

# Real Property, Probate & Trust



Vol. 29, Number 2

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

Summer 2001

## Perpetual Leases in Washington

by Roger D. Mellem, Foster Pepper & Shefelman PLLC

This article discusses “perpetual” leases which result when a lessee has an option to renew its tenancy under a generous (or poorly drafted) renewal clause. As the article notes, the law generally disfavors perpetual leases. Nevertheless, poor drafting may give a lessee a perpetual leasehold interest. With that pitfall in mind, the article offers examples of lease language that unequivocally grants a limited option to renew. Finally, the article suggests a defense to perpetual lease claims under Washington landlord-tenant statutes.

### I. The Law Disfavors Leases Having Uncertain Duration

At least 400 years of case law disfavors leases for uncertain duration. Following a case decided in the sixth year of the reign of Elizabeth, an Illinois court invalidated an oral lease because of its uncertain duration, held that the default periodic term of the lease was month-to-month, and granted summary judgment for the plaintiff-landlords. *Stannmeyer v. Davis*, 321 Ill. App. 227, 53 N.E. 2d, 24 (1994) (citing and quoting *Say v. Smith*, 1 Plow. Rep. 269 (C.B. 1564)). As the court in *Stannmeyer* reasoned, “There is nothing in the language of the alleged oral lease from which there can be a reasonable certainty of the date upon which it was the intention of the parties the oral lease should come to an end.” *Stannmeyer*, 321 Ill. App. at 25.

Justices of the Common Bench decided *Say* in 1564. The case involved a lease of 20 acres at a set price to be paid at the end of 10 years. The lessor granted the lessee a perpetual demise of land “from 10 years to 10 years continually following,” provided the tenant made the set payment. *Say*, 1 Plow. at 271. After several decades, the lessor decided to terminate the lease and seized the lessee’s cattle, which the lessee later sought to replevy. The Justices concluded there had been no valid lease:

[E]very contract sufficient to make a lease for years ought to have certainty in three limitations, viz. in the commencement of the term, in the continuance of it, and in the end of it: so that all these ought to be known at the commencement of the lease, and words in a lease, which don’t make this appear, are but babble, as Brown said. And these three are in effect but one matter, showing the certainty of the time for which the lessee shall have the land, and if any of these fail, it is not a good lease, for then there wants a certainty.

*Id.* at 272.

A few 20th century cases illustrate the common-law principle that an indefinite lease is terminable at the option of both the landlord and tenant. In *Urban v. Crawley*, 206 S.W.2d 158, 159 (Tex. Appropriate. 1947), the court examined a letter from a hotel to a prospective tenant, which read: “it is our understanding that your rent will be \$30 a month as long as you wish to keep it and with the understanding that you will continue to keep the apartment in good condition as far as redecorating and the hotel is not to furnish any paint, paper or labor used in the decorating of your apartment.” The court labeled this agreement “indefinite and uncertain.” *Id.* at 160. Moreover, the court held that such an “indefinite and uncertain” rental contract was terminable when either the hotel or the tenant “saw fit.” *Id.* In an earlier case, the Supreme Court of Missouri ruled, in substance, that a lease did not create a tenancy for years because it violated the common-law rule requiring that a definite term be fixed. *See Idalia Realty & Dev. Co. v. Norman*, 135 S.W. 47 (Mo. 1911). At issue in *Idalia* was a written lease of lands that was to run “until mill is removed.” *Idalia*, 135 S.W. at 48. The court quoted Coke with approval for the rule that, “For regularly in every lease for

*continued on page 2*

### TABLE OF CONTENTS

Perpetual Leases in Washington .....	1	Real Property Council Report .....	12
Note from the Chair .....	4	Recent Developments/Probate & Trust .....	13
Estate Planning Strategies for Small Wood Lot Owners .....	5	How to Reach Us .....	15
Recent Developments/Real Property .....	11	Probate and Trust Council Report .....	16

continued from previous page

## Perpetual Leases in Washington . . .

years the term must have a certain beginning and a certain end. *Id.* at 49.

### II. Overview of "Perpetual" Leases in Washington

The Supreme Court of Washington addressed the issue of perpetual leases twice in the same decade nearly 100 years ago, first in *Tischner v. Rutledge*, 35 Wash. 285, 77 P. 388 (1904), and next in *Morris v. Healy Lumber Co.*, 46 Washington. 686, 91 P. 186 (1907). Both courts recognized that perpetual leases could be enforceable when drafted properly.

*Tischner* was an action for unlawful detainer. The tenants leased a "store building" for \$33.33 per month "with the privilege at the same rate and terms each year thereafter from year to year." *Tischner*, 35 Washington. at 286. Addressing the tenants' contention that the lease created a "right of perpetual renewal," the court remarked:

Whether or not a lease providing for perpetual renewals is valid is a question upon which the authorities are not agreed, though perhaps the weight is with the holding that such leases are valid. On principle, it would seem that, where a person has the right to convey in fee absolute his whole estate, he could convey in the same manner a part of it less than the whole. But be this as it may, the authorities are uniform on the propositions that the law does not favor perpetual leases of the character claimed for this one, and that the intention to create such a lease must be expressed in clear and unequivocal language, and not be left to mere inference. Courts will also, whenever it is possible without doing violence to the plain meaning of words, so construe the language used as to avoid a perpetuity by renewal.

*Id.* at 288-89. Accordingly, the court concluded that the lease at issue, "when examined as a whole," did not provide for "perpetual renewals." *Id.* at 289. Also, the

court placed emphasis upon the lease's failure to employ terms such as "in perpetuity" or "forever" and its provision for returning the property to the lessor's possession in its original condition (minus wear and tear). *Id.*

In *Morris*, landowners sued their lessee to recover possession of their timber land. The tenant's lease provided access for removal of timber harvested from an adjacent tract. One clause of the lease rather awkwardly prescribed the following:

To have and to hold said strip for a period of one year from the 24th day of October 1889, and so on from year to year until the lease mentioned in this clause shall be terminated at the end of the first year or any subsequent year by the [lessee] giving to the [land owner] one calendar month notice in writing.

*Morris*, 46 Wash. at 688. Under both the law in effect at the time, Ballinger's Ann. Codes & Stat. § 4569, and today's statute governing tenancies for "indefinite" terms, RCW 59.04.020, "[w]hen premises are rented for an indefinite time, with monthly or periodic rent reserved, such tenancy shall be construed to be a tenancy from month to month, or from period to period on which rent is payable." The court concluded that the lease at issue was not a lease "for an indefinite time in the sense used in the Code," because it terminated either when the tenant defaulted or gave one calendar month's notice. *Id.* at 690. In effect, this court recognized a perpetual lease at the option of the tenant. Relying on *Tischner*, the court reasoned that, "A person owning land in fee may convey a fee, and, having power to convey a fee, may convey and [sic] interest in the land less than a fee." *Id.* at 691.

Roughly twenty years ago, the Court of Appeals revisited the perpetual lease issue. In *Oak Bay Properties, Ltd. v. Silverdale Sportsman's Center, Inc.*, 32 Wn. App. 516, 517, 648 P.2d 465 (1982), a

continued on next page

## Real Property, Probate and Trust Section 2001-2002

### Executive Committee

Barbara C. Sherland, Chair  
Warren E. Koons, Chair Elect  
Serena S. Carlsen, Past Chair

### Council Members

*Real Property*  
William Reetz, Director  
Stephen R. Crossland  
Timothy G. Krell  
Scott F. Campbell  
Maren K. Gaylor

### *Probate and Trust*

Thomas M. Culbertson, Director  
William L. Fleming  
Wendy S. Goffe  
James A. Flaggert  
Carol J. Hunter

### Newsletter

Karen L. Gibbon, Editor  
Elizabeth A. Fiattarone, Assistant Editor

### Editorial Board

*Real Property*  
Karen L. Gibbon, Editor  
Katherine Laird  
Virginia Pedreira  
Gretchen Valentine  
Michael Winslow

### *Probate and Trust*

Elizabeth A. Fiattarone,  
Assistant Editor  
Karen E. Boxx  
Kristina C. Udall  
Beth McCaw  
Heidi Lantz

### WSBA Liaison

Toni Doane

### WSBA Desktop Publisher

Clare M. Cox

*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, Fourth Floor  
Seattle, WA 98121-2330

Printed on recycled paper



continued from previous page

### Perpetual Leases in Washington . . .

lessor filed an unlawful detainer action to remove the lessee, which claimed it “had the perpetual right to renew [its lease] on a year-to-year basis.” After first reviewing the reasoning in *Tischner*, the court in *Oak Bay* noted that perpetual leases typically engender “judicial distaste,” which often moves courts to focus “on various important components of a lease to see whether they are clearly and unequivocally consistent with the notion of perpetuity.” *Id.* at 519.

Some general rules emerge from the *Oak Bay* court’s discussion of perpetual leases. First, where a lease allows for multiple renewals without specifying the number, it is generally so “indefinite and uncertain as to be unenforceable.” *Id.* Second, where a lease allows renewal in “general terms” courts typically allow only one renewal and, thereafter, a periodic tenancy. *Id.* (citing *Lonergan v. Connecticut Food Store, Inc.*, 357 A.2d 910 (Conn. 1975)). Third, where a lease requires the tenant to “take the positive act to renew rather than take the positive act to terminate the lease” a court is unlikely to find a perpetual lease. *Id.* (citing *Morris*, 46 Wash. 686; *President & Trustees of Ohio Univ. v. Athens Livestock Sales, Inc.*, 179 N.E.2d 382 (Ohio, App. 1961)). Fourth, where a lease includes restrictions on tenants’ use of the premises it seems unlikely that parties contemplated a perpetual lease. *Id.* at 520. Lastly, where a tenant is obligated to keep the premises “in good repair” and to “quit the premises in a neat and clean condition at the expiration of the term” the parties have likely signed a short-term lease. *Id.*

The court in *Oak Bay* reversed the trial court’s finding of a perpetual lease. Employing the rules listed above, the court concluded that the lease did “not measure up to the clear and unequivocal standard” and was, “therefore, ambiguous as a matter of law.” At the heart of the ambiguity in the lease were terms such as “with renewable option” and “the right to renew annually.” *Id.* at 519.

### III. Harmonizing Washington Case law with Decisions from other States

The scope of this article does not permit an exhaustive treatment of perpetual lease cases. Fortunately, Washington decisions accurately reflect the approach taken by a majority of state courts.

Because of their distaste for perpetual leases, courts typically construe a general option to renew to allow only one renewal. See, for example, *Lattimore v. Fisher’s Food Shoppe, Inc.*, 329 S.E.2d 346 (N.C. 1985) (finding automatic renewal clause does not express clear and unequivocal intent to create a perpetual lease). Likewise, where it is equally reasonable to construe a lease for a term certain or in perpetuity, courts prefer the former. See, for example, *Tucker v. Byler*, 558 P.2d 732 (Ariz. App. 1976). Additionally, where a lease provides for multiple renewals but fails to state a number, courts generally allow one renewal. See, for example, *Womack v. Hyche*, 503 So.2d 832 (Ala. 1987). As the court in *Oak Bay* observed, substantive restrictions and

omissions in a lease agreement also suggest a short-term lease rather than a perpetual one; if the lease contains use restrictions, fails to allow for rent adjustments, or provides that the property must be returned in its original condition, a court is likely to see the lease as not contemplating perpetual renewals. See, for example, *Drink, Inc. v. Martinez*, 556 P.2d 348 (N.M. 1976).

Courts will allow perpetual renewal where the renewal option contains unequivocal language such as “forever” or “in perpetuity.” See, for example, *Farris v. Laurel Explosives, Inc.*, 797 S.W.2d 487 (Ky. App. 1990). Where a lease provides for renewal from “year to year” by the lessee’s affirmative act (e.g., voluntary termination), a perpetual lease may exist. See, for example, *Department of Natural Resources v. Board of Trustees*, 318 N.W.2d 830 (Mich. App. 1982).

### IV. Drafting Tips to Avoid Perpetual Leases

Observing the general rules developed in *Tischner*, *Morris*, and *Oak Bay*, Washington courts may find “perpetual” leases where shoddy drafting produces an unequivocal statement of perpetuity. The following drafting tips prevent the unintentional creation of a perpetual tenancy:

- ◆ When providing a lessee with an option to renew the lease, state clearly whether this option is singular or successive. For example, avoid language like “annually renewable” or “with the option to renew” or “the right to renew annually.” None of these statements limits the renewal option. Instead, condition the option with language such as “renewable for one more annual period” or “lessee may renew the lease for another year.”
- ◆ If the lease allows for multiple renewals, state the allowable number clearly. For example, avoid language like “lessee may renew the lease until it has harvested all timber” or “lessee may renew the lease for at least three consecutive three year periods.” Instead, identify the number of allowable renewals unambiguously, allowing the lessee to “renew the lease for no more than two consecutive annual periods” as an example.
- ◆ Make renewal an affirmative obligation rather than the default rule. For example, draft the lease so that the lessee must “exercise an option to renew” rather than allowing renewal “unless lessee gives notice within 30 days of the end of the tenancy.”
- ◆ Limit the lessee’s use of the property. If the property owner contemplates a long-term (but not perpetual) lease, it should condition the nature of the tenancy with language such as “as long as lessee operates a laundromat.”

continued on next page

## Note from the Chair

by Serena Carlsen

The Executive Committee continues its work on legislative matters. Several bills being considered by the legislature will be of interest to you, so please take the time to read Warren Koons' and Tom Culbertson's columns in this newsletter.

The Midyear Meeting (now, Annual Meeting) was held on June 8-9 in Seattle, and was very successful. In response to the request of our members, a two hour ethics session was held on Friday morning as a separate session. As with past years, the concurrent session was held on Friday afternoon and included case law and legislative updates on Real Property and Probate and Trust. Seminar topics were offered from 8:30 a.m. to 5:00 p.m. on Saturday. This differed from our typical Friday afternoon, Saturday morning and Sunday morning format of past midyear meetings. We are looking for your feedback as to whether you liked this schedule.

The Section was able to engage several exceptional speakers to speak on cutting edge topics. In the Real Property program, Mr. Norwood Gay, Senior Vice President and General Counsel of Attorney Title Insurance Fund located in Orlando, Florida spoke on federal E-SIGN legislation, what it means to the future of title insurance and discussed the first electronic closing. Also, Mr. R. K. Arnold, President and CEO of MERS spoke on the Mortgage Electronic Recording System and the electronic transfer of mortgages. In the Probate and Trust program nationally renowned speaker Mr. Steven E. Trytten of Calleton & Trytten LLP, Pasadena, California, spoke on retirement plans and IRA distributions. This year's annual meeting was a challenging and informative program •

## WSBA Service Center

We're here to serve you! The mission of the WSBA Service Center is to respond promptly to questions and requests for information from our members and the public. Call us Monday through Friday, from 8:00 a.m. to 5:00 p.m. Or if you find e-mail a convenient way to communicate, send us a message at [questions@wsba.org](mailto:questions@wsba.org). Assistance is only a phone call or an e-mail away.

**800-945-WSBA • 206-443-WSBA [questions@wsba.org](mailto:questions@wsba.org)**

---

*continued from previous page*

### *Perpetual Leases in Washington . . .*

- ◆ Require the lessee to surrender the property in its original condition, taking into account normal wear and tear.

#### **V. Statutory Defenses to Perpetual Leases**

In four landlord-tenant statutes, the RCW embodies a policy against perpetual leases. First, as discussed in *Morris* nearly 100 years ago, under the RCW a tenancy for an "indefinite time" is "construed to be a tenancy from month to month, or from period to period on which rent is payable." RCWA 59.04.020. If the lessee has an option to terminate the lease by giving notice, a renewable lease is not for an "indefinite time." *Morris*. Second,

another provision provides that "In all cases where premises are rented for a specified time, by express or implied contract, the tenancy shall be deemed terminated at the end of such specified time." RCWA 59.04.030. Neither RCW 59.04.020 nor 59.04.030 applies to residential leases. RCWA 59.04.900 ("This chapter does not apply to any rental agreement included under the provisions of chapter 59.18.") Nevertheless, RCW 59.18.200 ("indefinite time") and 59.18.220 ("termination of tenancy for a specified time") are nearly identical to their counterparts in chapter 59.04. These statutes, in combination with the "unequivocal" test devised by courts, present a substantial obstacle for lessees' claims to perpetual leases. •

# Estate Planning Strategies for Small Wood Lot Owners

by T. Randall Grove, Landerholm, Memovich, Lansverk & Whitesides, P.S.

The small wood lot owner (20 acres to 640 acres of timberland) faces particular challenges if he or she wants to keep the tree farm in the family for the next generation. This article will focus on practical estate planning strategies available to assist the small wood lot owner to address these challenges in transferring the tree farm to the next generation.

## Challenges

Over the last 15 years, the increased value of timber and land have caused estate tax issues to become a major concern for many small wood lot owners. In addition, governmental regulations that restrict the harvesting of timber have increased significantly. Furthermore, the Growth Management Act (and the comprehensive plan adopted by each county) frequently restricts the ability of the small wood lot owner to subdivide the tree farm into smaller parcels. Tax and governmental regulation issues facing the small wood lot owner are complex.

The relative lack of liquidity associated with timberland and “family politics” creates additional challenges. It is not uncommon for a timber owner to want a particular child who is involved with the tree farm to have complete authority over the timber management and harvesting decisions (after the death of the timber owner) while providing that the other children simply receive an equal share of distributions. The highly discretionary decisions associated with timing and extent of the timber harvest can cause the children who simply have a beneficial interest (but no control) to perceive the situation as unfair. Concerns with respect to future family disagreements and possible liquidation of the tree farm (contrary to the intent of the parent) are not uncommon.

It can be difficult for the small wood lot owner to develop a practical plan for paying estate tax. Typically, the small wood lot owner does not want a major portion of the property logged in order to pay estate taxes. Furthermore, the high volatility of timber prices and increased restrictions on logging create a significant uncertainty regarding reliance on the cutting of timber to pay estate taxes. In addition, it can be more difficult for small wood lot owners in the Pacific Northwest to qualify for special estate tax relief than farmers and owners of other types of businesses.

## Objectives

1. **Management of the Tree Farm** • Small wood lot owners typically want to retain control during their lifetime while involving one or more of their children in the tree farm. The parent may want to transfer control of the tree farm to one or more of the children in order to provide the greatest assurance that the tree farm will continue on in accordance with the parent’s management approach.

2. **Retention of Benefits** • Small wood lot owners are often “land rich and cash poor” and his/her economic security during retirement years may depend upon benefits received from the tree farm. Upon death, the wood lot owner may want benefits received by children to be subject to a timber management plan, rather than having the timber management plan subject to the cash flow desires of the non-participating children.
3. **Efficiency in Making Transfers** • Small wood lot owners often want to make transfers that will provide equal benefit to children in a manner that is consistent with their desires for management and benefit. Gifts or post-death transfers of undivided interests are simple to execute, but may seriously undermine a timber management plan for the tree farm. Management by a committee of tenants-in-common is rarely efficient because any party may veto the decision of the majority. The transfer of a separate parcel to each child may be impractical or restricted due to minimum parcel size. Furthermore, such approach will not utilize the most effective estate and gift tax planning and the overall management plan for the tree farm. The establishment of an entity (limited liability company) provides the greatest flexibility, simplicity and equity regarding transfers while promoting an efficient management plan and a variety of tax planning opportunities.
4. **Implementation of Plan** • The simplest approach for the small wood lot owner is to implement a plan only after his or her death (after the death of the surviving spouse). However, this approach does not provide the greatest benefits and efficiency if any estate tax is owed or if the beneficiaries do not cooperate fully with each other.

If the small wood lot owner is willing to make commitments regarding the future management of and benefit from the tree farm, then it is most beneficial to implement a plan for the tree farm during the lifetime of the small wood lot owner. Current implementation enables the parent to utilize current values of land and timber, and current tax law. More importantly, the current implementation of a plan involving one or more of the children assuming a key management role can be very significant in promoting future family harmony and efficiency of management.

If a plan is implemented by a surviving spouse after the death of one spouse, then special tax planning opportunities may be realized. Assuming the tree farm

*continued on next page*

*continued from previous page*

### *Estate Planning Strategies . . .*

was held as community property, the basis for income tax purposes was adjusted to current fair market value at the time of death, eliminating all pre-death appreciation for capital gain purposes. IRC Section 1016(b)(6). The surviving spouse may also disclaim an undivided interest in the tree farm. Furthermore, if an entity such as a limited liability company (“LLC”) or family limited partnership (“FLP”) is established by the surviving spouse and children following the disclaimer of an undivided interest to children, the non-tax reasons for establishing the LLC are enhanced. Significant non-tax reasons are important in supporting the valuation discounts taken if the IRS audits subsequent gifts made to the children or the surviving spouse’s estate. However, deferral of plan implementation until after the death of one spouse may not utilize the most effective estate tax planning options available.

5. Estate and Gift Tax Planning • Small wood lot owners typically want to reduce or eliminate estate and gift taxes without too much complexity. Many estate and gift tax planning strategies can be utilized effectively in the small wood lot context. However, strategies that reduce the value of the land and timber for gift and estate tax purposes by segregating equity ownership from control of the tree farm serve both the non-tax and tax planning objectives of many small wood lot owners. The special provision for paying estate tax over a 15-year period under IRC Section 6166 can be particularly useful for small wood lot owners. Special post-death estate tax benefits for farmers under IRC Section 2032A and family business owners under IRC Section 2057 may possibly provide significant benefit. However, the expensive technical requirements and practical considerations associated with such benefits often reduce their utility to the small wood lot owner. The estate plan should emphasize flexibility and the achievement of non-tax planning objectives in light of the likelihood of significant transfer tax law changes.

#### **Estate Planning Strategies**

In identifying appropriate estate planning strategies the wood lot owner must first develop a Timber Management Plan that includes the goals for the tree farm regarding harvest and improvement of the stand of timber; management and ownership (including future ownership) within the family; and the tree farm activities undertaken in the past as well as the future activities needed in order to accomplish the goals. The plan may be simple, but it must be practical and updated on a periodic basis.

The Timber Management Plan can provide the following benefits:

1. A clear statement of intent for focusing the current and future management efforts and building consensus within the family after the death of the parent.
2. Support for the characterization of the tree farm as a business for IRS purposes in order to be eligible for various estate tax benefits.
3. Support for special use valuation as “timberland” for state property tax purposes. When a transfer of the property is made to a family business entity such as an LLC, a timber management plan must be submitted to the county for approval.

#### **Entity Planning**

Over the last ten years, entities such as FLPs and LLCs have become very popular in strategies for achieving tax savings. However, the entity strategy will accomplish the objectives of the small wood lot owner only if it is designed and implemented to accomplish non-tax purposes in the most tax efficient manner. Under most circumstances an LLC provides the most favorable combination of efficient management; limitation of liability; simplicity in transferring interests (LLC units may have both economic and voting rights or economic rights only); flexibility in designing different rights associated with an interest in the entity; income tax benefits (all items of income and expense flow through to the members); perpetual existence; and estate and gift tax benefits.

The recent changes in state law have made LLCs and FLPs essentially comparable with respect to several issues including duration of the entity; withdrawal of members from the entity; the rights of transferees who are not granted voting rights; dissolution of the entity and extent to which a discount is allowed for federal estate and gift tax purposes.

In Washington, both Limited Liability Companies (RCW Chapter 29.15) and Limited Partnerships (RCW Chapter 25.10) allow the parties to override state law in the governing instrument. However, the default provisions of the Washington state statute are very important for discount planning in the federal estate tax context. In order to avoid the application of IRC Section 2704(b) (ignoring certain restrictions for valuation purposes) the provisions of the governing instrument must not impose requirements that are more restrictive than the default provisions under state law in many respects.

#### **Design of the LLC**

The LLC Operating Agreement will appoint one or more managers and the managers may appoint officers to conduct the ongoing business. Most small wood lot owners want to retain overall control (including the power to remove and appoint the manager) and either retain operational control (exercise of all LLC manager duties) or delegate operational control to one or

*continued on next page*

*continued from previous page*

## *Estate Planning Strategies . . .*

more family members. If overall control is handled by one individual and operational control is held by another individual, the person holding overall control may be designated as the Manager and the individual holding operational control may be designated as President of the LLC (subject to removal by the Manager). This approach is appropriate if the small wood lot owner depends upon a child to conduct the activities of the tree farm.

Most small wood lot owners also want the flexibility to retain an appropriate portion of the LLC equity ownership and give equity interests to family members. If two classes of LLC units are established, the small wood lot owner may transfer equity ownership (Class B Units) without giving up control. Class A Units typically have full voting rights as well as economic rights while Class B Units have economic rights and very limited voting rights. This capital structure is a functional equivalent of general partner interests (Class A Units) and limited partner interests (Class B Units) in an FLP. If the capital structure of the LLC provides for 2 percent of the value of the entity to be allocated to the Class A Units and 98 percent of the entity value to be allocated to the Class B Units, nearly all of the LLC equity may be transferred to children while the small wood lot owner maintains control. However, the economic rights of Class A and Class B Units should be the same, unlike common and preferred stock rights, in order to avoid the requirements and disadvantages of IRC Section 2701.

The fair market value of the Class B Units is much less than the fair market value of the assets owned by the entity because the Class B Units lack control, are not readily marketable and the owner of Class B Units has no right to withdraw his or her interest from the entity (minority, lack of marketability and “lock in” discounts). The value of an asset for gift tax purposes is equal to the amount a willing buyer would pay a willing seller. IRC Section 2512. The fair market value of an interest in the LLC is based upon the facts and circumstances of the particular situation (e.g., benefit, control, value and type of assets, provisions of agreement, amount of liquidity, earnings history and future prospects). The party transferring the interest in the LLC has the obligation for estate and gift tax purposes to determine the value of the units that are transferred. In order to meet the valuation obligation, appraisers are typically needed to appraise the land, the timber and the applicable discounts. Commonly, a particular appraiser may only have the expertise to provide one of such appraisals, thus requiring that a separate appraiser be retained to accomplish different aspects of the overall appraisal. The discount appraisal should meet the requirements of the adequate disclosure regulations (IRC Regulation Section 301.6501(c)-1(f)(2)) applies to gifts made after December 31, 1997. Meeting the disclosure requirements gives the donor the benefit of the three-year statute of limitations limiting the IRS’s ability to question the valuation of the gift in the future.

The capital structure of the LLC is important for non-tax reasons as well. Among other benefits, the LLC promotes the

management of the tree farm while also providing for equal benefit to all children.

### **Drafting Tips**

The LLC Operating Agreement should reflect the type of arms length business arrangement that unrelated third parties would enter into regarding distributions, authority of the manager, rights of non-managers, accountability of the manager, transfer rights, withdrawal of a member and dissolution restrictions. In addition, the Operating Agreement should address the fair rent to be paid for any personal use of LLC assets by the parent. If the manager has authority that exceeds that which would be present in a typical business situation between third parties, then the IRS may utilize various arguments to undermine the tax effectiveness of gifts (IRC Sections 2036; 2038; 2703; 2704) and qualification for annual exclusion gift treatment under IRC Section 2503(b).

The Operating Agreement should also retain the fiduciary obligation of the manager under state law; the state law provisions for rights of transferees; perpetual existence and restrictions on withdrawal of a member. If provisions of the Operating Agreement are more restrictive than state law, then the greater restrictions (particularly with respect to liquidation of the entity) will not be considered in the amount of discount allowed by the IRS. IRC Section 2704(b). If the provisions of the Operating Agreement are less restrictive than state law, the amount of discount will be reduced.

If the provisions of the Operating Agreement reflect a “family deal” that grants extraordinary management powers to the small wood lot owner (e.g., absolute discretion on whether to make distributions and treating the LLC assets like his or her personal assets) then the LLC and gift planning may not be effective for gift and estate tax purposes. Any gifts of LLC units will be included in the decedent’s estate for estate tax purposes. *Estate of Schauerhammer v. Comm’r*, 73 T.C.M. (CCH) 2855 (1997); *Estate of Reichardt v. Comm’r*, 114 T.C. 144 (2000). Furthermore, gifts will not qualify as a present interest and thus will not be eligible for the gift tax and exclusion.

If the small wood lot owner and the family are not willing to operate the LLC in an arms length manner with provisions that reflect a business deal, then they should not expect estate and gift tax benefits. In such situations, it may be best to focus on liquidity planning and the non-tax issues referenced above.

### **Implementation of the LLC**

The LLC should be fully implemented and operated for a period of time before any gifts are made from parent to children. The initial phase of LLC implementation includes formation of the LLC; meaningful contribution to the LLC by each party to the agreement; and completion of the transfers of assets to the entity.

Special consideration should be given to parcels of real estate that are transferred to the entity and parcels of real estate that are retained by the small wood lot owner. The principal residence of the small wood lot owner and any parcel of real

*continued on next page*

*continued from previous page*

### *Estate Planning Strategies . . .*

estate that the small wood lot owner wants to give to a particular child should not be transferred to the LLC under general circumstances.

Transfers of real property will likely involve special steps to continue the forest use for state real property tax purposes and the preparation of the timber management plan. If the small wood lot owner retains one or more parcels, a boundary line adjustment or other steps may be required in order to locate the principal residence on the retained parcel. Alternatively, if all real estate, including the principal residence is transferred to the LLC, the small wood lot owner should enter into a lease of the principal residence and pay fair market value rent in order to avoid inclusion of the real property in the small wood lot owner's estate for estate tax purposes. IRC Section 2036.

After the transfers of assets to the LLC are completed, LLC units should be issued in exchange for contributions on a pro rata basis for each party (e.g., for every \$100 of assets contributed, a member receives 2 Class A Units and 98 Class B Units). It is also important to clarify the roles of the LLC manager, attorney and accountant regarding initial administration of the LLC. The small wood lot owner and appropriate family members should meet with the accountant and attorney to identify duties and steps that will be taken by each party. The attorney should communicate regarding the responsibilities of the LLC manager; state law requirements for the LLC; federal law requirements, including tax reporting; provide a checklist of issues that may arise with respect to the LLC and whether the attorney, the accountant or another advisor should be contacted.

Once the LLC is legally effective, the LLC manager must operate the tree farm within the LLC. Failing to do so may result in the loss of a part or all of the tax and non-tax benefits of the plan.

After a period of time for initial operation of the LLC (typically, thirty days to one year), the small wood lot owner may want to make a final decision regarding gifts of Class B Units to family members. It is important to have a clear separation between the time when funding of the entity is completed and the time when final decisions are made regarding gifts. The tax benefits of the gifts will be undermined if transfer of the tree farm to the LLC occurs after gifts of LLC interests are made. *See Estate of Shepard v. Comm'r*, 115 T.C. 226 (2000).

The parent must decide the quantity and class of units to give each family member. If Class B Units are given, then a substantial discount for federal gift and estate tax purposes will be realized. If Class A and Class B Units are given to the same person, the valuation discount applicable to the transferred units will be diminished or eliminated. If the small wood lot owner gives up control in the formation of the LLC or upon gifting shortly after formation, the IRS may contest discounts by asserting a "gift on formation" or "step transaction" theory. *See Estate of Cidulka v. Comm'r*, T.C. Memo 1996-149.

A gift tax return (IRS Form 709) must be filed by April 15 of the year following the year of gift, including the appraisals.

There are significant administrative efficiency advantages and potential estate tax advantages if taxable gifts as well as annual exclusion gifts are made. If the small wood lot owner makes gifts to family members that exceed the annual gift tax exclusion amount at the end of the year of LLC formation and at the beginning of the next year, the donor and family receive the benefit of the annual exclusion gifts in both years; utilization of the applicable exclusion amount to the extent that the gifts exceed the annual gift tax exclusion amounts; and only one appraisal is needed for each of the land, timber and discounts. In addition, status quo for the ownership of the LLC will be achieved without ongoing changes. By making taxable gifts future appreciation attributable to the equity interests that were gifted will be shifted to the junior generation.

#### **LLC Administration**

Consistency in following the provisions of the agreement is very important. Distributions should be made in accordance with provisions of the Operating Agreement. The LLC should establish its own bank accounts and business procedures that are appropriate under the particular circumstances. The personal bank accounts of the small wood lot owner should not be utilized. Lease payments for any LLC assets that are personally used by members of the LLC should actually be made (or included as income for IRS reporting purposes) if the person using the asset is eligible for compensation from the LLC.

#### **IRS Attacks on Discounts Associated with Entity Planning**

The IRS has typically been unsuccessful in contesting the tax savings resulting from gifts of an entity interest except where the family does not follow the administrative provisions of the Operating Agreement, where the parent retains all benefits or the LLC is not implemented in the proper manner. *Kerr v. Comm'r*, 113 T.C. 449 (1997); *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000); and *Estate of Shepard v. Comm'r*, 115 T.C. 226 (2000).

The courts have recently upheld the validity of business entities used in the family context for gift and estate tax purposes. *Church v. Comm'r*, 85A.F.T.R. 2d 2000-804 (D.C. Tex. 2000); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Knight v. Comm'r*, 115 T.C. 506 (2000). In each case, the court did not agree with the following IRS technical arguments to: disallow the existence of the entity for gift and estate tax purposes under IRC Section 2703; disallow consideration of restrictions on the limited interest under IRC Section 2704(b); find a gift upon formation; and ignore the entity based upon a "substance over form" argument. However, the court allowed only minimal discounts if the non-tax reasons for the entity planning were insignificant.

Based upon current case law, substantial estate and gift tax benefits in the context of an LLC may be achieved if the LLC is implemented for substantial non-tax (as well as tax) reasons; the

*continued on next page*

*continued from previous page*

### *Estate Planning Strategies . . .*

Agreement is well drafted to reflect an arms-length third-party arrangement; the plan is implemented properly; the LLC is administered consistently in a businesslike manner; and the appraisal of land, timber and discounts are thoroughly and expertly done.

#### **Practical Utilization of Special Estate Tax Benefits**

If the small wood lot owner's estate is projected to owe estate tax and is comprised of 35 percent or more of timberland and other closely-held business assets, the estate may be eligible for one or more special post-death estate tax benefits. Large gifts of LLC Class B Units may disqualify the estate from receiving a post-death special estate tax benefit (hereinafter post-death benefit) under IRC Sections 2032A and 6166. Therefore, in most situations, primary emphasis should be placed either on entity gift planning (achieving discounts) or post-death benefit planning. If it is uncertain whether post-death benefit planning will be needed in order to reduce the estate tax to a manageable level, it is best to plan for maximum flexibility. If the tree farm is operated as a business, then options will be preserved for potentially utilizing the post-death benefits.

Active management as a business is a key step in receiving post-death benefits including the fifteen-year estate tax payment plan at low interest (IRC Section 6166); special use valuation resulting in a reduction of timberland value by up to \$750,000 for estate tax purposes (IRC Section 2032A); deduction for qualified family owned business interests up to \$625,000 in 2000 (IRC Section 2057).

Unless appropriate steps are taken, a tree farm may be regarded as simply an "investment" rather than a farm business. The risk of characterization as an investment is great if there has been no recent income from timber harvest. In such case, it is particularly important to document activities that improve the stand of timber. The business activity requirements of each post-death benefit referenced above are specific to the particular code section and the technical requirements of each should be carefully examined.

IRC Section 6166 estate tax deferral was granted when the decedent rented the farm property on a crop share basis but participated in important management decisions regarding planting, types of crops and weed control and made regular site visits. Rev. Rul. 75-366, 1975-2 C.B. 472, The Revenue Ruling stated that an individual is engaged in business activity if "he cultivates, operates or manages a farm for gain or profit . . ." Such activity is required in order to distinguish business assets from investment assets.

If the small wood lot owner or his or her agent or family member carries on activities that improve the stand of timber and periodically generate income, then estate tax deferral treatment will be granted to the small wood lot owner's estate. This post-death estate tax benefit may be the most readily obtainable and practical of the post-death estate tax benefits referenced above

because it provides an opportunity to pay the estate tax over an extended period of time at a very low interest rate (estate tax on the first \$1,000,000 of closely held business value interest at a rate of only 2 percent per annum). A practitioner should carefully study the requirements of any of the post-death estate tax benefits referenced in this article.

If the timberland and other business assets comprise 50 percent or more of the small wood lot owner's gross estate (including the value of gifts made during lifetime) and a qualified heir or longtime employee will commit to operating the tree farm for at least ten years after the death of the small wood lot owner, then the estate tax deduction under Section 2057 should be examined. For purposes of passing the "50 percent test", all lifetime gifts of QFOBIs are included in the calculation. However, the maximum deduction (based upon current law) is \$625,000. The benefits decrease as the applicable exclusion amount increases, and the effort and expense needed in order to satisfy the requirements is substantial. This post-death benefit should be examined under the facts of each situation.

Section 2032A Special Use Valuation can provide a very substantial benefit (up to \$750,000 of reduction in the value of business assets). It is most practical to utilize this post-death benefit if a valuation formula method involving lease rates for comparable land can be utilized. However, in the Pacific Northwest, land is typically not leased to a tenant for timber growing purposes. Since comparable leases are required in order to qualify for the "formula method" under IRC Section 2032A(e)(7), small wood lot owners in the Pacific Northwest are not able to utilize this efficient statutory approach.

The alternative for achieving IRC Section 2032A qualification is to elect valuation under IRC Section 2032A(e)(8) based upon five valuation factors (essentially all facts and circumstances). There is relatively little legal precedent or specific guidance from the IRS with respect to qualification under IRC Section 2032A(e)(8). TAM 9328004 provides discussion of the factors but does not give any certainly regarding valuation because there are no rules with respect to the weighting of the factors (factors include the capitalization of income and the capitalization of fair rental value of the land for farming).

If the tree farm produces a consistent cash flow from thinning/harvesting operations and if the tree farm property value is influenced significantly by residential development/recreational uses, then it may be practical to pursue the multiple factor method (even if there are no "comparable leases"). If the capitalization of income factor and the capitalization of fair rental value factor cannot be effectively evaluated, the results of the IRC Section 2032A(e)(8) analysis are very uncertain.

#### **Include Appropriate Provisions in the Estate Planning Documents of the Small Wood Lot Owner**

Special consideration should be given to any tax formula provisions (for spouses) that define the marital deduction and

*continued on next page*

*continued from previous page*

## *Estate Planning Strategies . . .*

credit shelter portions of the decedent's estate if potential planning under IRC Sections 2057 or 2032A is desired. *Estate Planning, for Farmers and Ranchers*, 3rd ed./Kelley, Ludtke and Steinineyer, West Group (1999); *Planning and Drafting Under the Taxpayers Relief Act: Section 2057*; Kelley, D., Chapter 13, 44th Annual Estate Planning Seminar, Seattle, WA, (1999).

The estate planning documents may include a statement of intent regarding the long-term ownership of the tree farm, special trust distributions for children after the death of the small wood lot owner, the extent of benefit and timing of the benefit to be received and provisions regarding termination of the trust if an entity is established in the future or if the timberland is sold.

The trust provisions may include express authorization for the trustee to establish an LLC or other entity (See RCW 11.98.070); a grant of authority to the trustee to manage the tree farm in accordance with the small wood lot owner's desires (possibly waiving diversification duties and waiving or modifying other fiduciary duties); inclusion of a principal and income provision regarding equitable allocation of proceeds from timber sales between principal and income; and waiver of the conflict of interest if the trustee is also a beneficiary.

A financial durable power of attorney should include a grant of broad powers for the attorney-in-fact to establish one or more business entities, manage such entities and transfer entity interests. In addition, such document should grant broad powers for a non-family member attorney-in-fact to make gift transfers either outright in trust or to a Uniform Transfers to Minors Act account.

### **Liquidity Planning**

If the small wood lot owner projects that the estate will have significant liquidity needs after considering non-tree farm assets, appropriate planning with respect to maximizing the unified credit, discounted entity gifts and post-death estate tax benefits, then he or she will want to examine other liquidity alternatives.

Cutting timber to generate cash may be very appropriate or it may be impractical depending upon price, cost basis or income tax issues, maturity of the stand and future plans. Borrowing is an alternative but depends upon the availability of cash flow to service the debt.

If the small wood lot owner is insurable and has the cash flow available to pay premiums, life insurance is an option. Life insurance proceeds will not be included in the small wood lot owner's estate if the life insurance is purchased by other family members or an irrevocable trust for the benefit of such family members. If the small wood lot owner does not want to make the commitments associated with discounted gift planning and if the post-death estate tax benefits are not practical, life insurance may provide the best solution to the liquidity problem. Furthermore, life insurance proceeds (or other liquidity techniques) may be used to distribute assets to family members who are not involved in the management of the tree farm, rather

than including them as "equity only" participants in the tree farm over an extended period after the owner's death.

As a last resort, sale of a portion of the tree farm may be necessary in order to provide sufficient liquidity in order to preserve the remaining portion of the tree farm.

### **Charitable Planning**

Charitable planning may be utilized during lifetime or at death to produce a variety of benefits for the small wood lot owner, family members, and one or more qualified charities. Charitable planning approaches may be utilized in conjunction with liquidity planning and other estate tax planning strategies in order to provide a well-balanced approach.

A split-interest trust may be established that retains lifetime cash flow for the timber owner and distributes the remainder to a qualified charity. These objectives may be accomplished through establishing a Charitable Remainder Trust ("CRT"). Tax benefits include no recognition of capital gain at the time timber is sold (if timber is sold by the CRT); partial income tax deduction; and estate tax deduction.

A split-interest trust may be established that distributes an amount (or a percentage of value) to a qualified charity for a period of years (or the small wood lot owner's lifetime) and the remainder may be distributed to family members. This objective may be accomplished through the establishment of a Charitable Lead Trust ("CLT"). Tax benefits include either an income tax deduction or exclusion of tree farm income from the gross income of the small wood lot owner and discount for gift and estate tax purposes on the future transfer of the tree farm to family members.

A "charitable conservation easement" may be granted to a land conservation entity (e.g., Columbia Land Trust) that prescribes a particular timber management approach. For example, the easement may restrict extensive clear cutting, subdivision and development of the property. In order to implement the easement, the land conservation entity and small wood lot owner develop a plan and the entity periodically monitors compliance with the plan. The small wood lot owner receives a charitable income tax deduction based upon the reduction in fair market value that occurs after the easement is implemented. In addition, the fair market value of the land may be significantly reduced for federal estate tax purposes. If the small wood lot owner wants to limit logging and development, this approach can yield very favorable tax and non-tax benefits.

### **Conclusion**

If the objectives of the timber owner are clear and appropriate strategies are utilized, then the objectives can be accomplished and very significant benefits can be realized by the small wood lot owner's family, despite the changes in timber prices, taxes and governmental regulations. •

## *Recent Developments*

### Real Property

*by Scott B. Osborne, Graham & Dunn PC, Seattle*

---

#### WASHINGTON COURT OF APPEALS

---

#### ***Harting v. Barton, 101 Wn.App. 954 (2000)***

Harting leased a farm to Barton. Barton paid a lump sum in advance for rent. Barton was also to pay a share of the crops grown each year to Harting as additional rent. The lease contained an option allowing Barton to purchase the land for a price of \$800,000. The lease contained operating covenants that required Barton to operate the farm in a “professional farm-like manner” and prohibited any waste or damage to the property. Any disputes under the lease were to be resolved by mediation.

Barton was unable to plant a crop in 1996 because of his financial situation. Barton failed to keep the real estate taxes current and he allowed weeds to grow on the land to the extent that crop production was reduced. Harting notified Barton that the lease was terminated and commenced an action to regain possession of the property. Following Harting’s taking action to terminate the lease, Barton attempted to exercise the purchase option. Harting refused to honor the exercise of the option. The trial court terminated the lease and the option based on Barton’s failure to properly operate the farm and pay real estate taxes.

On appeal, the judgment was affirmed. Barton objected to the trial court ruling on the grounds that the dispute was required to be mediated. Although the lease contained a mediation provision, the court found that Barton waived this requirement by not demanding mediation. During the trial, Harting presented several witnesses that testified that Barton did not farm in a professional manner. The court’s finding that the farm was not operated in a “professional farm-like manner” was supported by substantial evidence. Since there was not independent consideration for the option, the termination of the lease also terminated the option.

#### ***Lane v. Wahl, 101 Wn.App. 878 (2000)***

Despite the tendency of courts to blur real estate law principles with contract law, occasionally the difference can affect the outcome of litigation. The Lanes owned property in a rural area near Moses Lake. They built two houses on the property and used the balance of the land as a Christmas tree farm. They sold one of the houses, but the conveyance violated restrictive covenants applicable to the property that specified a minimum lot size. In order to accommodate a subsequent sale of the house, the Lanes quit claimed remaining property to the purchasers of the house in order to satisfy the minimum lot-size requirement. In exchange, the Lanes received a 10-year lease on the quit-claimed property, with a 10-year renewal option, so that they could continue farming Christmas trees. The Lanes had the right to terminate the

lease at any time. A subsequent purchaser of the house attempted to terminate the lease. The Lanes sought a declaratory judgment validating the lease. The trial court held that the lease was valid, but held the Lanes liable for certain herbicide damage to the property. The Lanes were awarded attorneys fees for the costs incurred in defending the lease.

The purchaser contended that the provision in the lease that allowed Lane to terminate the lease at any time rendered the agreement illusory under contract law. Under contract law, an agreement that can be terminated at any time by one party is an illusory promise and not enforceable. The court noted that a lease is a conveyance, however, and normal contract rules of interpretation do not apply to leases for a fixed period. A lease for a fixed term that can be terminated at the option of either of the parties is not invalid. The court also upheld the award of attorneys fees was proper, since the Lanes prevailed on the principal issue before the court, which was the validity of the lease.

#### ***Kenney v. Read, 100 Wn.App. 467 (2000)***

Letters of credit have played an increasing role in providing security deposits for lease transactions. A recent Washington case had the opportunity to construe the effect of the issuance of the letter of credit on the underlying lease agreement between the landlord and the tenant.

Read leased a radio station to Rook Broadcasting for a nine-month period. To secure the payment of the rent, Rook was required to provide Read with a letter of credit. Kenney supplied the letter of credit based on inducements from Rook. Although all of the rental payments were paid, Read drew on the letter of credit based upon a provision in the lease that allowed drawings if the letter of credit was not replaced within ten days of expiration. Read retained a portion of the proceeds based on other claimed breaches under the rental agreement. Kenney sued to recover the amounts drawn. The trial court dismissed the claim on summary judgment, holding that the draw was proper under the letter of credit. In effect, the trial court determined that since the draw did not violate the letter of credit terms, Kenney had no claim.

The Court of Appeals reversed. Although the draw was permitted under the letter of credit, and therefore had to be honored by the issuing bank, the real issue between Kenney and Read was whether the underlying agreement permitted Read to retain the letter of credit proceeds. Based on a review of the agreement, the court found that here was a material issue of fact as to whether the letter of credit was intended to secure lease

*continued on next page*

---

## REAL PROPERTY COUNCIL REPORT

by Warren Koons, Davis Wright Tremaine LLP, Bellevue  
Director - Real Property Council

It is the Spring of 2001, and notwithstanding our recent kaleidoscope of troubles from the Florida vote count embroilment, to “pardon-gate,” the departure of A-Rod, drought, energy crisis, Mardi Gras mayhem, 6.8 earthquake, nosedive in the NASDAQ, semi-departure of Boeing, dot-com bust, economic slowdown, etc. — still, despite these and our many other vicissitudes, life is good! The flowers will bloom this spring, even so. T.S. Eliot said, “And all shall be well and all manner of things shall be well...” I agree with him completely!

Why bring all this up? Because I think it is vital to our effectiveness as lawyers that we be able to take the long view of things and look for the good and the opportune, that we not succumb to the discouragements, expediencies or difficulties of the moment. Our clients need our good judgment, and we cannot provide them with good judgment if we don’t keep things in perspective. Our clients need us to help them sort through their tangled problems and find clear, appropriate courses to take. They need us to help them find opportunity in difficulty. They sometimes need us to counsel them against doing something which in the stress of the moment looks to them like a solution, but which is actually harmful, stupid or wrong. We cannot serve in this role, or at least we cannot do it very well, if we ourselves have a depressed, defeated or short-sighted outlook. How often a negative attitude or short term thinking leads to missed opportunities and blunders — for our clients and for ourselves!

I’ll get off my soapbox. Thanks for allowing me to indulge in my musings a bit here. This is my final report to you as Director of the Real Property Council, and I have appreciated the opportunity to serve. As of the midyear meeting in June, Bill Reetz will become the new Director. Bill’s appointment as the new Director is good news indeed. Bill is dedicated, energetic and well versed in the issues that will face the Real Property

Council in the coming year. I look forward to working with Bill again, as well as with the other new Real Property Council members Maren Gaylor and Scott Campbell.

One of the important issues that the Real Property Council will face in the coming year is to try and work with other lawyers and stakeholders to devise an appropriate legislative solution to the on-going problem of lengthy delays in the reconveyance of deeds of trust. We intend to help form a taskforce to draft a proper legislative solution to this problem, one that hopefully can be introduced in the next legislative session.

In the 2001 legislative session, efforts were made by the Washington Land Title Association and others to introduce legislation that attempted to solve the problem of delays in deeds of trust reconveyances. That proposal (H.B. 1158 and S.B. 5706), which failed to make it out of committee, would have amended the Deed of Trust Act by allowing the borrower, underlying property owner, escrow company or title company, as a “person entitled,” to appoint a successor trustee and issue a request for reconveyance of the deed of trust if the beneficiary failed to timely request the reconveyance. The Real Property Council strongly opposed that legislation. (If you would like to see a copy of our letter in opposition, please let me know.) Simply put, the Council felt that H.B. 1158/S.B. 5706 would cause more problems than it would solve, and that the solution to the problem needed further and more careful study. We anticipate working closely on the taskforce with the WLTA to come up with a more workable alternative to solve the problem of delays in deed of trust reconveyances.

*If you have any comments or suggestions, or if you are interested in assisting the work of the taskforce on reconveyances, please e-mail me at: warrenkoons@dwt.com. •*

---

*continued from previous page*

### *Recent Developments: Real Property*

obligations other than rent. The case was remanded for trial on that issue.

#### **Carlstrom v. Hanline, 98 Wn.App. 780 (2000)**

A recent case has clarified the obligations of Seattle landlords to renew expired leases to residential tenants. Hanline leased a room from Carlstrom in Seattle. The lease provided that the term ended on April 1, 1998. Hanline made several complaints about the condition of the premises. When the lease expired, Carlstrom sought to evict Hanline. The tenant contended that the eviction was without just cause and violated the Seattle just cause eviction

ordinance. The trial court issued a writ of restitution in favor of Carlstrom.

On appeal, the court affirmed the termination. The termination date of the lease was not ambiguous. A tenant holding possession after termination of the lease is guilty of unlawful detainer. The just cause eviction ordinance adopted by Seattle did not compel the automatic renewal of the lease and did not prevent a landlord from recovering possession of premises following the expiration of the term. •

## *Recent Developments*

### Probate and Trust

*by Alice E. McCarty and Wendy S. Goffe, Graham & Dunn PC, Seattle*

---

#### WASHINGTON COURT OF APPEALS

---

#### ***Estate of Gardner, 103 Wn. App. 557 (Div. III 2000)***

**Summary:** A decedent's surviving spouse is entitled to 100 percent of the decedent's ERISA-governed pension benefits where a former spouse waived her right to any marital interest in the decedent's property, under a dissolution decree.

**Facts:** Robert Gardner and his first wife, Deirdra, were married in 1966, had three children and lived in North Carolina. Robert designated Deirdra as primary beneficiary of his TIAA-CREF retirement pension. He designated the children as contingent beneficiaries. ERISA governs the pension plan.

In 1991, Robert and Deirdre divorced under North Carolina law. The dissolution decree released each of them from "any marital interest or right of any type in either real or personal property owned by the other party" under the laws of North Carolina or any other state or federal law involving division of property acquired during marriage. Also included in the decree was a mutual waiver of any right to assert a statutory or distributive share in each other's estate.

In 1992, Robert began teaching at Whitman College, in Walla Walla, and married Donna Cook. Prior to their marriage, he had contacted TIAA-CREF to change his retirement pension beneficiary designation. Robert died in 1996. Donna found the change of beneficiary form that Robert had signed in 1993, but never sent to either TIAA-CREF or Whitman College. Donna submitted a claim for 100 percent of the pension proceeds. The children submitted a claim for 50 percent as contingent beneficiaries under the original designation, asserting that Donna was entitled to no more than 50 percent of the pension as the surviving spouse.

The trial court found that the former spouse's waiver of her interest in the plan was enforceable and that federal law entitled the surviving spouse to 100% of the pension proceeds. The Court of Appeals affirms.

**Discussion:** Under ERISA-governed pension plans, only two methods exist for a plan participant to designate a beneficiary other than a surviving spouse. The first is to obtain the written consent of the surviving spouse, waiving his or her interest in the pension proceeds. The other method is for the former spouse to obtain an assignment of a portion of the pension plan as part of a property settlement, in the form of a Qualified Domestic Relations Order (QDRO). Here, Deirdra, the former spouse, waived all of her interest in Robert's ERISA-governed plan at the time of their dissolution. Furthermore, even though the court applied federal law to reach its decision, it acknowledged in dicta that, decision under Washington law, RCW 11.07.010(2)(a)

provides that a spouse named as beneficiary of an ERISA plan automatically loses rights under the plan upon dissolution of the marriage. The Court found that the children of Robert and Deirdra did not have a valid claim to any portion of the plan proceeds, because they remained contingent, not primary, beneficiaries.

#### ***Marriage of Litowitz, 102 Wn. App. 934 (Div. II 2000)***

**Summary:** In a dissolution proceeding, where there is an issue as to the award of "pre-embryos" (the Court's term for a zygote of less than 16 cells) created by a third party egg donor and the sperm from the husband, the constitutional right of the husband not to procreate will prevail over an egg-donor contract where there disposition of pre-embryos, in the event of dissolution, is not contemplated, and the pre-embryos will be awarded to the husband.

**Facts:** Becky and David Litowitz contracted with an egg donor at an *in vitro* fertilization clinic in California. (Note: Washington law prevents parties from contracting for surrogacy if the surrogate is to be compensated. RCW 26.26.230.) David's sperm fertilized five eggs, which produced five pre-embryos. Three of the pre-embryos were implanted in a surrogate mother and produced one child, Micah. The other two pre-embryos were preserved through cryogenic freezing for use at a future time. At the time Micah was born, however, Becky and David had separated and begun dissolution proceedings.

During the dissolution proceeding, Becky sought custody of the pre-embryos with the intent of implanting them in a surrogate mother to produce another child, for which she would be the primary parent. David, too, sought custody of the pre-embryos because he wanted to place them with an out-of-state adoptive couple.

The trial court awarded the pre-embryos to David, applying the best interest of the child standard. The Court of Appeals affirmed the lower court's finding; however, it based its holding on David's constitutional privacy right not to procreate, as the only progenitor in this dispute.

**Discussion:** In a dispute where the disposition of pre-embryos is involved, the Court finds that it is contrary to public policy to force one individual to become a parent against his or her will. The genetic material of the pre-embryos includes the eggs from the egg donor and David's sperm. Therefore, David is the only progenitor in this dispute and his right not to become a parent will prevail over Becky's desire to have another child, based on his constitutional privacy right not to procreate.

*continued on next page*

*continued from previous page*

### *Recent Developments: Probate and Trust*

In dicta, the court indicated that it would not enforce a contract to allocate ownership of the pre-embryos that was contrary to public policy, even if such an express contract existed. However, it was not necessary in this case to determine whether the contract was contrary to public policy. In this instance, the contracts between Becky and David and the egg donor did not contemplate the disposition of the pre-embryos, stating only that Becky and David, the intended parents, have the “sole right to determine the disposition” of the eggs. With the addition of David’s sperm, the Court found that the eggs no longer existed. Thus, the provision in the agreement that the eggs would be returned to the egg donor, at the egg donor’s request, had become unenforceable.

Becky and David’s consent agreement for cryopreservation of the pre-embryos provides only that “[i]n the event we are unable to reach a mutual decision regarding the disposition of our pre-embryos, we must petition to a Court of competent jurisdiction for instructions concerning the appropriate disposition of our pre-embryos.” Therefore, the Court found no express or implied contract regarding disposition of the pre-embryos in favor of Becky. The Court affirmed the trial court decision, awarding the pre-embryos to David, based on his constitutional privacy right not to procreate.

#### ***Pennington v. Pennington, 142 Wn. 2d (2000).***

**Summary:** Evidence of a meretricious relationship between cohabitating parties will be insufficient to warrant an equitable distribution of property upon termination of the relationship where the court finds that the relationship does not satisfy the five non-exclusive factors for a meretricious relationship outlined in *Connell v. Francisco*, 127 Wn. 2d 339 (1995), and where the Court finds that no substantial value is added by the cohabitant seeking an equitable distribution of property.

**Facts:** In the first of two consolidated cases, Clark Pennington (“Pennington”) and Evelyn Van Pevenage (a.k.a. Sammi Pennington) (“Van Pevenage”) began a relationship in 1983 and Van Pevenage moved into a home owned by Pennington in 1985. Van Pevenage financially contributed to the furnishings and upkeep of their home, received medical benefits through Pennington’s business, was listed on Pennington’s life insurance as the beneficiary, and drew checks on Pennington’s business account. Van Pevenage did not hold joint title on any of the assets, however. Van Pevenage moved out in 1991 when Pennington refused to marry her, briefly lived with someone else, but later resumed cohabitating with Pennington when he suffered a stroke. Van Pevenage quit her job in order to take care of Pennington. They lived together until 1993.

In the second case, James Nash (“Nash”) and Diana Chesterfield (“Chesterfield”) began dating in 1986 and moved into a home owned by Chesterfield in 1989. While living together, Nash and Chesterfield opened a joint checking account

to which they both contributed funds. The account was opened for the purpose of funding living expenses; it was used to pay the mortgage and taxes on the house, as well as groceries, utility bills, and other miscellaneous expenses. Contributions to the account were initially equal, but over time Nash contributed more than Chesterfield, paying a greater share of vacation and dining out expenses.

Nash and Chesterfield periodically assisted each other professionally. Nash aided Chesterfield with work-related travel logs and offered her the use of the computer at his dental practice. Chesterfield aided Nash as a temporary dental assistant, helped process accounts payable for several months, and performed word processing tasks. Nash offered to compensate Chesterfield for her help, but she refused to accept his offer.

They ceased cohabitating in 1993. In 1994, they briefly reconciled and began dating again, although they did not resume living together. They planned to marry, but permanently terminated the relationship in 1995.

**Discussion:** Washington does not recognize common law marriage, but does recognize meretricious relationships. A meretricious relationship is a stable, marital-like relationship where both parties cohabit with knowledge that a lawful marriage between them does not exist. When a meretricious relationship terminates, the courts will consider equitable distribution of property.

Meretricious relationships are analyzed under five non-exclusive factors outlined in *Connell v. Francisco*, 127 Wn. 2d 339 (1995). Those factors are: Continuous cohabitation, duration of relationship, purpose of relationship, pooling of resources and intent of the parties. These factors are meant to reach all relevant evidence helpful in establishing whether a meretricious relationship exists. Thus, whether relationships are properly characterized as meretricious depends upon the facts of each case.

In the Pennington/Van Pevenage relationship, the State Supreme Court determined that the totality of the circumstances did not support finding a meretricious relationship under the factors outlined in *Connell*. Specifically, the Court looked to the periods of time when Pennington and Van Pevenage were not living together and when Van Pevenage lived with another person for one month. The Court further noted that, even though the couple combined resources to furnish their homes, none of the loan or title documents contained Van Pevenage’s name. Over the course of their ten-year relationship, they never maintained joint checking or savings accounts. The Court also looked at Pennington’s refusal to marry Van Pevenage. In sum, the Court found that the lack of significant pooling of resources, periods of separation, cohabitation with another partner, title in one person’s name only, and refusal to marry did not rise to the level of a meretricious relationship. The Court affirmed the Court of Appeals.

*continued on next page*

## HOW TO REACH US

### Section Officers 2001-2002

**Barbara C. Sherland, Chair**

Stoel Rives LLP  
600 University Street, Suite 3600  
Seattle, WA 98101-3197  
Phone: 206-386-7691  
Fax: 206-386-7500  
E-mail: bcsherland @stoel.com

**Warren E. Koons, Chair Elect**

Davis Wright Tremaine LLP  
10500 NE 8th Street, Suite 1800  
Bellevue, WA 98004  
Phone: 425-646-6100  
Fax: 425-646-6199  
E-mail: warrenkoons@dwt.com

**Thomas M. Culbertson, Probate & Trust  
Council Director**

Lukins & Annis, P.S.  
West 717 Sprague Avenue, Suite 1600  
Spokane WA 99201-0466  
Phone: 509-455-9555  
Fax: 509-747-2323  
E-mail: tculbertson@lukins.com

**William Reetz, Real Property Council Director**

Transnation Title Insurance Company  
1200 Sixth Avenue, Suite 100  
Seattle, WA 98101  
Phone: 206-628-2803  
Fax: 206-343-7220  
E-mail: breetz@landarn.com

**Karen L. Gibbon, Newsletter Editor**

6317 Phinney Avenue N.  
Seattle, WA 98103  
Phone: 206-782-1456  
Fax: 206-782-1399  
E-mail: kgibbon@gibbonlaw.com

---

*continued from previous page*

### *Recent Developments: Probate and Trust*

In the Chesterfield/Nash relationship, the Court found that the four years that the couple lived together was insufficient to meet the continuous cohabitation and duration of the relationship factors. The Court reasoned that the time between the first and final separation when the couple lived apart was material. In addition, the Court determined that the parties' joint checking accounts and pooling of economic and professional resources did not meet the level required to establish a meretricious relationship. Specifically, the Court cited the facts that they had not purchased property jointly, had maintained separate bank accounts and

contributed separately to their respective retirement accounts as material. Furthermore, the Court found that the mutual intent of the parties too equivocal. The Court chose not to address the issue of professional goodwill. Therefore, given the facts presented, the relationship between Chesterfield and Nash did not rise to the level of a meretricious relationship and the equitable principles recognized in *Connell* are not triggered. Again, the Court reversed the Court of Appeals.

The Court remands both cases back to the trial courts for further proceedings consistent with the opinion. •

---

## PROBATE AND TRUST COUNCIL REPORT

*by Thomas M. Culbertson, Lukins & Annis, PS, Spokane  
Director - Probate and Trust Council*

As we move into the new year, legislative matters continue to dominate the Probate and Trust Council's activities, with the Section's midyear meeting getting increased attention.

Four bills sponsored and/or supported by the probate and trust side of RPPT have, as of this writing (late March), made it through one chamber of the legislature and are working their way through the other, hopefully on the way to the Governor's desk.

**Powers of Attorney** • The first bill deals with powers of attorney and is the result of over a year's deliberations by a RPPT task force chaired by Professor Karen Boxx. The purpose of this legislation is to give third parties greater comfort in relying upon powers of attorney, while at the same time doing everything reasonably possible to protect vulnerable principals from abuse by agents. In the words of the task force, the goal is to make powers of attorney "easier to use and yet harder to abuse."

Under present law, third parties are absolved from liability for relying on a power of attorney if their reliance is "without negligence and in good faith" (RCW 11.94.040). Under the proposed legislation, a third party is presumed to satisfy that standard if it receives a contemporaneously executed affidavit from the attorney-in-fact, setting forth various factual matters set forth in the statute. That safe harbor is available unless the third party knows the factual assertions in the affidavit to be false.

To better protect principals, agents and third parties, virtually any matter concerning a power of attorney can be resolved by the court as a special proceeding under RCW Chapter 11.96A. Such matters may include, for instance, disputes concerning the validity of a power of attorney, the appropriateness of an attorney in fact's actions, and the refusal of a third party to honor a power of attorney.

Finally, a new section in RCW 11.94 would provide that a power of attorney naming a spouse is automatically revoked upon entry of a decree of divorce or legal separation, similar to RCW 11.12.051 and 11.07.010 concerning wills and non-probate beneficiary designations.

The power of attorney task force views this legislation as only a part of its mission. It is now working on other issues relating to powers of attorney, especially the possibility of adopting a statutory form. Meanwhile another task force is being formed, jointly with the Elder Law Section, to look at

issues which are unique to health care powers of attorney and to determine whether the existing statute is adequate.

**Rule Against Perpetuities** • A second bill would simplify the rule against perpetuities, as applied to trusts and powers of appointment, by simply stating that an interest must vest within 150 years of the effective date of the instrument creating the trust or power. The bill would amend RCW 11.98.130, which deals only with trusts and powers of appointment. Other applications of the rule against perpetuities have only a common law (i.e. no statutory) basis and are not affected by this bill. Members of the Real Property Council are considering whether (and how) to make such simplification apply to all applications of the rule against perpetuities.

**Technical Amendments to TEDRA** • The committee which drafted TEDRA, with a year of practical application under its belt, has prepared a bill making some technical amendments, none of which are of much substantive significance. However, as of this writing, some opposition has surfaced, not regarding the amendments, but regarding provisions of both TEDRA itself and the Trust Act of 1984. The doctrine of virtual representation and the process for appointment of special representatives have in particular led to some surprising controversy, despite the fact that they have been part of the law for years. The committee is hopeful that some educational efforts on its part will allay the critics.

**Animal Trust Act** • This bill would validate trusts set up for the benefit of animals. As introduced, it broadly referred to all non-human animals, but in its most recent form it defines "animal" as an animal with vertebrae. The bill also 1.) gives persons with an interest in the animal's welfare the right to obtain court enforcement of the trust terms, 2.) provides that the rule against perpetuities applies to trusts for animals, and 3.) provides for the ultimate disposition of the trust assets if the trust instrument is silent in that regard. •

Visit our section web page  
at  
[www.wsba.org/sections/rppt/home.htm](http://www.wsba.org/sections/rppt/home.htm)