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SENATE NATURAL RESOURCES

ENRFBM NO. 3

DATE 3/21/11

BILL NO. SB 409

Montana &
*Washington
(*currently inactive)

October 2, 2009

Governor Schweitzer
Board of Land Commissioners
Montana State Capitol Building
Box 200801
Helena, MT 59601-0801

Re: Cabin site lease rate alternatives; "Analysis of Lease Rent Calculation Alternatives for Cabinsites on Montana's State Trust Lands" September, 2009

Dear Governor Schweitzer and Members of the Land Board:

I write on behalf of Montanans for the Responsible Use of the School Trust ("MonTRUST") to comment on existing proposals for cabin site lease rate alternatives. In summary, MonTRUST cannot endorse any of the five DNRC proposed alternatives. Instead, we offer an additional alternative which we believe is more consistent with the Constitution, the law, and with past decisions on this issue.

History

As you are no doubt aware, prior to the tenure of this board, MonTRUST was the plaintiff in a series of court cases intended to more thoroughly enforce the application of trust law to the management of Montana's school trust lands. In *MonTRUST vs. State*, the 1st Judicial District Court issued its Decision, Order and Permanent Injunction ("MonTRUST Decision") on April 1, 1998, held that 10 statutes facially violated the Enabling Act and Constitution for breach of trust responsibilities. (Copy attached). In addition, Judge McCarter held that the cabin site leasing process then employed by the Land Board violated the Enabling Act and Constitution, as applied. At pp. 9-10, relying upon the quarter-million-dollar state study (commonly called the "Duffield Study") the Court said,

The Court concludes that Section 77-1-208, M.C.A. is *not invalid on its face* as applied to school trust lands. The Department's policy of charging a rental rate of 3.5 percent of the appraised value, however, deprives the school trust of revenue to which it is entitled under the Enabling Act's mandate that the property be leased at full market value. *The rental rate of 3.5 percent benefits the leaseholders but not the trust.* Thus, the Department's practice of issuing lease renewals at a charge that is less than that which reflects the fair market

rental rate is unconstitutional.

(Emphasis added). Judge McCarter's decision on the cabinsite issue was unanimously affirmed by all seven judges of the Supreme Court. *MonTRUST v. State* (1999), 1999 Mont. 263, 989 P.2d 800.

Subsequently, DNRC convened a negotiated rule-making committee ("NRMC") consisting of MonTRUST, other trust beneficiaries, state officials, and lessee representatives. In lengthy meetings in 2000, the NRMC crafted three recommendations to the Land Board. (See, 2009 Analysis, Appendix F):

1. To raise the cabinsite lease rate to 5% of appraised value,
2. To employ a "one-time" phase-in of the 5% rate over five years (to be completed January 1, 2008), and
3. That the Land Board "...support legislation providing *general fund* tax relief for lessees with financial hardship."

At the time the Land Board adopted these recommendations, MonTRUST expressed concern that the proposals might *fail* to achieve "full market value," and thus breach the Enabling Act and violate the permanent injunction. However, MonTRUST agreed to wait to see what would happen, expressing concern that the Department continue collection of empirical information on lease assignments (like that analyzed in the Duffield Study).

In the ensuing years, DNRC nominally raised the lease rate to 5% and inaugurated a phase-in. *But, no other recommendations of the NRMC have been adopted.* Contrary to NRMC recommendation #2, the intended "one-time" phase-in has not only exceeded "five years," going past the January 1, 2008 end date, the Department's proposed implementation would engage a new five-year phase-in with every Dept. of Revenue appraisal cycle (See, 2009 Analysis, pp. 20-21, Sec. 4.1).

Similarly, regarding recommendation #3, the leaseholder negotiators participating in the NRMC wisely realized that the hardship visited on some leaseholders by rising cabinsite rates could not constitutionally be relieved by compromising rentals under the Board's trust responsibilities. However the NRMC unanimously agreed that *general fund* relief to lessee hardship cases *was* appropriate and should be initiated by the Land Board with the legislature. But, the Land Board at the time never implemented that recommendation.

The Current Situation

Contrary to the NRMC, the Department has stated, as currently implemented, "...the real rate of return obtained by the state, .. *never* reaches 5%." (2009 Analysis, Sec. 2.0, p. 6, final para., emphasis added). In fact, the phase-ins have resulted in a situation under which the 2009 rent payments average a mere 2.01% of 2009 appraised values. Even measured against historic 2003 appraisals, they obtain only 4.74%. *Id.* In the eleven years since the MonTRUST Decision, rents have never reached the five percent recommended by NRMC,

and fall far short of the 6% to 12% recommended by the Duffield Study (relied on by Judge McCarter). Thus, the *actual rent collection since 2001 has consistently failed to achieve full market value as required by the permanent injunction.*

This is further confirmed by the lease assignment values collected in Appendixes E3 and E5 of the 2009 Analysis. Of the 56 cabinsite property sales between 2002 and 2008, forty-four sales produced very substantial leasehold values (the difference between the sale price and the value of the improvements being sold). This is powerful evidence, as discussed in the Duffield Study, that lease rates, eleven years post-MonTRUST and sixteen years post-Duffield, are *still* well below market value.

Simultaneously, as rents have risen over the decade, lessees, especially those with lower income, have begun to feel the economic pinch, and their understandable protests lead to the present review and controversy. This has been compounded by global recession, whereby property values have likely declined subsequent to 2008 DOR appraisals. In private meetings held with DNRC, various leaseholders devised Alternative No. 4 involving a freeze on further rent increases, another study of the situation, combined with another formula for recalculating rentals. MonTRUST was neither involved in those meetings, nor invited to attend.

The Land Board is thus pressed to provide economic relief to leaseholders at the same time it exercises its fiduciary responsibilities to trust beneficiaries.

MonTRUST's positions on the Alternatives

Based primarily on the evidence recited above, MonTRUST *does not believe that any of the alternatives* in the 2009 Analysis comply with the state's trustee duty to obtain full market value. Most of the alternatives evince a design to provide relief out of trust revenues to leaseholders in contravention of the trustee duty of undivided loyalty to the beneficiaries, only. In our view, none therefore comply with Judge McCarter's permanent injunction, with the Constitution, or the Enabling Act.

Concerning Alternative 1, as described above, MonTRUST respectfully disagrees with the Department that it achieves full market value. Obviously, therefore, if Alternative 1 fails, then the others must fail as well, since they provide *less* income than Alternative #1. (2009 Analysis, p. 29, Table 11).

Alternative 3 appears to potentially provide more trust income, but in doing so, it produces predictability with a cost of arbitrariness. By projecting historic figures, divorced from ongoing market forces, it extracts both lessees and beneficiaries even further from true market conditions. A major problem with formulas – such as phase-ins, and value projections – is that they tend to be sluggish in the face of real economic conditions. The current formula has obviously been sluggish to catch rents up with the bull market of the past few years, and its is probably sluggish now, in following the current bear market

Key Under

conditions.

Alternative 4 is touted by the lessees' attorney, Mr. Waterman, as a way of preventing "increased lease rates" working "to destroy the market for leased property" and causing "the entire program to fail" (Waterman letter to Land Board, Sept. 2, p.2). But, despite the lessees' dire predictions of program failure, they have not produced any significant evidence of such an imminent disaster.

The leaseholder's survey was self selected by the individual respondents most upset about rents, thus reflecting worst-case examples. The survey's return rate was very low compared to the total 764 cabin leases. As a matter of social science, self-selected survey responses are inherently less reliable than hard data from the market place. At this point, there is no significant evidence of lease abandonment. The indications of difficulty with sales of leasehold improvements reflects nothing more than current economic conditions, which make it hard to sell *any* interest in real estate.

Of the 56 recent cabinsite sales, only one sale, Missoula # 3062705, shows a negative leasehold value (evidence that rent may be too high). Most show huge positive leasehold values (evidence rent is too low).

Most important, there is no evidence which would support a freeze of any kind under current conditions. The current lease vacancy rate is a mere 4.7% (802 lots, 38 vacancies). DNRC indicates that most of these 38 lots have been long vacant and are not subject to active promotion by the Department, so even the 4.7% overstates the real vacancy situation. If current execution of the cabin lease program breaches the permanent injunction, a freeze most certainly would.

MonTRUST's Solutions

That is not to say that under current economic conditions that market values are not in remission, or that rent increases are not a hardship for at least some lessees. But there are ready remedies for such consequences that do not require compromise of trust responsibilities, and do not require yet-another economic study to devise yet-another formula to derive "market value" by committee. MonTRUST therefore proposes as follows.

[1] **Valuing cabinsites.** The free marketplace provides a responsive and effective gauge of what is a fair price for a product. The marketplace is the mechanism we use to buy and sell our businesses, cars, homes, and most other things in this society. Competitive bidding would quickly demonstrate what people are, or are not, willing to pay for cabinsite leases when they come vacant, whether by expiration or otherwise. It could provide an opportunity, if only the former leaseholder bids, for her to *reduce* her rent when the economy turns down. And it would be equally responsive on the upside. There is no reason it cannot be used for cabin leases.

The current cabin site statute, §77-1-208, does not prohibit competitive bidding for cabin-site leases. It merely provides authority for setting rates if there are no competitive bids. On the other hand, §77-6-202, M.C.A. provides,

77-6-202. Lease by competitive bidding – full market value required.

When the department receives an application to lease an unleased tract, it shall advertise for bids on the tract. The tract must be leased to the highest bidder ...

Section 77-6-204, then defines an "unleased tract" as, "*When a lease expires, is canceled, or is voluntarily terminated under 77-6-116..*" (emphasis added).

The only thing prohibiting competitive bidding of cabinsite leases, is an administrative rule, ARM §36.25.117(3)(a), readily amended by this Board without legislative action. MonTRUST heartily commends this board to repeal or amend that section to allow a reasonable program of competitive bidding for cabin sites.

[2] Relief to lessees. Besides the relief that may be available to lessees who get no competing bids when they wish to renew or retain their lease on vacancy, there is the yet untried recommendation of the Negotiated Rule Making Committee. MonTRUST once again urges the Board to implement what its predecessor board did not: To sponsor a legislative package that would enable leaseholders to get general fund relief so they can competitively stay on their leases. Whether such relief is means-tested or not, would be at the discretion of the Board and ultimately, the legislature. MonTRUST would support either alternative so long as the relief is from the general fund, and not from the trust.

With this brief review, on behalf of the members of MonTRUST, I wish to thank you for your concern about this issue. We are happy to supply what help we can as matters develop.

Very truly yours,



Roy H. Andes

cc: Tommy Butler
MonTRUST
other interested parties