Property, Probate & Trust Section:

### Director, Probate & Trust Council

Timothy R. Osborn - Microsoft Corporation (Redmond)

### Real Property Council

Kathryn R. McKinley - Layman, Layman, McKinley & Robinson, PLLP (Spokane)

Marco de Sa e Silva - Davis Wright Tremaine, LLP (Seattle)

### Probate & Trust Council

Kenneth M. Kilbreath - Inslee, Best, Doezie & Ryder (Bellevue)

Fred Emry - Paine Hamblen Coffin Brooke & Miller (Spokane)

Pursuant to the Bylaws, Lora L. Brown of Stokes Lawrence, P.S. (Seattle) will become chair of the Section for the 2005-2006 term and Steve Crossland of Crossland Law Office (Cashmere) will become chair-elect.

Any Additional nominations should be received by the current Chair, William H. Reetz of Land America Financial Group, 1200 6th Avenue, Suite 1900, Seattle, WA 98101, no later than 20 days before the annual meeting which will be held during the Real Property, Probate & Trust Section Midyear Meeting scheduled for June 10, 11, & 12, 2005 at the Davenport Hotel, Spokane Washington. Nominations must include the name of the person to be nominated and written endorsement by five members of the Real Property, Probate & Trust Section.

Unless additional nominations are received, the persons nominated by the Nominating Committee shall be deemed elected.

**WSBA Service Center**  
**800-945-WSBA • 206-443-WSBA**  
**questions@wsba.org**

## Midyear Meeting News

The Midyear Meeting for the Real Property, Probate & Trust Section will be held June 10th through 12th at the Davenport Hotel, Spokane, Washington. Seminar co-chairs Charles W. Riley, Jr., Lane Powell Spears Lubersky, LLP (Seattle) and Jody M. McCormick, Witherspoon, Kelley, Davenport & Toole, P.S. (Spokane) are putting together an outstanding array of programs that will have something for everyone. There will also be the usual opportunities to see old friends and make new ones at this beautiful location. We expect that our block of allotted rooms will sell out before the meeting, so make your plans now to join us at Spokane. You can contact the Davenport Hotel at 1-800-899-1482. The website for the Hotel can be found at <http://www.thedavenporthotel.com>.

## 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](mailto:sharlene@wsba.org).

## Recent Developments

# Probate and Trust

*by Colonel F. Betz, Perkins Coie LLP, Seattle*

### ***Estate of Wylie M. Hemphill et al v. State of Washington, Docket Number 74974-4, (2/3/2005)***

#### **Summary:**

The original initiative creating the Washington State estate tax, the Washington Supreme Court's interpretation of the applicable statute, and the current wording of the statute confirm that Washington has a "pickup" tax based on current federal law, not an independent state estate tax. Thus, any amount of Washington state estate tax not fully absorbed by a current federal credit for state estate taxes is an invalid independent tax.

#### **Facts:**

With the enactment of the federal Economic Growth & Tax Relief Reconciliation Act in June of 2001 (commonly referred to as the "2001 Tax Act"), the federal applicable credit amount (the amount one can pass at death without incurring any federal estate tax) was indexed to gradually increase. Also under the 2001 Tax Act, the credit for state death taxes (the amount of estate tax paid to a state that is credited against the federal estate tax) decreased to zero in 2005. Washington State, however, did not update its state estate tax law after the 2001 Tax Act to match current federal law. Consequently, the calculation of the Washington State estate tax was no longer in synch with the federal law, generating additional estate taxes payable by Washington taxpayers.

As a result, a class action lawsuit was brought on behalf of Washington State taxpayers requesting a refund of amounts paid over and above the amount that would have been due after the 2001 Tax Act if the Washington State estate tax was equivalent to the credit for state death taxes under current federal law. The plaintiffs argued that the amount of state tax should equal the amount of the federal credit allowed for state estate tax, or the "pickup" amount.

#### **Discussion:**

In its ruling, the Washington Supreme Court held that any amount of a state estate tax not fully absorbed by a current federal credit is an invalid tax under current Washington law. Without legislative intervention, the outcome of the Court's decision will require the State of Washington to refund the amount in excess of the federal credit for state estate taxes to certain taxpayers who paid estate tax after 2001, and will prohibit the imposition of state estate taxes in future years when there is no longer any federal credit for state estate taxes paid. The Supreme Court remanded the case to the trial court.

The Department of Revenue subsequently issued an announcement stating its intention to delay any action on refunds until the trial court renders its final order. With the announcement, the Department issued a new estate tax return, which can be found at [http://dor.wa.gov/docs/forms/misc/waestatetransftrtrn\\_e.pdf](http://dor.wa.gov/docs/forms/misc/waestatetransftrtrn_e.pdf).

### ***Woodard v. Gramlow, 123 Wash.App. 522, Division Three (2004)***

#### **Summary:**

Proceeds of an insurance policy can be directed to pay the debts of a testator's estate if the testator expressly identifies, by clear and apt language in the will or testamentary trust, an intent to subject such otherwise exempt property to the debts of the estate.

#### **Facts:**

Ms. Gramlow prepared Ms. Young's will, an attachment to the will, and a living trust for Ms. Young. Ms. Gramlow was the named executor of Ms. Young's will, although she was later removed and replaced with Mr. Woodard. Ms. Gramlow is not an attorney.

A life insurance policy owned by Ms. Young named Ms. Gramlow as the sole beneficiary. Mr. Woodard petitioned the court to determine the rights of the parties, including whether the attachment to the will was intended to be incorporated as part of the will.

The trial court determined that the attachment was intended by Ms. Young to be part of her will and that the attachment created a testamentary trust. The corpus of the trust was determined to be comprised of the proceeds of the life insurance policy, which made the proceeds subject to the administration and control of Ms. Young's estate. Ms. Gramlow appealed.

#### **Discussion:**

When construing a will, the court must ascertain the testator's intent from the four corners of the document. A court may admit extrinsic evidence to explain the language of the will only if it finds the testator's intent is ambiguous. The terms of a will or trust instrument are ambiguous if they are susceptible to more than one meaning. The Court of Appeals admitted extrinsic evidence of Ms. Young's intent, i.e., the attachment to the will, because the will was poorly drafted and the attachment led to confusion and dissension between the parties. In admitting extrinsic evidence, the Court took into consideration the fact that Ms. Gramlow was not a trained legal advisor.

continued from previous page

## Recent Developments: Probate and Trust

The attachment to the will, entitled “Instructions to my executor: Jacqueline B. Gramlow,” evidenced an intent to be incorporated as part of the will. The witness signature page stated: “4 pages including Attachment.” The incorporated document need not be contained in the body of a will as long as the intent to incorporate clearly appears from the will and the will clearly and definitely describes the documents intended to be incorporated, so that no room for doubt can exist as to what papers were intended.

The attachment to the will created a testamentary trust that was incorporated into Ms. Young’s estate by the wording on the witness signature page. This attachment required the life insurance proceeds to pay all just debts, funeral expenses and expenses of last illness. The attachment then stated that after all expenses are paid, the rest of the insurance proceeds should be invested in CD’s. The Court determined the insurance proceeds were intended to serve as the corpus of the testamentary trust.

Exempt property, such as insurance proceeds, can be used to pay the debts of the estate as long as the testator’s intent to do so is clear in the language of the will or trust. Here, the intent was evident. Thus, the insurance proceeds were directed to pay the final expenses of the estate.

### **Estate of Burks, 124 Wash.App. 327, Division Two (2004)**

#### **Summary:**

General language in a will referring to certain bank accounts and savings accounts is not enough to change the beneficiary of a nonprobate asset to the beneficiary identified under the will, unless the will identifies an entire category of nonprobate assets to which the specific asset belongs, and specifically names the new beneficiary of the asset.

#### **Facts:**

Two payable-on-death account beneficiaries appealed the trial court’s ruling that the accounts were distributed in accordance with the decedent’s will rather than to the beneficiaries named on the accounts.

The language of the decedent’s will provided:

I have certain bank accounts and savings accounts and may in the future have other evidences of property which are or may be in the joint name of myself and one of my children. Such designation is for business convenience only and is not intended as a gift to such child.

The remainder beneficiaries of the will supported the position that this provision controlled the disposition of certain payable-on-death accounts. The trial court agreed and directed the payable-on-death account beneficiaries to return the funds to the estate.

#### **Discussion:**

The Court of Appeals framed the issue as whether the testator changed the payable-on-death account beneficiaries by the language in the will.

RCW 11.11.020 allows individuals to dispose of certain types of nonprobate assets through their wills. RCW 11.11.020(1) provides:

[s]ubject to community property rights, upon the death of an owner the owner’s interest in any nonprobate asset specifically referred to in the owner’s will belongs to the testamentary beneficiary named to receive the nonprobate asset, notwithstanding the rights of any beneficiary designated before the date of the will.

A “general residuary gift” does not entitle the devisees or legatees to the owner’s nonprobate assets. But a testamentary disposition of an owner’s interest in all nonprobate assets, or of all of a category of nonprobate assets, such as “all of my payable on death bank accounts” or similar language, is deemed to be a disposition of all the nonprobate assets the beneficiaries of which are designated before the date of the will.

The language of the decedent’s will did not specifically refer to the payable-on-death accounts and did not identify an entire category of nonprobate assets. In addition, the language did not identify a beneficiary. Thus, the will did not meet the statutory requirements to change the designated beneficiaries.

## 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).

## 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 contact Dené Canter at 206-727-8213 or [denec@wsba.org](mailto:denec@wsba.org).



## Recent Developments

# Real Property

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

### Takings, Lies (Alleged) and Mezzanine Loans

There is no unifying theme for the cases discussed in this edition of the *Newsletter*; just three interesting cases that highlight the diversity that confronts the real estate lawyer.

#### ***State of Washington v. Costich*, 152 Wn.2d 463, 98 P.3d 795 (2004).**

The decision of the Supreme Court in *Costich* clarifies the procedures applicable to proposed offers of just compensation may by condemning authorities to landowners. Washington has a statutory scheme that attempts to encourage property acquisitions by eminent domain to be completed through negotiation rather than litigation. Condemning authorities are required to formulate estimates of just compensation prior to offering to acquire the property, and then make all reasonable efforts to acquire the property through negotiation. RCW 8.26.180. If negotiations are unsuccessful, the State may nevertheless obtain immediate possession of the property by allowing the landowner to withdraw from the registry of the court the State's estimate of just compensation, while continuing to litigate the issue of just compensation. RCW 8.04.090 – 094. If immediate possession is granted, the landowner has the ability to recover attorney fees and litigation costs if:

The judgment awarded as a result of the trial [held for the purpose of fixing the amount of compensation] exceeds by ten percent or more the highest written offer in settlement submitted to those condemnees appearing in the action by condemnor in effect thirty days before trial.

RCW 8.25.070(1)(b).

It is within this statutory framework that the State Department of Transportation and Mr. Costich attempted to resolve a dispute concerning the valuation of the acquisition right-of-way by DOT from Costich. Initially, \$134,000 was offered, and this amount was deposited in the registry of the court. Costich withdrew the funds, but contested the value. Another DOT appraisal valued the property at \$191,200, but although DOT informed Costich of this value as required by law, DOT did not raise its settlement offer. On January 31, 2002, Costich's attorney received an offer of \$282,500 (which included the amount previously paid) "in full settlement." The offer expired by its terms on February 8, 2002.

Prior to the start of the trial on March 4, 2002, Costich prevailed upon the trial court to rule that the \$282,500 offer did not comply with the requirements of RCW 8.25.070 because (1) it was not broken down into components specifying the amount applicable to just value, attorney fees and other costs and (2) it

was not in effect for the thirty day period prior to the scheduled trial. The jury ultimately determined that the property was worth \$252,000. Since that amount was ten percent more than the \$134,000 offer, which was the last offer the trial court found to comply with RCW 8.25.070(1), Costich was awarded fees and other litigation costs, for a total judgment of \$365,669.20, comprised of the \$118,000 difference between the \$252,000 jury determination of just compensation and the \$134,000 Mr. Costich had already withdrawn from the court registry, \$88,157.75 in reasonable attorney fees, \$12,582.35 in expert witness fees, \$11,714.58 in prejudgment interest, and \$1,214.52 in costs. *Costich*, 152 Wn.2d at 469, 98 P.3d at 797.

The Court of Appeals affirmed rejecting DOT's position that the \$282,500 offer was valid offer of settlement. The court held that that in order for the offer to be valid, there had to be a separate statement of the amount offered as just compensation. In part, the Court of Appeals relied on *City of SeaTac v. Cassan*, 93 Wn. App. 357, 967 P.2d 1274 (1998), which held that the condemnee could not augment the difference between the condemnor's settlement offer and the just compensation award by using statutorily mandated attorney fees and expert witness costs.

The Supreme Court reversed the award of attorney fees and expert witness fees. Noting that prior decisions had authorized the condemning authority to make offers that exceeded the State's determination of fair market value, the Court observed that this tactic encouraged settlements. The Court also observed that *Cassan* may have been incorrectly decided. The Court was somewhat ambiguous in its discussion of *Cassan*, finally noting that even if statutorily awarded fees and litigation costs were included in the calculation, the award (less the amount previously paid) would still not exceed the DOT offer of \$282,500 by ten percent.

The Court also rejected the argument that the DOT offer had to remain open for acceptance for a period of thirty days. Admitting that the statute "certainly may be read either way, and the resolution of this issue would be much simpler had the legislature used more clarity when drafting the text," the Court concluded that the legislative history of the provision compelled an interpretation that the statute "imposed a temporal proximity requirement rather than a durational requirement." *Costich*, 152 Wn.2d at 477, 98 P.3d at 802. The Court did observe that there might be factual circumstances under which an offer that was available for a very short duration might not qualify under the statute, but that condition did not exist in this case.

*continued on next page*

*continued from previous page*

## **Recent Developments: Real Property**

We hold the State need not itemize in a condemnation settlement offer its opinion of the just compensation owed.

We further hold the settlement offer need not remain open for a 30-day period to remain valid.

*Costich*, 152 Wn.2d at 479, 98 P.3d at 803.

This decision changes the calculation condemnees must make when considering whether to accept a settlement offer from the State. The holding that the offer need only be made thirty days before the trial, and not remain open for a thirty-day period, compresses the time frame in which property owners must make their decision. More importantly, by allowing non-itemized settlement offers, the State puts additional pressure on property owners to consider their litigation costs as at least partially being incorporated into the just value of their property. Unfortunately, the ultimate determination of whether *Costich* is beneficial for property owners or the State turns somewhat on the fate of *Cassan*, which now seems to have been sent to the purgatory of criticism by *dicta*.

### ***Alejandre v. Bull*, 123 Wn. App. 611, 98 P.3d 844 (2004).**

This case involves the all-to-familiar factual pattern of a questionable septic tank and so-called Seller's Disclosure Statement described in RCW 64.06.020. Mary Bull agreed to sell her house to Alejandre. The purchase agreement contained a warranty that the property was served by a septic tank and a requirement that the tank be pumped prior to closing. The agreement also had an inspection contingency that required all inspections of the property had to be satisfactory to the buyer. Bull provided a Seller's Disclosure Statement. She noted no conditions on the form that constituted "material defects affecting this property or its value that a prospective buyer should know about."

The septic tank was pumped, and the buyer received a copy of the invoice that noted that the system's back baffle could not be inspected. The property was inspected by the lender prior to closing, and that inspection noted no problems with the septic tank. All of the inspections were accepted by the buyer.

After closing, Alejandre noted an odor in the house and gurgling water sounds. Ultimately, the septic tank had to be extensively repaired at a cost in excess of \$30,000. Alejandre sued Bull under various theories, including fraudulent concealment and negligent misrepresentation. Following the conclusion of the plaintiff's case, the judge took the case from the jury and dismissed all of the claims for failure to meet the burden of proof and by application of the economic loss rule. Alejandre appealed.

The Court of Appeals reversed and remanded, noting that the following evidence had been presented:

1. Bull had previously hired a septic service to look at the system because the ground around the tank was "squishy." She declined to have the system inspected, because of the cost, but for a time following the pumping of the system, she had her laundry done outside of the home to lessen the burden on the system.
2. Another person who had serviced the system advised Bull that she need to hook up to the city sewer system because her drain field was saturated and not working properly. She declined to connect to the city sewers because of the cost.

Viewing this evidence most favorably to the plaintiffs, the Court of Appeals concluded that a jury could conclude that the elements of fraudulent concealment and negligent misrepresentation had been met.

There are two ways to establish fraudulent concealment or misrepresentation. First, the plaintiff may affirmatively plead and prove the nine elements of fraud. Alternatively, the plaintiff may show that the defendant breached an affirmative duty to disclose a material fact. Washington has long recognized a common law rule that in a residential real estate transaction, a seller has a duty to disclose known defects in the property that are dangerous to the property, health, or life of a buyer, but which would not be revealed upon careful examination by the buyer.

*Alejandre*, 123 Wn. App. at 619, 98 P.3d at 848. (citations omitted).

A jury could have concluded from the evidence that Bull knew of the defect and failed to disclose it to the buyers. The failure to disclose would violate her common law duty of disclosure and constitute a misrepresentation under the Seller's Disclosure Statement.

The Court also rejected the "economic loss doctrine" as a defense for Bull. Although Washington does apply the economic loss doctrine to bar claims of negligent misrepresentation in the context of professional service contracts, in those instances in which the doctrine was applied, the contract had a clear allocation of the risk of loss. In this case, contract was a pre-printed form that "did not contain a negotiated provision ... whereby the parties agreed to allocate risk and future liability." *Alejandre*, 123 Wn. App. at 628, 98 P.3d at 852.

The economic loss doctrine is really another way of saying that the rights and remedies should be governed by the terms of that contract. Bull correctly pointed out that there was really no breach of contract proven, and in the absence of a breach of

*continued on next page*

*continued from previous page*

## **Recent Developments: Real Property**

contract, the buyer should not be able to recover. In the context of residential sales in Washington, the contract is just the starting point for the definition of parties' rights and obligations. Fortunately, the Court did hold out the possibility that buyers and sellers can, by specific negotiation, define their respective liability for future loss, thereby preserving the concept that a seller of property can achieve an "as is" sale, without warranty. If a seller is serious about achieving this result, the first item on the checklist should be the buyer's waiver of the Seller's Disclosure Statement, which continues to provide fertile ground for the germination of lawsuits by disappointed buyers.<sup>1</sup>

### **Casey v. Chapman, 123 Wn. App. 670, 98 P.3d 1246 (2004).**

Partnerships between individuals and entities often own or develop commercial real estate. For a variety of reasons, the partnership interests owned by a partner may be pledged as collateral for a loan. These loans are sometimes referred to as a variant of mezzanine financing (they are secured at partnership level, which is one level above the ground floor, which would be an actual mortgage on the real property). For lawyers that have been involved in these transactions, a nagging question at the conclusion of these deals is "Just exactly what did the lender get." The Court in *Casey* provides an answer to that question. Although not helpful to the lender in that case, provides some guidance for parties in future transactions.

Casey and Chapman were partners in a real estate development in Federal Way, Washington. In February, 1993, Casey bought Chapman's partnership interest for \$200,000. All of the existing partners signed the purchase agreement and acknowledged that Chapman was withdrawing from the partnership.

Casey paid the purchase price by \$15,000 cash, and a non-recourse promissory note in the amount of \$185,000, secured by a pledge of the acquired partnership interest. Casey defaulted on the note in 1995, and the terms of the deal were renegotiated. Casey agreed to pay Chapman \$400,000 for an extension of time to pay the original note. If Casey failed to pay this amount, Chapman was allowed to proceed with a foreclosure sale of the collateral under the Article 9 of the Uniform Commercial Code.

Casey failed to make the negotiated payment and Chapman conducted a sale of the partnership interest. The buyer was Bruno Investments, LLC, a limited liability company owned by Chapman. The bid for the interest was \$200,000. Following the sale, Chapman sought a declaratory judgment confirming that the sale of the partnership interest included "all voting rights, equity interests and economic interests." *Casey*, 123 Wn. App. at 676, 98 P.3d at 1249. Casey, in response, sought an upset price of \$400,000 as a condition of confirming the sale. The trial court refused to establish the upset price and held that the sale included as voting rights associated with the partnership interest.

The Court of Appeals reversed on the issue of the rights acquired in the foreclosure sale. The Washington Partnership Act in effect at the time of the transaction provided at RCW 25.04.270(1):

A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignees, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, . . . but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.

By application of this statute, when Casey acquired the partnership interest, he acquired only the rights to profits, not voting and management rights. Casey could not pledge any more than he acquired, and accordingly, Chapman acquired only a right to receive profits and nothing more.

In the absence of a clear statement that management, administration, or voting rights were included in the sale, we must conclude that such rights were not part of the transaction. The statute then in effect required such agreement by the partners.

*Casey*, 123 Wn. App. at 679, 98 P.3d at 1250-51.

The Court did note that under the revised Partnership Act, the definition of partnership interest at RCW 25.05.005(9) means all of a partner's interest in the partnership, including voting rights. However, this statute was not in effect at the time the Case pledge transaction took place.

The result in this case left the lender, Chapman, with something less than a satisfactory result. Although owning the right to receive profits from the partnership activity, the lender was not allowed to vote upon those transactions that might result in the realization of that profit, such as a sale of the underlying assets owned by the partnership. As indicated by the opinion, under the current Washington Partnership Act, the transfer of a "partnership interest" may include all voting rights. To avoid the result experienced by Chapman, the lender should have the other partners consent to the exercise of all voting rights by the lender, or other purchaser who acquires the interest at the foreclosure sale. Whether or not the other partners will allow a foreclosing lender participate in their business is another question.

<sup>1</sup> For a recent article containing a more thorough discussion of the effect of seller disclosure forms on residential transactions, see George Lefcoe, *Property Condition Disclosure Forms: How the Real Estate Industry Eased the Transition for Caveat Emptor to "Seller Tell All,"* 39 REAL PROPERTY PROBATE AND TRUST JOURNAL 193 (2004).

## HOW TO REACH US

### Executive Committee 2004-2005

**William Reetz, Chair**

Commonwealth Land Title Insurance Company  
1200 6<sup>th</sup> Ave., Suite 1900  
Seattle, WA 98101  
(206) 628-2803  
(206) 343-7220 fax  
breetz@landam.com

**Lora L. Brown, Chair Elect & Treasurer**

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

**Thomas M. Culbertson, Immediate Past Chair**

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

**Robert P. Beschel, Emeritus**

Winston & Cashatt  
601 W. Riverside Ave., Suite 1900  
Spokane, WA 98201-0695  
(509) 838-6131  
(509) 838-1416 fax  
rpb@winstoncashatt.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