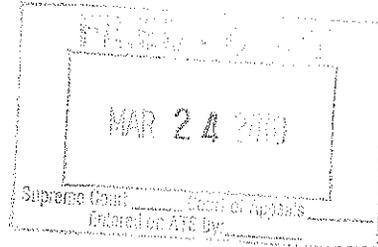


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**IN THE SUPREME COURT OF THE STATE OF IDAHO**

HON. LAWRENCE G. WASDEN, the  
Attorney General of Idaho, *ex rel.* the STATE  
OF IDAHO,

Petitioner,

vs.

IDAHO STATE BOARD OF LAND  
COMMISSIONERS, and GEORGE BACON,  
in his official capacity as Director of the Idaho  
Department of Lands

Respondent.

Supreme Court No. **37528**

**VERIFIED PETITION FOR  
ISSUANCE OF A WRIT OF  
PROHIBITION**

Petitioner the Hon. Lawrence G. Wasden, the Attorney General of Idaho, petitions this Court pursuant to Idaho Constitution, Article V, § 9, Idaho Appellate Rule 13(g), Idaho Code §§ 7-401 *et seq.*, and applicable substantive law, to issue a Writ of Prohibition (a) against the

Idaho State Board of Land Commissioners (“Board”) and the Director of the Idaho Department of Lands (b) to prevent the following actions (c) contrary to or in excess of his/its authority under Idaho law:

(a) That George Bacon, the Director of the Idaho Department of Lands, and the Board,

(b) be prohibited and enjoined from signing and implementing so-called “cottage leases” for rental of state endowment lands held in trust for the public schools, normal schools and the Idaho State Hospital,

(c) unless and until they are leased under terms meeting the requirements of Idaho Constitution, Article IX, § 8.

In support of this Petition for the Issuance of a Writ of Prohibition, Petitioner, the Attorney General of Idaho, alleges as follows:

### **I. Jurisdiction**

1.

This Court has jurisdiction to consider this Petition and to grant relief pursuant to Idaho Constitution Article V, § 9, Idaho Appellate Rule 13(g), Idaho Code §§ 7-401 *et seq.*, and applicable substantive law.

### **II. Description of the Parties and Their Roles in State Government**

2.

Petitioner is the Attorney General of the State of Idaho. The Attorney General of Idaho is a constitutional office established by Idaho Constitution, Article IV, § 1. The Attorney General

is required by Idaho Code § 58-120 to represent the State of Idaho “in all suits, actions, contests or controversies relating to or involving state lands.” The Attorney General has authority under the common law and under Idaho Code § 67-1401(5), to “supervise ... persons holding property subject to any public or charitable trust and to enforce whenever necessary any noncompliance or departure from the general purpose of such trust” and to “institute, in the name of the state, any proceeding necessary to enforce compliance with the terms of the trust or any departure therefrom.”

3.

The Attorney General is a member of the State Board of Land Commissioners. The other members of the Board are the Governor of Idaho, the Superintendent of Public Instruction, the Secretary of State, and the State Controller. Idaho Constitution, Article IX, § 7; Idaho Code § 53-101.

4.

Under Article IX, § 8 of the Idaho Constitution, the Board is the trustee of public schools, normal schools and state hospital lands in the vicinity of Priest Lake and Payette Lake. The Constitution requires the Board to manage the state endowment lands in a manner that “will secure the maximum long term financial return to the institution to which granted or to the state if not specifically granted.” Idaho Constitution, Art. IX, § 8. *See also* Idaho Code § 58-119(3) (referring to lands held in trust); § 58-133 (same); § 58-136 (same); and § 58-156(3) (declaring that “the endowment lands are held in trust by the state board of land commissioners and are managed to generate the maximum long-term financial returns to the public school endowment”).

5.

The Idaho Department of Lands (“IDL”) is the executive agency established to administer state endowment lands. Idaho Code § 58-101; § 58-119. George Bacon is the Director of the Idaho Department of Lands. Among other things, Mr. Bacon’s duties and responsibilities include countersigning leases issued by the president of the State Board of Land Commissioners for rental of state endowment lands held for the benefit of public schools, state normal schools and the state hospital. Idaho Code § 58-121.

6.

Other real parties in interest include persons desiring to renew “cottage leases” during the upcoming calendar year, public schoolchildren, college students and patients of the state hospital, who are the beneficiaries of the three trusts involved.

**III. The Board’s Action on March 16, 2010 Means that the Trusts’ Beneficiaries Will Not Receive the Money to which They Are Entitled Under Idaho’s Constitution and Idaho Code § 58-310A**

7.

On March 16, 2010, the Board voted 3-2 to implement a 4% annual rental rate, based on average property values of the previous decade, with a 5 year phase-in, and a premium rent of the greater of 10% of the gross income or 50% of the net income received by lessees when conveying leaseholds to assignees. The Board’s action means that the trusts’ beneficiaries will not receive the money they would receive if the Board were getting market rent for the leases, as constitutionally and statutorily required.

Board member Ysursa acknowledged that the 4% would not meet market value: “the suggested four percent of a rolling ten-year average of the five year phase-in is not talking current market value. It’s talking less than four percent current market value.” Exh. 36 at 23-24.

Expert economists Terry Anderson and Reed Watson agreed. They concluded that using a ten year average land value to calculate rent would “make it virtually impossible for the Land board to charge lessees ‘market rent’ as required by the Idaho Code” because “the state will always be earning rents based on past rather than current land values and therefore, especially during times of appreciation, will continually be below market rents.” Exh. 31 at 3. Economists Anderson and Watson also expressed concern about policies that phase in rent increases or cap rent increases. They concluded phasing in target rents over a five year period “guarantees that the state is not securing market rents for the five year adjustment period [and] guarantees that the actual return will be less than the prudent market return.” Id. at 4.

At the March 16, 2010 Board meeting, four of the five Board members acknowledged that the subcommittee’s recommendation would not achieve a market rental rate. Exh. 42 at 28, 31-32, 35.<sup>1</sup>

#### **IV. Premium Rent Occurs When Rental Rates Are Not at Market Value: an Explanation of Premium Rent**

8.

In 1981, the Board, in addition to requiring rental payments, invented the concept of “premium rent.” Premium rent is not rent at all; rather, it refers to the requirement that lessees pay 10% of the leasehold value upon assignment or transfer of the lease to someone outside the

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<sup>1</sup> Transcript, Agenda Item 8, Recommendation of the Cottage Site Subcommittee, Land Bd. Meeting (March 16, 2010)

lessee's immediate family. Exh. 1.<sup>2</sup> Leasehold value is determined by subtracting the value of the improvements and the personal property from the total sale price. IDAPA 20.03.13.25. Premium rent was imposed as a compromise to avoid the "very large increases" in annual rent that would have been necessary to reflect fair market values. Exh. 1. Premium rent was adopted so that when lessees assigned leaseholds for value, "the State could share in the profit." Exh. 2.<sup>3</sup> In essence, upon assignment of a cottage site lease, premium rent offsets a portion of the rent the State would have collected during the remaining term of the original lease, if the contract rental rate had been set at the market rate.

In 1987 the Board adopted a rule extending premium rents "through December 31, 1992 or until contract rents have been increased to full market rents, whichever comes first." IDAPA 20.03.13.27. Although the premium rent rule expired in 1992, the Board, in recognition of the fact that annual rents remained well below fair market value, has continued to impose the premium rent requirement as a matter of policy and contract. Exh. 18.<sup>4</sup>

The continued imposition of premium rent has proven problematic. Board members, IDL staff, and outside consultants all agree that its continued existence is an admission that contract rents are below market rents.

Board members initially conceived premium rent as a temporary measure that would have utility only as long as rents remained below market values. In 1998 Board member J.D. Williams stated that "when market value is reached the Land Board should look at removing it." Exh. 16 at 8.<sup>5</sup> Appraisers John McFadden and Bradford Knipe, hired by the Board in 1998 to examine rental rates both agreed that the large amounts of money being paid to acquire

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<sup>2</sup> Land Bd. Meeting Minutes (Aug. 4, 1981)

<sup>3</sup> Land Bd. Meeting Minutes (Oct. 13, 1981)

<sup>4</sup> Land Bd. Agenda Memorandum, Cottage Site Rental Policy Recommendations, (June 11, 1991).

<sup>5</sup> Land Bd. Cottage Site Subcommittee Meeting Minutes (Nov. 23, 1998).

leaseholds confirmed that contract rents were well below market rents. Exh. 26 at 22; ex 27 at 151.<sup>6</sup>

In 2008, Board member Ysursa informed the lessees that “if we really are at market rent, we shouldn’t be seeing that leasehold value,” and stated premium rent “was put in . . . to justify 2.5, which was low from every other study that was done. And that’s why it was put in.” Exh. 33 at 61-62.<sup>7</sup> A 2008 analysis by the Policy Analysis Group of the University of Idaho College of Natural Resources affirmed that leasehold value accrues “where contract rent is lower than market rent.” Exh. 25, Attachment 1 at 11.<sup>8</sup>

In 2010, Board member Ysursa reiterated that premium rent is a “kind of the stop gap measure because over the years [we had a] lease rate that . . . was lower than any of these studies, be it Duffield, be it Knipe, be it McFadden, be it others.” Exh. 36 at 57.<sup>9</sup> Board member Ysursa stated: “If we were at market rent, we wouldn’t need premium rent.” Exh. 41 at 56.<sup>10</sup>

## **V. The History of Lessees Benefitting at the Expense of the Beneficiaries: an Overview of the Cottage Sites’ Leasing Program**

9.

The Board leases 355 recreational home sites on Priest Lake and 167 recreational home sites on Payette Lake. Exh. 25, Attachment 1 at 1.<sup>11</sup> The recreational home sites have traditionally been referred to as “cottage sites.” The 355 cottage sites at Priest Lake are located

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<sup>6</sup> John T. McFadden, Appraisal Report, Bradford T. Knipe, Complete Appraisal.

<sup>7</sup> Transcript, Land Bd. Cottage Site Subcommittee Meeting (April 22, 2008).

<sup>8</sup> Cook and O’Laughlin.

<sup>9</sup> Transcript, Land Bd. Meeting (Feb. 16, 2010).

<sup>10</sup> Transcript, Land Bd. Cottage Site Subcommittee Meeting (March 1, 2010).

<sup>11</sup> Philip S. Cook and Jay O’Laughlin, Analysis of Procedures for Residential Real Estate (Cottage Site) Leases on Idaho’s Endowment Lands at 1 (October 2008), attached to Idaho State Bd. of Land Comm’rs, Agenda Memorandum, Recommendation of the Cottage Site Subcommittee (Feb. 16, 2010).

on public school lands. Of the 167 cottage sites at Payette Lake, two are located on public school lands, 56 on normal school lands and 109 on state hospital lands.

The majority of the cottage sites were first leased in the mid 1940s and early 1950s, though some date back to as early as 1924. Exh. 20 at 1.<sup>12</sup> Each cottage site lot is owned in fee simple by the State of Idaho as trustee for public schools, normal schools (Idaho State University, Department of Education, and Lewis-Clark State College), and the state hospital. The improvements on the cottage site lots are owned by the lessees.

10.

Rents for Priest Lake lots in 1945 were as low as \$10 per year. Exh. 25, Attachment 1 at 4.<sup>13</sup> From 1945 through 1988, rents remained relatively flat, with only sporadic increases. Id.

11.

In 1986, IDL estimated that the state was receiving a return on assets value of 0.67% for all cottage site leases. Exh. 3.<sup>14</sup> In response, the Board adopted a rental rate based on a percentage of the value of the cottage site after subtracting the value of all lessee-owned improvements. The initial rental rate was 2.5%, to be implemented in 1989 using a two-year rolling average of fair market value. Id. The rental schedule was modified in 1988 by adopting a phase-in schedule that limited annual rent increases to no more than 25%. Exh. 4.<sup>15</sup>

12.

Until 1990, expiring cottage site leases were "subject to disposal at public auction" pursuant to the provisions of Idaho Constitution Article IX, § 8 and the provisions of Idaho Code § 58-310, providing procedures for conflict auctions. The Board, however, discouraged public

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<sup>12</sup> Land Bd. Agenda Memorandum, Cottage Site Rental at Priest and Payette Lakes (April 8, 1997).

<sup>13</sup> Cook and O'Laughlin.

<sup>14</sup> Land Bd. Meeting Minutes (June 25, 1986).

<sup>15</sup> Land Bd. Meeting Minutes (May 17, 1988).

auctions by posting notices of availability only on the local court house bulletin board, instead of advertising them as they did on other expiring leases. Exh. 28b.<sup>16</sup> As a result, prior to 1990, few applications for conflict auctions were received and none had proceeded to auction. Exh. 28a at 2.<sup>17</sup>

By 1990, demand for cottage site leases had increased significantly, so that people were willing to pay “substantial amounts of money to buy their leasehold” from existing lessees. Exh. 28b.<sup>18</sup> The large increases in leasehold values accrued because contract rent was below market rent. Two pending applications for conflict auction prompted the Board to delay the applications and seek legislative action to protect the lessees.

13.

In written testimony submitted to the Legislature in 1990, cottage site lessees complained that conflict auctions were unfair because “[o]ne hundred percent of the money from a conflict bid goes to the State,” Exh. 28b.<sup>19</sup> Lessees argued that they would lose the “substantial amounts of money” they had paid to predecessor lessees for the right to assume the lease. Id.

Legislators questioned whether eliminating the public auction requirements conflicted with the duty to obtain maximum long-term returns. Exh. 28c at 5. Senator Vance stated: “the constitution requires that the State manage the land to experience maximum gain [but] it is hereby declared that we aren’t going to do it anymore. That’s what they’re saying. It’s the craziest thing I’ve ever witnessed. I can’t believe it.” Id. at 7.

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<sup>16</sup> Senate Resources and Environment Committee Minutes of February 16, 1990.

<sup>17</sup> Senate Resources and Environment Committee Minutes of February 9, 1990.

<sup>18</sup> Senate Resources and Environment Committee Minutes of February 16, 1990. The quoted material is from the attached written statement of Payette Lakes Cabin and Pilgrims Cove Association titled “Questions and Answers Concerning Lease Lot Issues”.

<sup>19</sup> Senate Resources and Environment Committee Minutes of February 16, 1990. The quoted material is from the attached written statement of Payette Lakes Cabin and Pilgrims Cove Association titled “Legislative Fact Sheet in Support of SB 1516.”

Ultimately, the Idaho Legislature, concerned that “the conflict application and auction procedure have caused considerable consternation and dismay to the existing lessees at the prospect of losing a long-time lease,” Idaho Code § 58-310A(1)(e), abolished the use of public auctions as a means of establishing market rents and established a general requirement that the Board “ensure that each lot generates market rent throughout the duration of the lease.” Idaho Code § 58-310A(3).

Nonetheless, during the legislative debates, Legislators expressed dismay over the large leasehold values being retained by lessees upon assignment or sale of the leases. For example, Senator Reed stated: “I do have a problem in thinking if any profits are going to accrue from the exchange of those leases that profits should perhaps go to the state. Now how do you respond to that sort of glitch where it is possible for the lessees to make some money off of their leases.” Id. at 11.<sup>20</sup>

Senator Donesley stated: “you’ve described the benefit of enjoying the property and then selling it for a profit after the enjoyment of the property. Somewhere in there is a slice of the state given that it is state property being enjoyed, it’s appreciating and the profit from the sale which is going into private pocket and now we’re having a bill to protect that kind of a situation.” Id. at 22.

Senator Calabretta asked: “[s]o, roughly, a million dollars are transacted on state properties by the assignment of the lease and we get out of that ninety thousand, or a hundred thousand dollars in any given year?” Id. at 23.

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<sup>20</sup> Transcript of Senate Resources and Environment Committee Meeting February 16, 1990.

Senator Reed concluded by stating: "I think an awful lot of the questions that have come up today really relate to another policy which deals with the whole aspect of transfer. So I think we don't just need to deal with hot potatoes, perhaps, although there's nothing cool about the issue of transfer, but I think we really should put this on the legislative agenda and address that in the future . . . should they be able to have assignments, and big money and all this kind of stuff without passing along to the state their fair rate?" Id. at 25-26.

The legislative history suggests that in passing Idaho Code § 58-310A, the expectation was that the issue of large leasehold values being pocketed by lessees upon transfer of leaseholds would be resolved by requiring market rent throughout the duration of the lease. IDL Director Stan Hamilton testified "As rents go up, the leasehold values do come down. And there is a relationship there than can be determined." Ex. 28c at 24. He further testified that if the legislation passed the Board might consider increasing the premium rent up to 50 or 60 percent. Id. at 23.

15.

The passage of Idaho Code § 58-310A prompted the Board to take action in 1991 to reexamine its rental policies to comply with the new statutory requirement to obtain market rent. To determine market rent, the Board had the Real Estate Consulting Group perform an initial appraisal on 13 lots at Payette Lake and 16 lots at Priest Lake. Exh. 18.<sup>22</sup> The Real Estate Consulting Group recommended a variable rate of return tied to lot values, with rates of 4.5% to 5.5%; however, a subcommittee of Board members rejected that recommendation and proposed continuing the then-present Board policy of phasing in a 2.5% rental rate. Id.

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<sup>22</sup> Land Bd. Cottage Site Subcommittee Memorandum (June 11, 1991).

Board member Jerry Evans observed that the professionals hired by the Board had concluded that “a more reasonable rate of return would be between 4-1/2% and 5-1/2%,” and he expressed concern that the “subcommittee recommendation chooses to ignore this professional advice.” Exh. 6, at 2.<sup>23</sup> He cautioned that “the phase-in schedule must be abandoned because the law is in effect now and it says market rent throughout the duration of the lease.” Exh. 5 at 4.<sup>24</sup>

Instead of abolishing the phase-in schedule, however, which at that time limited annual increases to no more than 25%, the Board modified it to further restrict annual rent increases to 5.3%. Exh. 7 at 4.<sup>25</sup> The Board’s action ignored information presented by IDL staff demonstrating that a phase-in rate of 5.3% annually would not achieve the target of 2.5% of land value “because land values—and target rentals—are rising faster than 5.3% annually.” Exh. 19 at 3.<sup>26</sup>

16.

In 1997, the Board again reviewed the cottage site lease rates. Following adoption of the phase-in schedule with a 5.3% annual rent increase cap, leasehold values escalated. Exh. 8 at 4.<sup>27</sup> In “some cases local property taxes actually exceed[ed] the rent the Department receive[d] for the property.” Id. Because of the disparity between the rapid rise in market value and the cap on rent increases, the actual rate of return was 1%. Exh. 20. at 13.<sup>28</sup> IDL staff recommended

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<sup>23</sup> Land Bd. Meeting Minutes (June 11, 1991).

<sup>24</sup> Land Bd. Meeting Minutes (July 10, 1990).

<sup>25</sup> Land Bd. Meeting Minutes (June 9, 1992).

<sup>26</sup> Land Bd. Agenda Memorandum, Cottage Site Rental Rates (June 9, 1992).

<sup>27</sup> Land Bd. Meeting Minutes (June 4, 1997).

<sup>28</sup> Land Bd. Agenda Memorandum, Cottage Site Rental at Priest and Payette Lakes (April 8, 1997).

that rents be raised over a five year period to achieve a return of 5% of property value. Id. at 18-19.

In 1997, the Board, after hearing from a number of lessees, once again rejected staff recommendations to raise the rent and instead affirmed the 2.5% rental rate “with the understanding that it can be reopened based on incoming information.” Exh. 8 at 12.<sup>29</sup> The Board then commissioned two appraisal reports, one for Priest Lake, and one for Payette Lake, and asked the appraisers to determine market rents. John McFadden, in his report for Priest Lake, recommended a rental rate of 3.5% of fee simple value, but also noted that there was a “relatively wide range of indications for the rate of return.” Exh. 26 at 24-25.<sup>30</sup> McFadden derived the 3.5% rate of return by analyzing leasehold sales. Exh. 16.<sup>31</sup> McFadden recommended close monitoring of leasehold values as an indicator of market rent, with the notation that once “the market level is reached for rents, true leasehold values should be zero and that market for cabins should remain active.” Exh. 26 at 25<sup>32</sup>.

The appraisal report for the Payette Lake cottage sites, prepared by Bradford T. Knipe, concluded that under then-existing Board policies, a 4% rate of return was justified, though he believed a 6% rate of return would be fair if accompanied by certain conditions to provide certainty to lessees. Exh. 27 at 156, 163.<sup>33</sup> Knipe also emphasized the role of leasehold values in assessing market rent, stating that when “lessees are paying anything more than the

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<sup>29</sup> Land Bd. Meeting Minutes (June 4, 1997).

<sup>30</sup> John T. McFadden, Appraisal Report: Project Report with Comparable Sales for Priest Lake Cottage Site Appraisals 24-25 (1998).

<sup>31</sup> Land Bd. Cottage Site Subcommittee Meeting Minutes (Nov. 23, 1998).

<sup>32</sup> John T. McFadden, Appraisal Report: Project Report with Comparable Sales for Priest Lake Cottage Site Appraisals (1998).

<sup>33</sup> Bradford T. Knipe, Complete Appraisal, Self Contained Report and Market Analysis of 14 Payette Lake Cabin Sites, (1998).

depreciated/contributory value of the former tenant's building and site improvements, the market is acknowledging rents are below market rental return levels." Id. at 151.

17.

In 1998, a subcommittee of Board members, appointed to make a recommendation on the cottage site leases, met to consider the recommendations of the Knipe and McFadden reports. McFadden reiterated his conclusion that the persistent sale of leasehold interests, which were then routinely selling for \$100,000, was clear evidence that contract rents were below market rents. Exh. 16 at 6.<sup>34</sup> IDL director Stanley Hamilton pointed out that the presence of "substantial leasehold values . . . indicates a very clear issue that we are not at market rent." Id. at 8.

The cottage site subcommittee report acknowledged that the recommended rental rate of 3.5% for Priest Lake cottage sites "with an annual escalator of eight percent" was "strongly supported by the past 21 year trend study." Exh. 21.<sup>35</sup> Likewise, they acknowledged that the appraisal of the Payette Lake cottage sites indicated a market rent of 4 percent. Id. They concluded that such rates were equitable "if the only aspect of the current rental policy subject to change is the rate of return." Id. But, they nonetheless adopted a rental rate of 2.5% because such a rate "recognizes and takes into consideration the lessees sweat equity and site improvements." Id. The lessees argued that the Board needed to "give credit for improvements—not to the house, but to the lot." Exh. 16 at 5.<sup>36</sup>

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<sup>34</sup> Land Bd. Cottage Site Subcommittee Meeting Minutes (Nov. 23, 1998).

<sup>35</sup> Land Bd. Cottage Site Subcommittee Report (Dec. 15, 1998).

<sup>36</sup> Land Bd. Cottage Site Subcommittee Meeting Minutes (Nov. 23, 1998).

18.

The annual rental rate has remained ostensibly at 2.5% since 1998, but real returns have at times fallen below 2.5% due to freezes on valuation of cottage sites in the face of rapidly rising land values.

19.

In the last several years, leasehold values and premium rents have escalated to the point where in many cases the value of leaseholds far outweighs the value of improvements. For example, in 2008, a Payette Lake cottage site leasehold sold for \$863,280, while the lessee's improvements sold for \$36,720. Exh. 22 at Attachment 4.<sup>37</sup> Ninety percent of the proceeds from sales of leaseholds go to the lessees. Since 2003, "cottage site owners have realized in excess of \$25 million for the use of State endowment land," while the endowments have received only \$2.7 million in premium rent from leasehold assignments. Exh. 25 at 3.<sup>38</sup> As one lessee who paid \$750,000 for a leasehold wrote to Board members, "the past policies of the Land Board allowed the previous leaseholder to make very substantial profits at the expense of the State and to myself." Exh. 39.<sup>39</sup>

20.

In four of the last seven years, the amount of money received by lessees for the conveyance of leaseholds exceeded the total rent received by the Board on behalf of endowment beneficiaries. Exh. 38.<sup>40</sup> For example, in 2006, nine lessees received \$6,482,709 for the

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<sup>37</sup> Land Bd. Agenda Memorandum, 2009 Rent Changes for the Payette Lake and Priest Lake Cottage Sites (June 19, 2008).

<sup>38</sup> Land Bd. Agenda Memorandum, Recommendation of the Cottage Site Subcommittee (Feb. 16, 2010).

<sup>39</sup> Letter, Karl Klokke to Land Board members (Feb. 24, 2010).

<sup>40</sup> Spreadsheet Comparing Annual Rents to Leasehold Sales, 2001-2009, provided by Idaho Department of Lands in response to request from Attorney General Lawrence Wasden (March 1, 2010).

conveyance of leaseholds. That same year, the total amount of annual and premium rent received by the Board for all 522 cottage sites was \$4,022,676. Id.

21.

In 2007 land values in Valley County increased dramatically. The assessed value of waterfront lots increased an average of 47%, while the assessed value of second tier lots increased 88%. Exh. 21.<sup>41</sup> In response, the Board initially entertained a motion to limit the 2008 rent increase at Payette Lake to 25%. Exh. 12<sup>42</sup> Ultimately, the Board approved a substitute motion to freeze the 2008 rent for the Payette Lake cottage sites at the 2007 rate. Id. The rents collected at Priest Lake, however, increased 15% for 2008, based on an evaluation of market data from the prior five years. Exh. 23 at 1.<sup>43</sup>

#### **VI. The 2007 Appointment of a Two-Person Subcommittee Did Not Resolve the Issues Surrounding the Cottage Site Leases**

22.

In 2007, the Board appointed two Board members – Secretary of State Ben Ysursa and Superintendent of Public Instruction Tom Luna - to form a subcommittee to recommend a rental formula to be applied to the cottage sites during the lease term that starts January 1, 2011. Exh. 11. at 6.<sup>44</sup> Over the next several years, the subcommittee held a series of meetings with lessees to hear their concerns and to evaluate alternative methods of calculating rents.

The members of the subcommittee expressed the desire to work on a “collaborative basis” with the lessees to establish a mutually-agreeable rent. Exh. 33 at 46.<sup>45</sup> Board member

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<sup>41</sup> Land Bd. Agenda Memorandum, Land Board Cottage Site Subcommittee Report (Dec. 15, 1998).

<sup>42</sup> Land Bd. Meeting Minutes (Dec. 4, 2007).

<sup>43</sup> Land Bd. Agenda Memorandum, 2009 Cottage Site Rental Rates at 1 (Dec. 16, 2008).

<sup>44</sup> Land Bd. Meeting Minutes (June 12, 2007).

<sup>45</sup> Transcript, Land Bd. Cottage Site Subcommittee Meeting (April 22, 2008).

Luna described the subcommittee's mission as an opportunity "to meet our obligation on the Land Board to bring some stability . . . to these cottage site leases, and, you know, for those who own the leases." Id. at 5. Board member Ysursa stated he was "very sympathetic to the plight of the cottage site owners as far as predictability and stability as far as these rapid escalation of rents." Exh. 34 at 28.<sup>46</sup>

23.

On June 19, 2008, the Board met to determine 2009 rents. IDL staff recommended that rents at Payette Lake be increased to reflect current assessed value, which, due to the 2007 rental freeze, would have resulted in a 47% rent increase for waterfront lots and an 88% rent increase for second tier lots. Exh. 22.<sup>47</sup> IDL staff recommended a 23% increase for Priest Lake cottage sites, as recommended by a consultant after reviewing the past five years of market data. Id. The Board rejected the recommendations and voted to limit the rent increases at Payette Lake and Priest Lake to 15%, effective January 1, 2009. Exh. 13.<sup>48</sup> On December 16, 2008, however, the Board rescinded all rent increases for 2009, and froze rents at 2008 levels for both Payette Lake and Priest Lake. Exh. 14.<sup>49</sup> IDL staff calculated that the rent freezes would result in a 2009 revenue loss of \$1,776,560 for the Payette Lake cottage sites and \$583,691 for the Priest Lake cottage sites. Exh. 23 at 2.<sup>50</sup>

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<sup>46</sup> Transcript, Land Bd. Cottage Site Subcommittee Meeting (May 18, 2009).

<sup>47</sup> Land Bd. Agenda Memorandum, 2009 Rent Increases for the Payette Lake and Priest Lake Cottage Sites (June 19, 2008).

<sup>48</sup> Land Bd. Meeting Minutes (June 19, 2008).

<sup>49</sup> Land Bd. Meeting Minutes (Dec. 16, 2008).

<sup>50</sup> Land Bd. Agenda Memorandum, 2009 Cottage Site Rental Rates (Dec. 16, 2008).

24.

On June 16, 2009, the Board met to determine rents for 2010. Market data indicated that assessed values for Payette Lake cottage sites decreased by 5% in 2009. Exh. 24 at 1.<sup>51</sup> IDL staff noted, however, that without the rent freezes in 2008 and 2009, rents would be 39% higher for waterfront lots and 78% higher for second tier lots. Id. At Priest Lake, the market data for the previous five years indicated that rents should be increased by 26%. Id. at 2.

IDL staff, however, recommended that rents not be increased for 2010. Id. The Board agreed and again froze rents. Id. at 3. As a result, the effective rent rates for 2010 were 2.03% for Priest Lake, 1.7% for Payette Lake waterfront lots, and 1.33% for Payette Lake second tier lots. Id. at Attachment 1. Total revenue was \$2,027,222 less than would have been received at the contract rate of 2.5% of current assessed value. Id.

25.

On February 16, 2010, the Board met to determine rents for 2011. The subcommittee's report to the Board recommended "a target annual lease rent ("target rent") will be calculated at 4.0% of the average appraised value of each lot over the most recent 10 years (the sum of the 10 prior years appraised or indexed values for each lot divided by 10). Actual rent will increase or decrease annually from the prior year's rent at a constant percentage rate to reach the target rent in year five. Every five years from the effective date of the lease, the actual rent will be recalculated using this same methodology and appraised values of the lot for the most recent 10 years. Lot values shall be appraised by the applicable county assessor or determined by an Idaho Certified Appraiser, at the discretion of the Department. At the end of the (sic) each five year

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<sup>51</sup> Land Bd. Agenda Memorandum, 2010 Rent Changes for Payette Lake and Priest Lake Cottage Sites (June 16, 2009).

period under the lease, the target rent will be calculated at 4.0% of the average value for the duration of the lease.” Exh. 25 at 3.

The subcommittee’s rationale for its recommendations was that “severely impairing or eroding longstanding business relationships with our lessees is not in the best interest of our trust beneficiaries” and the fact that fluctuations in rent “cause[] concern for cabin site lessees.” Id. at 3. The subcommittee report expressed the concern that “raising rents too high would result in these lands going unleased, to the detriment of beneficiaries.” Id. In presenting the subcommittee report to the Board, however, subcommittee member Ysursa described the process as “balancing our constitutional mandate in article 9, section 8, prudent investor standards, whatever you want to say, with the long-term relationship we have with the lessees.” Exh. 36 at 3.<sup>52</sup>

26.

An analysis of the subcommittee’s recommendation prepared by IDL Director George Bacon concluded that while the target rate would be 4%, the effective rental rate (actual rent returns compared to current land value) would vary between 2.37% and 2.43% if land appreciated at 4.8% annually. Exh. 29 at Appendix 3.<sup>53</sup> If land were to appreciate at an annual rate of 10.30%, the effective rental rate would stabilize at around 1.54%. Id. at Appendix 3. Director Bacon concluded: “I do not believe the Subcommittee’s recommendation insures that each leased lot generates market rent throughout the duration of the lease, but neither does the current system.” Id. at 2. 36.

Director Bacon also examined recent leasehold sales, which indicated that the contract rate of 2.5% of current assessed or appraised value that was in effect in recent years was below

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<sup>52</sup> Transcript, Land Bd. Meeting (Feb. 16, 2010).

<sup>53</sup> Letter, IDL Director George Bacon to Lawrence Wasden, Feb. 12, 2010.

market value. In 2008 and 2009, two “down” years in the real estate market, 21 leaseholds sold for \$6,392,039, an average of over \$300,000 per leasehold. Id. at Attachment 1.<sup>54</sup> Director Bacon stated: “[b]ased on the numerous studies previously commissioned and conducted by real estate experts, it appears as long as there is leasehold value, the rent charged is not at market.” Id. at 2.

27.

In 2010, Board member Lawrence Wasden commissioned economists Terry L. Anderson and Reed Watson to independently examine the issue of market rent generally and to determine whether the subcommittee recommendation would achieve market rent and fulfill the Board’s duty to maximize the long term financial return for endowment beneficiaries. Idaho Const., art. IX, § 8. The economists concluded that the subcommittee recommendation would not fulfill the Board’s duty to maximize the long term financial return for the endowment beneficiaries.

Economists Anderson and Watson found particularly troubling the subcommittee’s proposal to “smooth” rent increases by using both a ten year rolling average to establish lot values and a five year phase-in to reach the rent based on such ten-year average value, since it “guarantees that the state is not securing market rent for the five year adjustment period.” Exh. 31 at 4. In response to questioning from Board member Ysursa, Mr. Anderson emphasized that the combination of rolling average and phased-in target rent would “hamstring the Board in meeting its fiduciary responsibility” to obtain market rent. Exh. 36 at 88.<sup>55</sup>

During the February 16, 2010 meeting, Board member Ysursa asked Mr. Anderson his opinion regarding the subcommittee’s rationale for combining rent smoothing with a phase in:

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<sup>54</sup> An additional 27 leaseholds were transferred to family members or family trusts. Such “love and affection” transfers are not subject to the leasehold reporting requirement and do not pay premium rent for the assignment of the lease.

<sup>55</sup> Transcript, Land Bd. Meeting (Feb. 16, 2010).

If we, as the current Board members voted for freezes along the way, were we complicit in these current scenarios . . . the State helped create the imbroglio that we're in, and what I'm suggesting, and the Subcommittee is suggesting, we didn't. We need to get out of it and have some measure of fundamental fairness involved when we do come out of this. To immediately put a four hundred percent increase on the lessees is in my opinion unconscionable . . . .

Id. at 84. Mr. Anderson responded that trying to phase in a new rental structure “with this rolling appraised value, and phasing it in with some target rent, not target rate, target rent, is not a good way to appease your conscience.” Id. at 85.

Lessees had much the same view of the proposed “smoothing” methodology. Attorney Terry Cottle, representing the Payette Lakes Cabin Owners Association, later wrote that “averaging that total with the value of the Leased Premises for the previous ten years does not give one current market rent; it simply produces an arbitrary number and does so under the assumption that current market rent is somehow achieved by deferring to the economic conditions of the previous decade.” Exh. 40 at 2.

Economists Anderson and Watson also concluded that the proposal to gradually increase premium rent until it reaches 50% of leasehold value “validates that the board has not been charging market rents, that below market rents have contributed to leasehold values, and that the state has been missing out on revenues that a prudent investor would have captured.” Exh. 31 at 4.

28.

In examining the history of Board actions regarding cottage sites, economists Anderson and Watson concluded that a phenomena known as “rent seeking” had thwarted past proposals to obtain market rent. Id. at 12-13. They explained that “rent seeking” occurs when a small, politically influential group uses political pressure to receive the benefits of a public lands rental

policy while the costs are diffused over a larger group. With the benefits “concentrated, the small group can afford to exert political pressure for a policy which benefits it; with the costs diffused, however, it is not worth it for anyone in the large group to organize political opposition.” Id. at 13.

29.

At the February 16, 2010 Board meeting subcommittee member Ysursa moved to adopt the recommendation of the subcommittee. Board member Wasden, mindful of his two prior votes to freeze rents, reminded the other Board members that the question before them was “how to fulfill the Board’s fiduciary duty to the trust beneficiaries to achieve the maximum long-term financial return from the cottage site lessees.” Id. at 116. While Board member Wasden recognized the lessees’ desire to preserve their family ties to the state cottage sites, he maintained that “nothing in the Idaho Constitution provides that the Board should seek, in the administration of this trust, to preserve family traditions.” Id. at 117. Board member Wasden asserted that “the Constitution expressly requires the Land Board to exercise a duty of undivided loyalty to the endowment beneficiaries,” so that “the Board in its trust capacity cannot take into account matters other than the maximum long-term financial return to the trust beneficiaries.” Id. Board member Wasden indicated he would “vote in opposition to the Subcommittee’s proposal” because it fell “short of meeting this Board’s constitutional duty to achieve the maximum long term financial return to the endowment beneficiaries.” Id. at 118.

Board member Ysursa challenged Wasden to propose his own lease terms and conditions: “What are you in favor of what we ought to do?...” Id. at 120. In response, Board member Wasden pointed to the expert report he had commissioned from economists Terry Anderson and Reed Watson. Id. at 121. Economists Anderson and Watson had examined all previous work commissioned by the Board to determine market rent, including comparables showing market

rates of 3.5% to 6%, and had concluded that “the more economically sound approach” was to use a method developed by John Duffield to estimate market rents using leasehold values. Exh. 30 at 5-6.<sup>56</sup> The Duffield model can be used to “calculate an implicit market rental rate of return” because “positive leasehold values reflect the buyer’s valuation of below market rental rates.” *Id.* When applied to the cottage site sales the Duffield model suggested an implicit rate of return of 6% of appraised market value.

Board member Wasden concurred with Anderson and Watson’s analysis and stated his belief that a market rent “would require six percent tied to T-bills, assessed value, ten-year leases.” Exh. 36 at 121.<sup>57</sup>

30.

At the February 16, 2010 meeting, Board member Ysursa withdrew his motion to approve the subcommittee’s recommendation, and without apparent consensus on the issues of market rent and premium rent, the Board voted to defer decision on those issues and have the cottage site subcommittee report back in one month with a recommendation for final action. *Id.* at 131-32. The Board did vote unanimously to limit the lease term to ten years, and to order IDL staff to report back to the Board by January 2011, with a plan for unifying ownership of cottage sites. *Id.* at 127-29.

31.

At the March 9, 2010 Board staff briefing, IDL staff made a final review of the issue of market rent and circulated draft recommendations to the Board staff members. IDL staff recommended that the Board “establish a rental structure that achieves market rates between four

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<sup>56</sup> Terry L. Anderson and Reed Watson, Report to Idaho Attorney General Regarding Cottage Site Leases (2010).

<sup>57</sup> Transcript, Agenda Item 7. Recommendation of the Cottage Site Subcommittee, Land Bd. Meeting (Feb. 16, 2010).

and six percent of land value, with the ability for the Board to change the rate from year to year.” Exh. 43.<sup>58</sup> Annual recommendations to amend rental rates would be made by IDL staff based on monitoring of leasehold values during lease assignments. Id. IDL staff recommended eliminating premium rent once rental rates reflected market rates. Id.

32.

The subcommittee’s final recommendation was presented to the Board on March 16, 2010. Exh. 37.<sup>59</sup> Despite an earlier concession from subcommittee member Ysursa that the 4% rental rate, when combined with the subcommittee’s recommended “smoothing effect” resulted in rents “quite a ways away from market rent,” Exh. 36, at 111-112, the subcommittee did not alter its previous recommendation for annual rent. Indeed, the only change made by the subcommittee was to succumb to pressure from lessees to reduce the premium rent. The subcommittee agreed to discard its recommendation that the Land Board phase in a requirement for lessees to pay 50% of gross leasehold value upon transfer of the leasehold interest. Id. Instead, the subcommittee recommended that lessees be required to pay either 10% of gross leasehold value or 50% of net leasehold value,<sup>60</sup> whichever was greater for each individual sale. Id.

33.

At the March 16, 2010 Board meeting, four of the five Board members acknowledged that the subcommittee’s recommendation would not achieve a market rental rate. Subcommittee chairman Ysursa explained:

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<sup>58</sup> Idaho Department of Lands Cottage Site Considerations & Recommendation (draft circulated to Land Board staff on March 9, 2010).

<sup>59</sup> Addendum to Cottage Site Subcommittee Report (March 16, 2010).

<sup>60</sup> Net leasehold value is calculated by determining gross leasehold value then deducting the amount the lessee originally paid (if any) to acquire the leasehold.

And I use the term four, and I've been – and I've stated this many a time, at the end of a five-year period, this, frankly, gets them to a little bit over what they agreed to ten years ago on two point five of current. I find it incredulous at times that the lessees are outraged that I would suggest this type of rate when it, in fact, is very close to the two point five percent of current that they agreed to ten years ago. Why aren't we at current? We, as a Board, all – everyone on this Board has voted for a freeze at least two times; some of us three times. We are complicit in the problem that we're at – that we're not even at the two point five. And we need to be reasonable and fair in the way we extricate ourselves, and I believe that immediately going to a huge increase goes against all sense of fairness to both sides.

....

Do we acknowledge that we're not at market rent by using the term premium rent? Yes. We've done that since 1981.

Exh. 42 at 28.<sup>61</sup> Board member Donna Jones stated:

I do disagree with your rental rate recommendation. Just – I don't think that will bring us to a true market rent, as you said. And by continuing to collect the premium rent, we're openly acknowledging that our rental rate is too low. That was – that would be my comments.

Id. at 31. Board member Lawrence Wasden stated:

Governor, I think my – my voice has been heard on this. About a month ago at our previous Land Board meeting I reiterated my concerns. We have an obligation to obtain the maximum long-term return. Those are words that mean a lot to all of us. I – I cast no aspersions regarding that. We have an obligation to act as a prudent investor. We have an obligation to have undivided loyalty to the beneficiaries, and we are statutorily required to get market rent for the duration of the lease. I do not believe we will be fulfilling that responsibility with regard to this motion. I will be voting no.

Id. at 31-32. Board member Thomas Luna stated:

We're never going to see true market rent, or true market value, as long as there's this comingling of government and private sector. . . . The other point, Governor, is we're never going to maximize earnings for these properties, or this asset, until

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<sup>61</sup> Transcript, Agenda Item 8, Recommendation of the Cottage Site Subcommittee, Land Bd. Meeting (March 16, 2010).

we sell them. . . . [W]e've never realized our full return to benefit the beneficiary  
. . . . Id. at 35.

34.

Despite the discussion on March 16, 2010, acknowledging that the subcommittee's recommendation would not achieve market rate, the Board voted 3-2 to implement the subcommittee's recommendation.

The new rents are scheduled to go into effect on January 1, 2011. The rental schedule adopted by the Board on March 16, 2010, will be included in new leases being finalized for the lease term starting January 1, 2011. Such leases are scheduled to go into effect on January 1, 2011. Under the terms of Idaho Code § 58-307, all cottage site lessees must reapply to renew their leases by April 30, 2010. New leases for the 2011-2020 lease term may be finalized and signed anytime thereafter.

35.

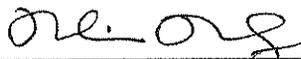
In the absence of writ of prohibition enjoining the signing and implementation of the cottage site leases, the endowment beneficiaries will be deprived of rental income that they are constitutionally and statutorily entitled to receive. In addition, if the cottage site leases are implemented the lessees will continue to pocket the lion's share of the leasehold value, value that should accrue to the endowment beneficiaries.

Wherefore, the Attorney General respectfully requests that this Court issue a writ of prohibition prohibiting the Board and the Director of the Department of Lands from signing and implementing the cottage site leases unless and until they are leased under terms meeting the requirements of Idaho Constitution Article IX, § 8.

DATED this 24<sup>th</sup> day of March 2010.

STATE OF IDAHO  
OFFICE OF THE ATTORNEY GENERAL

By   
STEVEN L. OLSEN  
Deputy Attorney General

BY   
MELISSA MOODY  
Deputy Attorney General

## EXHIBIT LIST

1. Land Bd. Meeting Minutes (August 4, 1981).
2. Land Bd. Meeting Minutes (Oct. 13, 1981).
3. Land Bd. Meeting Minutes (June 25, 1986).
4. Land Bd. Meeting Minutes (May 17, 1988).
5. Land Bd. Meeting Minutes (July 10, 1990).
6. Land Bd. Meeting Minutes (June 11, 1991).
7. Land Bd. Meeting Minutes (June 9, 1992).
8. Land Bd. Meeting Minutes (June 4, 1997).
9. Land Bd. Meeting Minutes (Oct. 21, 1997).
10. Land Bd. Meeting Minutes (Dec. 15, 1998).
11. Land Bd. Meeting Minutes (June 12, 2007).
12. Land Bd. Meeting Minutes (Dec. 4, 2007).
13. Land Bd. Meeting Minutes (June 19, 2008).
14. Land Bd. Meeting Minutes (Dec. 16, 2008).
15. Land Bd. Meeting Minutes (June 16, 2009).
16. Land Bd. Cottage Site Subcommittee Meeting Minutes (Nov. 23, 1998).
17. Transcript, Land Bd. Cottage Site Subcommittee Meeting (June 3, 1991).
18. Land Bd. Agenda Memorandum, Cottage Site Rental Policy Recommendations (June 11, 1991).

19. Land Bd. Agenda Memorandum, Land Board Cottage Site Subcommittee Recommendation for Rental Rates (June 9, 1992).
20. Land Bd. Agenda Memorandum, Cottage Site Rental at Priest and Payette Lakes (April 8, 1997).
21. Land Bd. Agenda Memorandum, Land Board Cottage Site Subcommittee Report (Dec. 15, 1998).
22. Land Bd. Agenda Memorandum, 2009 Rent Changes for the Payette Lake and Priest Lake Cottage Sites (June 19, 2008).
23. Land Bd. Agenda Memorandum, 2009 Cottage Site Rental Rates (Dec. 16, 2008).
24. Land Bd. Agenda Memorandum, 2010 Rent Changes for Payette Lake and Priest Lake Cottage Sites (June 16, 2009).
25. Land Bd. Agenda Memorandum, Recommendation of the Cottage Site Subcommittee (Feb. 16, 2010), with Attachment 1: Philip S. Cook and Jay O'Laughlin, Analysis of Procedures for Residential Real Estate (Cottage Site) Leases on Idaho's Endowment Lands (October 2008).
26. John T. McFadden, Appraisal Report: Project Report with Comparable Sales for Priest Lake Cottage Site Appraisals (1998).
27. Bradford T. Knipe, Complete Appraisal, Self Contained Report and Market Analysis of 14 Payette Lake Cabin Sites (1998).
- 28a. Senate Resources and Environment Committee Minutes of February 9, 1990.
- 28b. Senate Resources and Environment Committee Minutes of February 16, 1990 (with attached written statement of Payette Lakes Cabin and Pilgrims Cove Association titled "Questions and Answers Concerning Lease Lot Issues").
- 28c. Transcript of Senate Resources and Environment Committee Meeting February 16, 1990 (prepared by Attorney General's Office from tape on file with Legislative Services Office).
29. Letter, IDL Director George Bacon to Lawrence Wasden, Feb. 12, 2010.

30. Terry L. Anderson and Reed Watson, Report to Idaho Attorney General Regarding Cottage Site Leases (2010).
31. Terry L. Anderson and Reed Watson, Analysis of Subcommittee Recommendation to the Idaho Board of Land Commissioners (2010).
32. Deliberately left blank.
33. Transcript, Land Bd. Cottage Site Subcommittee Meeting (April 22, 2008).
34. Transcript, Land Bd. Cottage Site Subcommittee Meeting (May 18, 2009).
35. Transcript, Agenda Item 10, Cottage Site 2010 Rent Changes and Update on Cottage Site Subcommittee, Land Bd. Meeting (June 16, 2009).
36. Transcript, Agenda Item 7. Recommendation of the Cottage Site Subcommittee, Land Bd. Meeting (Feb. 16, 2010).
37. Addendum to Cottage Site Subcommittee Report (March 16, 2010)
38. Spreadsheet Comparing Annual Rents to Leasehold Sales, 2001-2009, provided by Idaho Department of Lands in response to request from Attorney General Lawrence Wasden (March 11, 2010).
39. Letter, Karl Klokke to Land Board members (Feb. 24, 2010).
40. Letter, Terry Copple to Land Board members (March 12, 2010).
41. Transcript, Land Bd. Cottage Site Subcommittee Meeting (March 1, 2010).
42. Transcript, Agenda Item 8, Recommendation of the Cottage Site Subcommittee, Land Bd. Meeting (March 16, 2010).
43. Idaho Department of Lands Cottage Site Considerations & Recommendation (circulated to Land Board Staff on March 9, 2010)
44. Letter from Attorney General Lawrence Wasden to Governor C.L. "Butch" Otter (Feb. 12, 2010).