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February 16, 2010

TO: Environmental Quality Council (EQC) Members

FR: Todd Everts, EQC Legal Staff

RE: Legal Analysis Regarding Full Market Valuation of State Land Cabin Sites

At the January 7, 2010, EQC meeting, several questions were raised regarding the current legal requirements of what constitutes full market value for state trust land cabin site leases. The purpose of this memorandum is to legally analyze those questions in less than 50 pages as requested by Senator Shockley.

The legal basis for the EQC's request regarding this issue is that the EQC has legislative statutory oversight functions for the Department of Natural Resources and Conservation (DNRC) and the entities attached to the DNRC.[1] Those legislative oversight functions include administrative rule review, draft legislation review, program evaluation, and monitoring functions.[2] This legal opinion does not reflect any opinion or action on the part of the EQC.

Specifically, after listening to the audio minutes of the Council's discussions regarding state cabin leasing valuation, I think that the Council asked that I analyze the following questions:

1. What are the current legal requirements with respect to obtaining full market value for state land cabin site leases?

Short Answer: The Enabling Act, the Montana State Constitution, state statutes, administrative rules, and case law all clearly require that state trust lands be managed by the state for the benefit of public education and other public services and that state trust lands be administered to return "full market value" to the beneficiaries. The Montana Supreme Court in 1999 specifically ruled that full market value must be obtained for state cabin site leases and that

[1] 75-1-324(10), MCA.

[2] Id.

the 1999 cabin site rental policy of 3.5% of the Department of Revenue's (DOR) appraisal process was significantly below full market value. The Montana Supreme Court has also held that under the Montana Constitution, the Legislature has been given the authority to determine the method by which full market value is to be ascertained. "Full market value" is currently defined by Rule 36.25.102, ARM, as the most probable price in terms of money that a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus. Current law requires that full market value of a "new" cabin site lease is obtained through a competitive bidding system. However, state law also requires that full market value for a renewal of a current cabin site lease be obtained not through a competitive bidding system but through the DOR property appraisal process that compares the value of similarly situated property. The Montana Supreme Court has ruled that the DOR appraisal process for cabin site leases is an acceptable alternative to a competitive bidding system only if full market value is obtained.

2. Is there a difference between full market valuation of a fee simple-owned cabin site lot and the full market valuation of a cabin site lot held in fee simple that is leased or rented?

Short Answer: No. The State of Montana holds cabin site state trust land in fee simple (absolute ownership) for the benefit of the state trust land beneficiaries. Unlike a typical private property owner that holds the property in fee, The Enabling Act, the Montana Constitution, and current state law require that the state as a trustee receive full market value for fee simple property interests/rights. Full market value is the most probable price that the property or property right/interest will bring in a competitive market. One of the many property rights/interests of fee simple ownership that has a value is the right of the property owner to lease or rent the property. A willing party may enter into a voluntary agreement with the state to lease state fee simple trust land for the right to occupy the state land and, if the lessee so chooses, place an improvement on the land such as a cabin. It logically and legally follows that full market valuation of fee simple property would reflect the value of all the fee simple property interests/rights, including the value of leasing or renting the property. Inversely, the value of the lease should reflect, at least in part, the full market value of the fee simple property itself less any restrictions/conditions placed on the lease.

3. Can the Legislature prospectively enact an alternative valuation process for state land cabin sites other than the Board of Land Commissioners' and DNRC's proposed valuation process?

Short Answer: Yes, the Montana Supreme Court has held that the Legislature has the authority to determine the method by which full market value is to be achieved. Statutes dealing with leasing state land cabin sites will pass constitutional muster only if full market value is obtained.

Overview of Cabin Site Leasing Valuation[3]

Historically, cabin site leases and the rates charged for those leases have a long and winding (sometimes circular) political and legal road.[4] Most of the cabin site leases were developed in the late 1940s and early 1950s. Lucky leaseholders back then were assessed an annual lease rent of $5.00. Later on, the lease rent was bumped up to $50 and $75 annually and for those especially choice lots, the going rate was $150 annually.

It was not until 1983, in response to concerns that the state land trust beneficiaries were not receiving a market return for cabin site leases, that the Legislature set the lease rent at 5% of the "lease value" of a cabin site. The old Department of State Lands[5] (DSL) was responsible for appraising the lease value, and the DSL determined that the lease value was calculated at 70% of the appraised value of the state land parcel. The 5% of the lease value (DSL 70% of appraised value of the state land parcel) actually translates into a lease rent 3.5% of the appraised value of the state land parcel.

Cabin site leases again were a hot topic during the 1989 Legislative Session. Enactment of Senate Bill No. 91 provided the Board of Land Commissioners with the authority and discretion to sell a state cabin site lot under lease as of October 1, 1989, if requested by a lessee. With some exceptions, Senate Bill No. 91 required all sales of leased cabin sites to be completed no later than 10 years after October 1, 1989. It also set up an appraisal and competitive bidding process in which the original lessee was allowed to match the highest bid.

The 1989 Legislature in enacting Senate Bill No. 226 also addressed the market value of cabin site leases by eliminating the DSL appraisal process and requiring the Board of Land

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[3]For a detailed state cabin site leasing historical chronology, see Analysis of Lease Rent Calculation Alternatives for Cabinsites on Montana's State Trust Lands, DNRC, pages 2 through 4, (September 2009).

[4]Based on the cyclic nature of the state cabin site leasing issue, the following Beatles lyrics to the song "Long and Winding Road" hold true:

The long and winding road
That leads to your [cabin] door
Will never disappear
I've seen the road before
It always leads me here
Lead me to your [cabin] door

[5] The Department of State Lands was dissolved in 1995 and the trust land functions were transferred to the Department of Natural Resources and Conservation.

Commissioners to value the leases at 3.5% of the appraised value as determined by the Department of Revenue (DOR).

In 1993, the Legislature passed Senate Bill No. 424 that required the Board of Land Commissioners to "attain full market value for leases on state school trust lands."[6] Specifically, as it relates to cabin site leases, Senate Bill No. 424 repealed the 1989 Senate Bill No. 226 provisions requiring that the cabin site leases be valued at 3.5% of the DOR appraised market value and instead required the Board to set the annual fee based on "full market value" for each cabin site and further required that the fee must attain full market value based on DOR appraised value.[7] Senate Bill No. 424 also established an advisory council to review the current lease rates and make lease rate recommendations to the Board.

In 1993, the DNRC commissioned an economic analysis of the values of surface uses on state lands, including an analysis of cabin lease rates.[8] Known as the "Duffield Study", it concluded that there is some evidence that rental rates for cabin site leases are below the market rental rates. The Duffield Study also concluded that market rates ranged from 8% up to 12%.[9]

With knowledge of the Duffield Study conclusions in hand, the Senate Bill No. 424 advisory council in 1994 recommended, and the Board concurred, that the cabin site lease rate should be maintained at 3.5% of the DOR appraised value and raised the minimum lease fee from $150 annually to $250 annually.

Montanans for the Responsible Use of the School Trust (Montrust) filed suit in 1997 challenging the constitutionality of a number of statutes, including the whether the state had obtained full market value for cabin site rentals. In 1999, the Montana Supreme Court held that the rental policy adopted by the Board of Land Commissioners that established the cabin site lease rate at 3.5% of the DOR appraised value violated the Montana Constitution and The Enabling Act requirement that full market value be obtained for school trust lands.[10] The Court noted that

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[6] Chapter 586, Laws of 1993, page 2336, citing the bill title.

[7] Chapter 586, Laws of 1993, Section 1 (1).

[8] Final Report, Economic Analysis of the Values of Surface Uses of State Lands, Task 2, Analysis of Cabin Lease Rates, Duffield, John, January 1993.

[9] Id. at page 17.

[10] Montanans for Responsible Use of School Trust v. State ex rel. Board of Land Commissioners, 1999 MT 263, 296 Mont. 402, 989 P.2d 800 (1999).

Montrust factually established through an economic analysis (the Duffield Study) that the rental policy's 3.5% rate was significantly below a fair market rental return.[11]

In response to the Montrust case, the Board of Land Commissioners in 2000 directed the DNRC to initiate a negotiated rulemaking process to establish a process for full market return from state cabin site leases. The rulemaking resulted in a lease rental of 5% of the DOR appraised value of the land (excluding improvements) that was phased in over 5 years as the sites came up for renewal. The last phase of the 2003 increases will be completed in 2013.

After the DOR 2009 appraised values were released, it was apparent that a number of state cabin lessees faced substantial increases in their lease rates due to increases in appraised values of the leased state trust land lots. Responding to leaseholder concerns, the DNRC held a series of public meetings in the summer of 2009 and convened a working group to address the issue. This effort resulted in the DNRC generating a cabin leasing valuation analysis and proposing several valuation alternatives. After taking into consideration public comment, the DNRC generated what has been dubbed the "3B Alternative".[12]

In December 2009, the Board of Land Commissioners directed the DNRC to initiate the administrative rulemaking process to implement the 3B Alternative. In early February 2010, the DNRC held two public hearings in Kalispell and Seeley Lake on the proposed rules. The DNRC plans to produce an environmental assessment on the proposed rules and complete the rulemaking process by June of 2010.

The proposed administrative rules that incorporate the 3B Alternative are the Board's and the DNRC's attempt to "provide a means for valuation and imposition of rental rates for cabinsite leases upon state trust lands that reflect changing market values of those leases while obtaining the full market value of those leases for the affected trust beneficiaries."[13]

Starting in 2010, under the proposed rules, a lessee would have two cabin site lease fee options. If either option results in a lease fee of less than $250, the minimum lease fee defaults to $250. The two options are:

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[11] Id.

[12] For a good explanation of the 3B Alternative, please referred to Fiscal Analyst Barbara Smith's explanation of the 3B Alternative in the handout Ms. Smith provided the EQC at the January meeting entitled "Cabin Site Leasing on School Trust Lands: A Look at the Proposed Formula", Report to the Legislative Finance Committee, November 9, 2009. With permission, I have used parts of Ms. Smith's explanation liberally in this opinion.

[13] MAR Notice No. 36-22-143, Reasonable Necessity Statement, page 48.

1. Choose to pay rental on the cabin site lease according to the existing terms and conditions, which include:

A. 5% of the 2009 appraised market value of the land, excluding improvements as determined by the DOR; or

B. A proscribed competitive bid amount set out in rule.

2. Sign and execute a 2010 supplemental agreement that calculates the minimum rent based on a series of sophisticated valuation methodologies. The minimum rent and future adjustments are based on a three-step calculation:

Step 1: *Determine Land Parcel Value of the Cabin Site.* The land parcel value is the 2003 DOR value projected to 2009 at 6.53% annually. This calculation takes the indexed value of the 2003 land parcel at an annual percentage rate (6.53%) that is based on the average annual real estate appraisal rate from 1983 to 2009 to determine the 2009 parcel value.

Example:	2003 DOR Land Parcel Value	=	$100
	6.53% compounded annually from 2003 to 2009	=	$46.14
	2009 Adjusted Land Value of the Parcel	=	$146.14

Step 2: *Determine the Base Rent.* The base rent for 2010 will be the lower of 5% of the adjusted appraised 2009 DOR parcel value or 5% of the actual 2009 DOR appraised value.

Example: Assuming the adjusted 2009 parcel value is less than the actual 2009 appraised value, then multiply the 2009 adjusted parcel value by 5% ($146.14 X 5%) = $7.31 rent for 2010.

Step 3: *Determine Rent in Subsequent Years.* Subsequent lease rent would increase or decrease annually based on the latest Lease Fee Index (LFI). The LFI is the average of the consumer price index (CPI) and the real estate index (REI), but the LFI can never be less than 3.25% or more than 6.5%. The CPI is a measure of the annual change in price of a basket of consumer goods over time. The REI is a moving 25-year average of the annual appreciation of all cabin site parcel values. The REI would be adjusted after every new DOR reappraisal cycle.

Example: The 2011 rent would be determined based on the following:

Base rent for 2010 base	=	$7.31

LFI = CPI (1%) + REI (8.74%))/2	=	4.87%
2011 rent adjustment = $7.31 x 4.87%	=	$0.35
Rental rate for 2011 = $7.31 + $0.35	=	$7.66

The proposed administrative rules note that all of the above rental rate calculations reflect the expenses commonly incurred by lessees in leasing state land.[14] Starting in 2025, the DNRC will have a lease fee adjustment and review the 2024 annual cabin site rental for each lease.[15]

Although it is not the subject of this requested legal analysis, it is very important to note that a recent fiscal analysis of the proposed 3B Alternative valuation process concluded that for certain cabin site leases, using a 2003 DOR appraised parcel value indexed to 2009, there can be a significant omission of value within the lease rental rate calculation.[16] The analysis concluded that the 3B Alternative could result in full market value not being achieved.

Currently, the DNRC administers 802 cabin sites and home sites throughout the state of which 764 sites are considered active leases.[17] The total revenue received to the various trusts from state cabin site leases amounted to $1,572,028 in fiscal year 2009, or only 1.84% of the all the state trust land revenues in fiscal year 2009.[18] The average annual lease rent for 2009 is $2,058.[19] Table 1, generated by the DNRC, shows the fiscal year 2009 cabin and home site revenue by each Trust.[20]

Table 1. Cabin Site Lease Revenue by Trust

Trust	Leases	FY09 Revenue
Common Schools	319	$438,335
MSU 2nd Grant	195	$501,472
MSU Morrill	2	$4,839
Public Buildings	55	$40,132
Deaf and Blind School	37	$27,360

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[14]MAR Notice No. 36-22-143, NEW RULE III (1).

[15]Id. at NEW RULE III(2).

[16] See Footnote #12.

[17]Analysis of Lease Rent Calculation Alternatives for Cabinsites on Montana's State Trust Lands, DNRC, page i, (September 2009).

[18]Id.

[19]Id. at page 5.

[20]Id. at page 2.

Trust	Leases	FY09 Revenue
School of Mines	107	$461,873
Veterans Home	1	$973
State Industrial School	35	$72,517
State Normal School	12	$22,297
U of M	1	$2,230
TOTAL:	**764**	**$1,572,028**

Question #1: What are the current legal requirements with respect to obtaining full market value for state land cabin site leases?

In order to understand the current legal requirements with respect to obtaining full market value for a state land cabin site lease, it is necessary to review the Organic Act of the Territory of Montana, The Enabling Act, the Montana Constitution, applicable statutory provisions and administrative rules, and relevant case law.

Prior to statehood, with the restless folks in Bannack and Virginia City extremely concerned and agitated that Montana be separated from the ungovernable expanse of the Idaho Territory, the U.S. Congress enacted the Organic Act of the Territory of Montana that provided a temporary government for the Territory of Montana.[21] Section 14 of the Act provided that

> sections numbered sixteen and thirty-six in each township in said territory shall be, and the same are hereby, reserved for the purpose of being applied to schools in said territory and in the states and territories hereafter to be erected out of the same.[22]

In 1889, Montana was admitted into the Union under the Omnibus Enabling Act of 1889.[23] Upon admission, Congress granted Montana the sixteenth and thirty-sixth sections of each township within Montana "for the support of common schools."[24] Montana also received additional grants of acreage for other educational and state institutions.

The Enabling Act in tandem with the Montana Constitution imposes fiduciary responsibilities on the state with regard to state trust land. In 1999, the Montana Supreme Court in the seminal

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[21] The Organic Act of the Territory of Montana, 13 Stat. 91, 1861-1865.

[22] Id. at section 14.

[23] The Enabling Act, 25 Stat. 676 (1889).

[24] Id. at section 10.

Montrust case provided the overarching framework for those fiduciary responsibilities.[25] The Court held that the federal grant of lands to Montana constituted a trust. The terms of the trust are set forth in the Montana Constitution and The Enabling Act. Montana's 1889 Constitution accepted the lands from the federal government and provided that those lands would be held in trust consonant with The Enabling Act and that the 1972 Montana Constitution continued those terms. The State of Montana is the trustee of those lands. The Board of Land Commissioners is the instrumentality created to administer that trust and is bound upon principles that are elementary in order to secure the largest measure of legitimate advantage to the beneficiary. The Board owes a higher duty to the public than does an ordinary businessman. Montana's constitutional provisions are limitations on the power of disposal by the Legislature. One very important limitation on the Legislature in the power of disposal is the trust's requirement that full market value be obtained for trust lands.

The Montana Supreme Court has also held that the state as the trustee has an undivided loyalty to the beneficiaries of the trust.[26] The Court noted that:

> When a party undertakes the obligation of a trustee to receive money or property for transfer to another, he takes with it the duty of undivided loyalty to the beneficiary of the trust. The undivided loyalty of a trustee is jealously insisted on by the courts which require a standard with a "punctilio of an honor the most sensitive." . . . A trustee must act with the utmost good faith towards the beneficiary, . . . and may not act in his own interest, or in the interest of a third person.[27]

The Court has also determined that the Board and the DNRC must have large discretionary power in managing state trust lands,[28] but that discretionary power is not unlimited and it must conform to the trust,[29] and that discretionary power must be consistent with the Constitution.[30]

The Board of Land Commissioners has the constitutional authority "to direct, control, lease, exchange, and sell school lands and lands which have been or may be granted for the support and benefit of the various state educational institutions, under such regulations and restrictions as

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[25]Montanans for Responsible Use of School Trust v. State ex rel. Board of Land Commissioners, 1999 MT 263, 296 Mont. 402, 989 P.2d 800 (1999).

[26]Wild West Motors, Inc. v. Lingle, 224 Mont. 76, 728 P.2d 412 (1986).

[27]Id.

[28]State ex rel. Evans v. Stewart, 53 Mont. 18, 161 P. 309 (1916).

[29]Toomey v. State Board of Land Commissioners, 106 Mont. 547, 81 P.2d 407 (1938).

[30]State ex rel. Thompson v. Babcock, 147 Mont. 46, 409 P.2d 808 (1966).

may be provided by law".[31] The Montana Constitution sets out the Board's authority regarding public trust land disposition:

> **Public land trust, disposition.** (1) All lands of the state that have been or may be granted by congress, or acquired by gift or grant or devise from any person or corporation, shall be public lands of the state. They shall be held in trust for the people, to be disposed of as hereafter provided, for the respective purposes for which they have been or may be granted, donated or devised.
> *(2) No such land or any estate or interest therein shall ever be disposed of except in pursuance of general laws providing for such disposition, or until the full market value of the estate or interest disposed of, to be ascertained in such manner as may be provided by law, has been paid or safely secured to the state.*
> (3) No land which the state holds by grant from the United States which prescribes the manner of disposal and minimum price shall be disposed of except in the manner and for at least the price prescribed without the consent of the United States.
> (4) All public land shall be classified by the board of land commissioners in a manner provided by law. Any public land may be exchanged for other land, public or private, which is equal in value and, as closely as possible, equal in area.(emphasis added)[32]

In addition, The Enabling Act also lays out some terms and conditions regarding state trust land disposition:

> That all lands granted by this Act shall be disposed of only at public sale after advertising--tillable lands capable of producing agricultural crops for not less than $10 per acre and lands principally valuable for grazing purposes for not less than $5 per acre .
>
> *The said lands may be leased under such regulations as the legislature may prescribe.*
>
> The State may also, upon such terms as it may prescribe, grant such easements or rights in any of the lands granted by this Act, as may be acquired in privately owned lands through proceedings in eminent domain: Provided, however, *That none of such lands, nor any estate or interest therein, shall ever be disposed of except in pursuance of general laws providing for such disposition, nor unless the full market value of the estate or interest disposed of, to be ascertained in such manner as may be provided by law, has been paid or safely secured to the State.* (emphasis added) [33]

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[31]Article X, section 4, of the Montana Constitution.

[32] Article X, section 11, of the Montana Constitution.

[33]Section 11 of The Enabling Act (as amended by the acts of May 7, 1932, Ch. 172, 47 Stat. 150 (1932), and October 16, 1970, Pub. L. No. 463, 84 Stat. 987 (1970)).

The Montana Supreme Court has ruled that The Enabling Act must be liberally construed with the view of accomplishing the object sought to be attained.[34] The Court has also held that The Enabling Act contemplates that an interest or estate less than the fee may be leased or disposed of.[35]

Statutorily, the Legislature has outlined the general powers and duties of the Board expressly authorizing the Board to "exercise general authority, direction, and control over the care, management, and disposition of state lands. . . ".[36] Under the direction of the Board, the DNRC is charged with the administration of state trust lands.[37] The "guiding principle" in the administration of Montana's trust lands is that "these lands and funds are held in trust for the support of education and for the attainment of other worthy objects helpful to the well-being of the people of this state as provided in The Enabling Act".[38] The Board is required to administer the state trust lands to secure the largest measure of legitimate and reasonable advantage to the state and provide for the long-term financial support of education.[39] It is consistent with the powers and duties of the Board that "the people are entitled to general recreational use of state lands to the extent that the trusts are compensated for the value of the recreation".[40] If the Board considers it in the best interests of the state, there is reserved from the sale of any state land a proscribed strip of land bordering navigable lakes, nonnavigable meandered lakes, and navigable streams.[41]

The Board is also required to manage state lands under the multiple-use management concept.[42] The law requires that:

> (1) The board shall manage state lands under the multiple-use management concept

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[34]State ex rel. Morgan v. State Board of Examiners, 131 Mont. 188, 309 P.2d 336 (1957), overruling Bryant v. State Board of Examiners, 130 Mont. 512, 305 P.2d 340 (1956)

[35]State ex rel. Hughes v. State Board of Land Commissioners, 137 Mont. 510, 353 P.2d 331 (1960)

[36] 77-1-202, MCA.

[37]77-1-301, MCA.

[38]77-1-202, MCA.

[39]Id.

[40]Id.

[41]77-2-303(2)(a), MCA.

[42]77-1-203, MCA.

> defined as the management of all the various resources of the state lands so that:
> (a) they are utilized in that combination best meeting the needs of the people and the beneficiaries of the trust, making the most judicious use of the land for some or all of those resources or related services over areas large enough to provide sufficient latitude for periodic adjustments in use to conform to changing needs and conditions and realizing that some land may be used for less than all of the resources; and
> (b) harmonious and coordinated management of the various resources, each with the other, will result without impairment of the productivity of the land, with consideration being given to the relative values of the various resources.[43]

The Board and the DNRC have defined the term "full market value" in administrative rule to mean:

> the most probable price in terms of money that a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus.[44]

Specific to cabin site lease valuation, the Board must set the initial (new or nonrenewed) cabin site lease fee based on a competitive bidding system.[45] A lessee that retains the lease is not required to go through a competitive bidding process to determine the value of the lease renewal.[46]

The Board must set an annual fee for existing cabin sites based on a full market value appraisal of the cabin site value as determined by the DOR.[47] The value may be increased or decreased as a result of the statewide property appraisal process without any adjustments as a result of phasing in values.[48] A lessee can appeal a cabin site value as determined by the DOR.[49]

The board must follow a prescribed process for disposal or valuation of any fixtures or

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[43]Id.

[44] ARM 36.25.102 (11).

[45]77-1-208(2), MCA.

[46]Id.

[47]77-1-208 (1), MCA.

[48]Id.

[49]Id.

improvements placed on the property by the current lessee.[50]

In setting lease rental rates and fees for cabin sites, the Board shall consider:

> the impact of the uses on the school trust asset, lessee expenses for management, water development, weed control, fire control, the term of the lease, the production capabilities, the conditions on the lease payment, and any other required expenses reasonably borne by the lessee. In setting cabin site lease rates, the board shall consider expenses that are commonly incurred by the lessees to preserve the value of the state land or to provide services commonly provided by private lessors in the area.[51]

Currently, under the Board and the DNRC administrative rules, the minimum rental rate (subject to a complicated series of valuation phase in requirements) is the greater of:

(1) 5% of the appraised market value of the land, excluding improvements as determined by the DOR; or
(2) $250.[52]

This rate takes into account the lessee expenses noted above that reflect the cost to the lessee of leasing state land.

As noted previously in this memorandum, the Montana Supreme Court in the Montrust case reviewed the full market value trust requirements as they specifically relate to cabin leases on state land. The Court held that:

1. The trust mandates that the State obtain full market values for cabin site rentals.

2. The rental policy adopted by the Board of Land Commissioners that established the cabin site lease rate at 3.5% of the DOR appraised value violated the Montana Constitution and The Enabling Act requirement that full market value be obtained for school trust lands because Montrust factually established through an economic analysis that the rental policy's 3.5% rate was significantly below a fair market rental return.[53]

Montrust also argued that the lease renewal preference (lease renewal without competitive

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[50] 77-1-208(3), 77-6-302, 77-6-303, and 77-6-306, MCA. See also ARM 36.25.110(6)(b).

[51] 77-1-106, MCA

[52] ARM 36.25.110(6)

[53] See footnote # 10.

bidding) accorded to cabin site lessees is unconstitutional because the preference keeps the cabin site rental rates below their full market value. The Montana Supreme Court disagreed, noting that the Legislature had statutorily required that the cabin site lease fee must attain full market value based on the appraisal of the cabin site value as determined by the Department of Revenue. The Court has held previously that the Legislature has been given the authority to:

> determine the method by which full market value is ascertained. The statutes dealing with the leasing of state land will pass constitutional muster as long as the concept of full market value is not abrogated.[54]

The Court concluded that Montrust had not shown that the renewal preference resulted in below-market cabin site renewal rates and therefore the preference did not violate the trust.

Montana is not alone in grappling with state trust land cabin site leasing valuation. The State Attorney General in Idaho recently concluded that a reviewing court would likely find that Idaho's cabin site leasing rules violated Idaho's constitutional mandate that state endowment lands be managed solely for the financial benefit of endowed institutions.[55] The Idaho Attorney General noted:

> The rates allowed leasehold values to accrue when contract rent is below market rent, then allow lessees to retain 90% of leasehold values upon assignment of the leases. A reviewing court is likely to find that the leasing rules impermissibly allowed lessees to receive over $21 million from the assignment of leaseholds in the last six years that rightfully should have gone to the beneficiaries.[56]

In conclusion, The Enabling Act, the Montana State Constitution, state statutes, administrative rules, and case law all clearly require that state trust lands be managed by the state for the benefit of public education and other public services and that state trust lands (including cabin site leases on state trust land) be administered to return "full market value" to the beneficiaries.

Question #2: Is there a difference between full market valuation of a fee simple-owned cabin site lot and the full market valuation of a cabin site lot held in fee that is leased or rented?

Overview of Fee Simple Property Interests and Leasehold Property Interests

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[54] Jerke v. State Dept. of Lands, 182 Mont. 294, 296, 597 P.2d 49, 51 (1979).

[55] Attorney General Opinion No. 09-1, Attorney General Lawrence G. Wasden, August 5, 2009.

[56] Id. at page 2.

When the state enters into a state trust land cabin site lease agreement with a willing lessee, it enters into to this voluntary agreement as the fee simple owner of the state trust land. In order to bring some clarity to the issue of state trust land cabin site valuation, it is essential to review the property interests involved in fee simple ownership versus leasehold rights for the use of a state land cabin site.

It is clear that The Enabling Act specifically contemplates that state trust lands "may be leased under such regulations as the legislature may prescribe."[57] The Montana Constitution specifically contemplates leasing state trust land interests.[58] As noted above in numerous Montana Supreme Court cases, the Court uses the terms "lease" and "rental" interchangeably and conjunctively when analyzing trust requirements for full market valuation. The Legislature, in setting out the full market valuation methodology for cabin sites in statute, uses the terms such as "lease", "lessee", "sublease", "lease fee" "lease rental rate", "license", "licensee", "rental rate", and "agreement rates".

The Board of Land Commissioners and the DNRC administrative rules define a "cabin site" to mean:

> land occupied or to be occupied for a non-commercial use as a temporary or principal place of residence, for a single family, or equivalent of the same, and the supporting buildings, in the immediate vicinity.[59]

The term "lease" means "a contract by which the board conveys state lands for a term of years for a specified rental, and for the use for which the land is classified."[60] A "lease fee adjustment" means a process by which the DNRC applies the rental rate contracted in the lease to the most recent appraised market value to determine whether it is necessary to adjust the annual rental payment.[61] The term "rental" is not defined in the state land statutes or rules but is used to characterize annual payments outlined in the lease agreement for a particular cabin site.

A lease can be described simply as an ownership interest where one party buys the right to occupy/use the state trust land lot for a given length of time (usually a period of years). This is different from fee simple ownership in the property in which the property is purchased outright

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[57]Section 11 of The Enabling Act (as amended by the acts of May 7, 1932, Ch. 172, 47 Stat. 150 (1932), and October 16, 1970, Pub. L. No. 463, 84 Stat. 987 (1970)).

[58] Article X, Sections 4, 5, and 10, of the Montana Constitution.

[59]ARM 36.25.102(6).

[60]ARM 36.25.102(15).

[61] ARM 36.25.102(16).

and held for an indefinite amount of time. A lease is also different from a tenancy/rent interest in which the right to use the property is rented on a periodic basis (i.e., weekly or monthly) and the rental use interest is usually subject to termination or renewal at the end of a short period of time.

The property interests involved in fee simple property ownership usually include but are not limited to such rights as:

The right to sell
The right to keep
The right to lease/rent
The right to bequeath
The right to do nothing
The right to ingress and egress
The right to improve the property

When the lessee enters into a voluntary state cabin site lease agreement, the lease provides the lessee the following rights:

Right to sell their improvements and assign the lease
Right to keep the lease
Right to sublease
Right to bequeath the lease
Right to do nothing
Right to ingress and egress year round
Right to renew the lease without competition
Right to mortgage their improvements
Right to qualified use of the site that excludes the public

A typical voluntary state cabin site lease agreement clearly spells out the terms and conditions of the lease, including the term of the lease, rental fees and adjustments, use restrictions of the lease, improvement conditions, responsibilities of the lessee, liabilities, transfer/sale/rental of the lease, lease revocation, and miscellaneous conditions.

A lessee is responsible for paying taxes upon improvements and property owned by the lessee that are on or about the leased premises during the term of the lease. The lessee does not pay property taxes on the state trust land parcel.

The calculated lease rental rate set out in the lease agreement is required to take into account lessee expenses, including weed control, fire suppression, water development, and other expenses that are commonly incurred by the lessees to preserve the value of the state land or to provide services commonly provided by private lessors in the area.[62]

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[62] 77-1-106, MCA.

It is important to emphasize that the state's fee simple property ownership includes the right to lease or rent. A state cabin lessee purchases the right to sublease or rent the leasehold interest. It logically and legally follows that the value of these property interests, among others, would be reflected in the full market value of the state cabin site lease rate.

Factors That Are Inherent in Achieving Full Market Valuation

With the property interests identified between fee simple ownership and the leasehold ownership, the question becomes how should these property interests be valued in order to achieve full market valuation? Full market valuation is a process that assumes that a commodity such as a property interest has a value that has the potential to achieve an income based on a percentage of that property interest's value. Full market value is the most probable price or rate of return that the property or property right/interest will bring in a competitive market.

The following series of hypothetical scenarios highlights some of the factors that go into achieving full market valuation for fee simple property and fee simple property that is leased:

> **Facts:** Darryl A and Darryl B and their other brother Darryl C are triplets. They also have a cousin named Darryl. Darryl A and Darryl B both own (in fee simple) adjoining lakefront lots on Flathead Lake that are identical in size, encumbering easements, parcel shape, lake frontage (quality and quantity), and lake views. Both lots are equal in desirability. Both Darryl A and Darryl B own mobile homes on their respective lots that are identical. In essence, Darryl A's and Darryl B's lots and the mobile homes are mirror images of one another. Darryl C owns a lakefront lot on the Berkeley Pit Lake in Butte, America, with a mobile home that is also identical to Darryl A's and Darryl B's mobile homes. Cousin Darryl doesn't own any property.
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> *Scenario #1: Valuation of Darryl A , Darryl B, and Darryl C's property.* In order to determine the full market value of each property, typically an appraisal would be conducted comparing the value of similarly situated fee simple-owned lots that have similar factors that are inherent to the land (location, desirability, restrictions, liabilities, etc.) and comparing similar mobile homes with similar factors like size, layout, and quality and cost of construction on similar lots. The appraisal process should result in Darryl A's and Darryl B's property (fee simple lots and mobile homes) being identical in value. As one would expect, Darryl C's property value would be different from his other two brothers based on the same inherent value factors. For purposes of the following scenarios, Darryl A's and Darryl B's property on Flathead Lake have each been valued at $100 ($10 for the mobile home and $90 for the fee simple lot). Darryl C's property on Berkeley Pit Lake has been valued at $20 ($10 for the mobile home and $10 for the fee simple lot).
>
> Scenario #2: *Effect on the valuation of all the Darryl brothers' property when Darryl A*

leases his mobile home and lot to Cousin Darryl. The same appraisal process would take place as described in Scenario #1 and the value of Darryl A, Darryl B, and Darryl C's property would remain the same. Inherent in the value of fee simple held property is the right to lease the property.

Scenario # 3: Cousin Darryl compares the value of annual lease rates between leasing Darryl A's lot and mobile home on Flathead Lake and leasing Darryl C's lot and mobile home on Berkeley Pit Lake. Darryl A's mobile home is identical to Darryl C's mobile home in every way. However, Darryl A is charging an annual lease rate that is five times higher than Darryl C's annual lease rate. Cousin Darryl wonders how Darryl A can get away with charging that obscene amount given that the mobile homes are identical. The difference in value reflects a number of factors related to the land, including proximity to amenities such as lakes and streams, national parks, shopping, and scenery. Also coming into play are differences in lease rate markets between Butte and the Flathead area, and cost differences between Butte and the Flathead area such as maintenance and property tax rates, etc.

Scenario #4: Darryl A removes his mobile home, sells it and leases his Flathead Lake lot to Cousin Darryl. Cousin Darryl buys a mobile home that is identical to all the Darryl brothers' mobile homes and places it on Darryl A's lot. Darryl A no longer owns a mobile home so his current structure value is zero. The value of Darryl A's fee simple lot should remain the same at $90 based on the appraisal process described in Scenario #1. Cousin Darryl's mobile home, being identical in all ways to the other Darryl brothers' mobile homes, should have the same value at $10. Cousin Darryl is voluntarily leasing the right to occupy Darryl A's fee simple lot and place his mobile home on that lot. Darryl A is under no obligation to lease Cousin Darryl the lot. If Cousin Darryl does not want to pay Darryl A's lease rate, then Darryl A has the option to advertise his desired lease fee in the newspaper or set up a minimum competitive bid process (i.e. public auction) to obtain his lease fee.

Scenario #5: Darryl A, Darryl B, and their other brother Darryl C sell their property. As fee simple property owners, the Darryl Brothers decide to put their lots and mobile homes up for sale in a competitive real estate market. The initial asking sales price of the property usually is based the valuation process used in Scenario #1. But each Darryl has the option of determining his own asking price based on his own sense of value. The competitive open market in which people essentially bid for the right to purchase the property will determine the actual value of each property interest.

There are several possible approaches to assessing the market value for leasing a state cabin site, including but not limited to:

1. A competitive bidding process that determines the value of the lease on the open market.

2. An appraisal process that compares what competing comparable properties are renting for in the local market place.
3. An appraisal process that compares comparable fee simple land values.
4. An appraisal process that includes a combination of market rent values and fee simple property values and then computes the ratio.
5. A valuation process that uses the sales prices in the assignment or transfer of state leases from one party to another to determine the lease value.

The DNRC and appraisal experts have strenuously evaluated the merits of these approaches.[63] One of the overriding conclusions is that factors inherent to the land (location, desirability) should be reflected in the fee simple land value.[64] Once the fee simple land value has been estimated, then a rate of return should be determined and applied uniformly across all leased lots. Factors inherent in the lease (use restrictions, risk uncertainty, etc.) should be considered in adjusting the final rate of return (lease rental rate) downward, if necessary.[65] Under no circumstances should one discount a property's fee simple value for poor access, to use an example, and then make a similar discount in the rate of return for that poor access.[66] Similarly, one should not penalize the fee simple value of the lot for issues stemming from the lease. The fee simple value and the lease restrictions are entirely separate matters and should always remain separate to maintain the integrity of the valuation process.[67]

Question #3: Can the Legislature prospectively enact an alternative valuation process for state land cabin sites other than the Board of Land Commissioners' and DNRC's proposed valuation process?

The Montana Supreme Court has held that the Legislature has the authority to determine the method by which full market value is to be achieved. Statutes dealing with leasing of state land will pass constitutional muster only full market value is obtained.[68] The legislature can label a valuation process however it wants, but the valuation process must return full market value of the property to the applicable trust beneficiary.

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[63] See footnote #3.

[64]See footnote #3 at page 4 and discussions in Appendix C.

[65]Id.

[66]Id.

[67]Id.

[68] Jerke v. State Dept. of Lands, 182 Mont. 294, 296, 597 P.2d 49, 51 (1979); See also Montrust at Footnote #10.