

ARBITRATION
JUDICIAL DISPUTE RESOLUTION, LLC

IN THE MATTER OF:

MINIMUM ANNUAL RENT ADJUSTMENT
FOR
SHELTER BAY LEASES 5020 AND 5086

ARBITRATION AWARD

PROCEDURAL INTRODUCTION: Arbitration was held before the undersigned arbitrator at Judicial Dispute Resolution in Seattle, Washington on November 12-16, 2007. The arbitration concerned the amount of the adjusted rent to be paid by the Shelter Bay Company (“Shelter Bay”) to the Swinomish Indian Tribal Community and the individual Tribal landowners (“the Tribe”) under two leases (numbers 5020 and 5086), containing the same relevant terms (“the Lease”). The Lease has a 75-year term which expires on June 30, 2044. Article 6 of the Lease provides:

The guaranteed minimum annual rentals during this lease term, as extended, shall be subject to review and adjustment by the Secretary at the end of the 24th lease year, and thereafter, at ten-year intervals. Such reviews shall give consideration to the economic conditions at the time and to land values, based on the then existing utilization authorized by Articles 7 and 9, but specifically will not consider any improvements made, placed, erected or constructed upon or to the land by the Lessee or

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1 sub-lessees, or the contributive value thereof to the real estate, whether
2 such improvements are required by this lease contract or not. The
3 market rental thus determined shall be the product of seven percent (7%)
4 of the appraised fair market value of fee title to the premises herein
5 demised, based on unimproved land values as above stated.

6 The first rent adjustment set by a prior arbitration panel covered the period from July 1, 1993
7 through June 30, 2003. The current arbitration concerns the market rent for July 1, 2003 through
8 June 30, 2013.

9 In determining the "fair market value of the fee title to the premises herein demised, based on
10 unimproved land values as above stated" pursuant to Article 6 of the Lease, I have considered
11 the record of the 1994 arbitration, the Order re: Interpretation of Leases dated January 21, 1994,
12 the Final Order: Fair Market Valuation Pursuant to Article 6 of Lease Numbers 5020 and 5086
13 dated June 1994, the subsequent administrative appeals and decisions, the testimony of the
14 witnesses and the exhibits entered into evidence at the arbitration held on November 12 through
15 16, 2007, the applicable law cited to me by counsel, argument and briefing of counsel, and my
16 earlier ruling by Order of Arbitrator on Tribe's Pre-Arbitration Motion.

17 PRELIMINARY INTERPRETATIVE RULING: After carefully reviewing the previous and
18 current proceedings and evidence, I find and conclude that in addition to the matters concluded
19 by the prior arbitration panel in its January 21, 1994 Order re: Interpretation of Leases, that in the
20 current and future rent adjustment reviews under the Lease it shall be inappropriate for the
21 parties or appraisers when using valuation methodologies such as the residual or discounted cash
22 flow analysis to use development costs that are required by changes in the law or regulations or
23 to include costs that would result in a development that would be qualitatively better or
24 upgraded. Including such costs is unreasonable and unfairly values the unimproved land.

25 ANALYSIS: The evidence presented in the current arbitration provided a wide range in values
by very qualified appraisers who all presented honest opinions based on different assumptions
and judgments.

1
2 On behalf of the Tribe, Anthony Gibbons presented four approaches with different final values—
3 a comparable sales approach (\$22,500,000), a developer's snapshot approach (\$25,830,000), and
4 two variations of a residual or discounted cash flow analysis (\$20,950,000, and \$35,550,000).
5 He also did a separate analysis of the marina (\$440,000). His final appraised fair market value of
6 the fee title to the property based on unimproved land values was \$26,000,000.

7 Murray Brackett testified in support of Shelter Bay. He used two approaches—
8 subdivision/development approach or discounted cash flow analysis (\$7,900,000) and a
9 comparable sales approach (\$7,000,000 to \$7,800,000.) His final appraised fair market value for
10 the fee title based on unimproved land values was \$7,800,000.

11 Raymond Dozier also testified for Shelter Bay. Although he did not do an appraisal, he testified
12 as to the mythologies of both Mr. Gibbons and Mr. Brackett. Mr. Dozier corrected for what he
13 found were mistakes in both appraisers' discounted cash flow analysis, and by changing different
14 variables or assumptions presented six additional final values under the subdivision or
15 discounted cash flow analysis. Although Mr. Dozier's testimony was helpful to the arbitrator in
16 understanding the differing appraisals of Mr. Gibbons and Mr. Brackett, I do not accept as
17 persuasive his different analyses. I did find persuasive, however, his testimony that if further
18 regulations come into play between the original signing of the lease and the ten-year rent
19 adjustment, the appraiser is only to consider the regulations that were initially in place. I also
20 found persuasive his testimony that in determining the appropriate construction costs under the
21 discounted cash flow analysis the appraiser should only consider those costs that actually existed
22 as compared to those that are far more expensive under current conditions. As he testified at
23 page 804 of the transcript: "if I was doing this appraisal, I would take into consideration not any
24 restrictive conditions that exist today or as of 2003 that didn't exist when they leased it. That's
25 not fair to the Tribe." His testimony is consistent with Mr. Gibbons and I find and conclude is
consistent with my above interpretation of the Lease.

1 In reaching my decision as to the appraised fair market value, the arbitrator will not attempt to
2 resolve all of the differences between the appraisers. I have, however, considered all of their
3 testimony in arriving at my decision.

4 When considering Mr. Brackett's testimony, I find and conclude that his opinion of final value is
5 too low. Initially, I do not accept the cost estimates used in his discounted flow analysis.
6 Certain costs are excessive because they are based on current regulatory requirements or
7 standards. These excessive costs include the wood piling, dock fire protection, cable television,
8 temporary erosion and sediment control, and permanent detention ponds. I find and conclude
9 that these excessive costs are approximately \$1,900,000.

10 I also find and conclude that other costs included in Mr. Brackett's discounted cash flow analysis
11 of approximately \$7,600,000 which were based on Michael Romano and Jeff Layton are
12 unreasonable. I note that both Mr. Layton and Mr. Romano provided cost estimates at the 1994
13 arbitration, however, I find and conclude in this arbitration that the costs that were provided by
14 Larry Halgren, Ted Everage and Darrel Evensen are more reasonable. The Tribes' cost
15 witnesses did not include costs for betterments or upgrades or costs required by current
16 regulations. I also find and conclude that the tribes' costs are a more reasonable estimate of the
17 cost of reproduction. I specifically reject Shelter Bay's cost evidence concerning the four lift
18 stations, the inclusion of increased dredging costs in addition to a 20% contingency, and the
19 costs relating to the marina, including the private docks.

20 As to the treatment plant, I find and conclude that the costs testified by Mr. Romano are too high
21 because they result in betterments or upgrades and are based, in part, on current regulatory
22 requirements. I also note that Mr. Romano's testimony about the costs of the 1994 treatment
23 plant upgrade is speculative and that his use of the Squaxim Tribe treatment plant was an invalid
24 comparable. In addition, when considering Mr. Webb's testimony in the last arbitration, I have
25 serious questions concerning Mr. Romano's trending of costs from 1993 to 2003.

1 In sum, I find and conclude that the costs estimates relied upon by Mr. Gibbons are more
2 accurate and reasonable than those relied upon by Mr. Brackett. I find and conclude that
3 approximately \$9,500,000 in costs should not have been included in Mr. Brackett's discounted
4 cost flow analysis.

5 I also find and conclude that Mr. Brackett's conclusion that the total value of the gross sell-out of
6 the finished lots is \$77,000,000 is too low. Although I do not totally accept Mr. Gibbons'
7 testimony that the lots above Martha's Beach should be valued as bluff waterfront, they do have
8 more value than Mr. Brackett concluded. I also find and conclude that lots owned in fee simple
9 have more value than leased lots. I therefore find and conclude that \$2,000,000 should be added
10 to Mr. Brackett's value of the finished lots, for a total of \$79,000,000.

11 After weighing the evidence, I find and conclude that a more reasonable value of the unimproved
12 land under a residual or discounted cash flow analysis is \$19,400,000. I arrive at this value by
13 reducing Mr. Brackett's costs by \$9,500,000 and adding \$2,000,000 to his finished lot value.
14 The net result is to increase Mr. Brackett's value under the discounted cash flow analysis of
15 \$7,900,000 by \$11,500,000. This value of the unimproved fee is less than Mr. Gibbons' two
16 residual analyses and his final value. The arbitrator could have attempted to resolve other
17 differences between the appraisers such as the appropriate discount rate or whether the value of
18 the timber should be considered, but as the testimony demonstrates, the discounted cash flow
19 analysis is subject to wide variation and I decline on this record to accept a higher value based on
20 different assumptions.

21 I note for the record that I did not find Mr. Gibbons' developer's approach or his second
22 discounted cash flow analysis to be helpful to the arbitrator. I understand his interpretation of
23 Article 6 of the Lease concerning the "existing utilization" language, but I am applying the
24 interpretation given by the prior arbitration panel as modified above. Mr. Gibbons has
25 consistently testified that he has not considered any improvements or their contributory value at
arriving at his conclusions as to value. I find, however, that in his second discounted cash flow
analysis which is based on the assumption that under the existing utilization of the property all of

1 the improvements are in place and that the utility of the raw land is immediate and therefore
2 there is an in-place demand is in fact a consideration of the contributive value of the
3 improvements. Without the improvements, the in-place demand would not exist. Regardless, I
4 find and conclude based on all of the evidence that a more reasonable value of the unimproved
5 fee under a residual or discounted cash flow analysis is \$19,400,000.

6 Both Mr. Gibbons and Mt. Brackett also used a comparable sales approach. It is undisputed that
7 there are few, if any, good comparable sales. The one exception was arguably Mr. Gibbons'
8 comparable number 1 and Mr. Brackett's comparable A, which involve the same property. Mr.
9 Gibbons has taken the total sales price paid for the property and divided it by the number of lots
10 and after making adjustments for time, location, and waterfront has arrived at a value of the
11 subject property of \$22,500,000. Mr. Brackett relies on the lot value included in the appraisal
12 done for the seller of the property of \$4,200,000 and concludes that after adjustments the value
13 of the subject property is \$7,000,000 to \$7,800,000. I find that Mr. Gibbons' analysis is more
14 persuasive. I find that the subject property has far better location, and that comparable 1/A has
15 inferior waterfront. I find that comparable 1/A supports a value for the subject property much
16 higher than the range given by Mr. Brackett but lower than the value given by Mr. Gibbons. In
17 my judgment, comparable 1/A supports a value in the range of the discounted cash flow analysis
18 value of \$19,400,000.

19 EFFECT OF SUBLEASE PAYMENTS: An issue has been raised as to whether the rent that the
20 sub-lessees pay acts as a cap on the amount of rent that Shelter Bay Company as Lessee should
21 pay to the Tribe.

22 In the 1994 rental adjustment proceeding, the Arbitration Panel and the Bureau of Indian Affairs
23 ("BIA") both concluded that the parties to the Lease never intended that the rent under the Lease
24 would ever exceed the amount collected from the sublease tenants. As stated in the Order re:
25 Interpretation of Leases dated January 21, 1994:

1 The parties contemplated that the rental stream from the sublessees of
2 the Lessee would be structured to provide security and protection for the
3 Lessor in the event of the inability of the Lessee to make rental
4 payments. The parties included provisions in the leases regarding the
5 Secretary's approval of the sublease master form and initial and periodic
6 review of sublease rental schedules. There is no evidence or language in
7 the leases to suggest that the parties contemplated or intended that the
8 result of future rental reviews would be adjustment of annual rentals
9 payable by the Lessee to the Lessor to a level above that of the adjusted
10 sublease rental stream.

11 In its Final Order re: Fair Market Valuation dated June 1994 the panel again stated:

12 The Panel also finds and concludes that when the lease provision are
13 construed as a whole its previous ruling concerning the rental stream
14 from the subleases contained in the last paragraph of its Order dated
15 January 21, 1994 should be reaffirmed.

16 On appeal the BIA Director stated that:

17 All of the arbitrators concurred that the lease did not intend for the rent
18 to the landowners to exceed the sublease income. We do not believe this
19 is an unreasonable interpretation of the leases... [I]t is my decision that
20 we cannot charge more than the rental income stream received by the
21 Shelter Bay [from the subleases].

22 On appeal, the Interior Board of Indian Appeals ("IBIA") did not address the issue in its
23 decision. As a result, Shelter Bay concedes in its Pre-hearing Brief at 31 that "the Tribe is not
24 legally precluded from attempting to re-litigate this issue."

25 I have reviewed the record of the 1994 rental adjustment proceeding. I find no evidence in the
record to support a finding that the parties intended that the sublease payments would act as a
cap on the payments due under the Lease. Alan Osberg testified that the rationale for using the
Consumer Price Index ("the CPI") for rent increases in the subleases was a business decision
relating to the sale of the subleases. (pp. 41, 60 of January 17, 1994 hearing). While it is true

1 that subleases were approved by the BIA, there is no evidence that the Tribe consented to a cap
2 or an amendment to the Lease.

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4 Further, Article 14A of the Lease provides that "all subleases shall be made expressly subject to
5 the terms of this lease, and no such sublease shall affect any of the obligations or liabilities of the
6 Lessee hereunder." By concluding that the sublease payments act as a cap, the 1994 Panel and
7 the BIA have in essence permitted the subleases to "affect the obligations and liabilities of
8 Lessees" in direct contravention of Article 14A. Although the Secretary approved the subleases,
9 I have been cited no legal authority to support the Secretary's authority to amend the Lease when
10 approving subleases. And, as I indicated above, there is no evidence that the Tribe agreed that
11 the subleases which were prepared by the Osbergs would be considered an amendment to the
12 Lease and act as a cap.

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14 I do agree that if there is a default under the Lease that the subleases would not be canceled and
15 that the Tribe as lessor would not retake possession of the subleased land. The Tribe would
16 become the landlord under the subleases and it appears would be only entitled to the sublease
17 payments from its new tenants. This result was clearly contemplated under the Lease and
18 protects both the lessor and sublessees if there is a default by the lessee. In my judgment, the
19 result on default does not support the conclusion that previous Arbitration Panel and the BIA
20 reached.

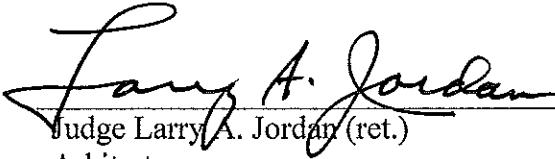
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22 Nor is such an interpretation reasonable. As indicated, the subleases are adjusted by the CPI
23 while the Lease is adjusted in accordance with Article 6. There is no mention of a cap in Article
24 6 and the result of permitting the sublease payments to act as a cap is to incorporate the CPI into
25 the rent adjustment process. Again, there is no evidence that the parties contemplated this result.
The subleases were "subject to" the terms of the Lease and the subleases were not intended to
affect the Lease terms. The interpretation of the prior Arbitration Panel and the BIA has the
opposite effect.

1 I find and conclude that the subleases payments do not act as a cap on the lease payments due the
2 Tribe under the Lease.

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4 CONCLUSION AS TO ANNUAL RENT: Based on all the evidence considered, I find and
5 conclude that the annual market rent under Article 6 of the Lease shall be \$1,358,000 which is
6 seven percent (7%) of \$19,400,000 which I find and conclude is "the appraised fair market value
7 of fee title to the premises demised, based on unimproved land values."

8 IT IS SO ORDERED.

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11 Dated: January 23, 2008

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14 Judge Larry A. Jordan (ret.)
15 Arbitrator
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