Unique and Hard to Value Assets

Promise, Peril and Process

Intro to UA’s

Unique and Hard to Value Assets

- Lexicon
- History
- Legal & Regulatory Environment

Introduction to UA’s – Lexicon

Formerly referred to as “Specialty Assets”, the OCC Unique and Hard to Value Assets Handbook (8/2012) sets out specific asset types as UA’s:

- Real Property
- Mineral Oil and Gas
- Closely Held Business
- Notes and Mortgages
- Life Insurance Trusts (ILITS)
- Alternate Investments (Hedge)

Introduction to UA’s – Legal & Regulatory Environment

- Common Law - “…trust law is an ancient field. The enforcement of trusts in the English court of Chancery can be traced back to the late fourteenth century and there is some indication that the courts of the English church may have been enforcing trusts even earlier.” *Langbein, John H., "Why Did Trust Law Become Statute Law in the United States?" (2007). Faculty Scholarship Series. Paper 496.*
- For 300 years case law governed the powers and duties of the Trustee.
- Then it all changed: “Wealth, in a commercial age, is made up largely of promises.” *Roscoe Pound*, *An Introduction to the Philosophy* of Law (1922)
- While case and common law are still significant – we have changed the venue….

Introduction to UA’s –Legal & Regulatory Environment

- Legislation – State Trust and Probate Codes – “The Uniform Trust Code the first national-level codification of the American law of trusts was promulgated in 2000….. In one sense, the Code marks a great departure by codifying a previously uncodified field. In another sense, however, the Code is simply the latest step in a trend toward statutory intervention in American trust law that has been underway for decades.” *Langbein ibid*

- The Uniform Principal and Income Act of 1931, subsequently revised in 1962 and 1997, which addressed the problems of allocating receipts, especially investment proceeds, and also expenses, between life and remainder interests in trusts.

- The Uniform Trusts Act of 1937, and the Uniform Act for Simplification of Fiduciary Security Transfers of 1958, which smoothed the purchase and sale of securities for trust accounts by relieving a party transacting with a trustee from the former duty to investigate the trustee's authority to engage in the transaction.

Introduction to UA’s – Legal & Regulatory Environment

- The Uniform Common Trust Fund Act of 1938, which over came the rule against commingling trust funds in order to allow bank trust departments to pool small trust accounts for investment purposes.
- The Uniform Trustees' Powers Act of 1964, which bestowed upon trustees a full range of transactional and managerial powers respecting trust property, especially buying, selling, voting, and otherwise dealing with securities;
- The Uniform Prudent Investor Act of 1994/5 now enacted in over 45 states and emulated in non-uniform legislation in virtually all the rest, which supplies the default standard of care for investing and managing trust assets.

Introduction to UA's –Legal & Regulatory Environment

- Regulation – OCC Unique and Hard to Value Assets Handbook (8/2012) & To a lesser extent the Personal Fiduciaries Handbook (2/2015) and The Mother of All Regulations: 12CFR 9 The Administrative Review.

- The UA Handbook sets out the asset classes previously defined and proceeds, in a rather confused narrative fashion, attempts to give guidelines, hints and safe haven procedures. (Authors Note: some of these hints are just old habits with a sort of regulatory magic dust sprinkled on them.)

Introduction to UA's – History

- It all started with UA's: "The trust originated as a device for transferring real property, at a time when real property constituted the main form of wealth. Trust conveyancing allowed an owner to escape the medieval rule, which lasted into the seventeenth century, that freehold land was not devisable." *Langbein ibid*
- The oldest trust in the US, dating back over 350 years to 1660, was established by William Payne, to hold real estate. (Note: It ended badly in litigation)
- Thomas Jefferson engages in asset protection for the benefit of his daughter. He leaves property to her in the form of a testamentary trust designed to protect her inheritance from the creditors of his insolvent son-in-law.

The Promise

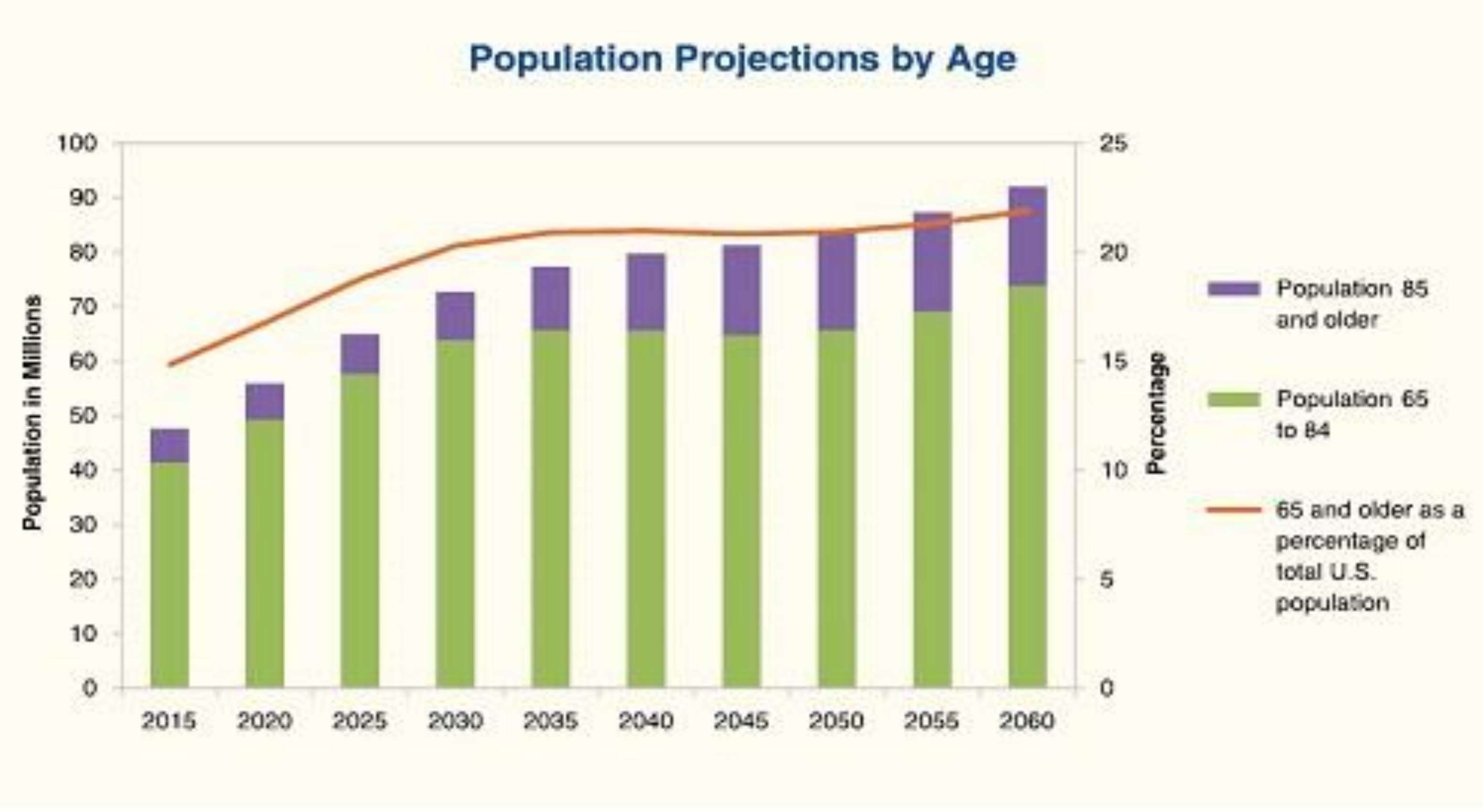
The Great Wealth Transfer

- What?
- How Much?
- The Unique Asset Component
- When

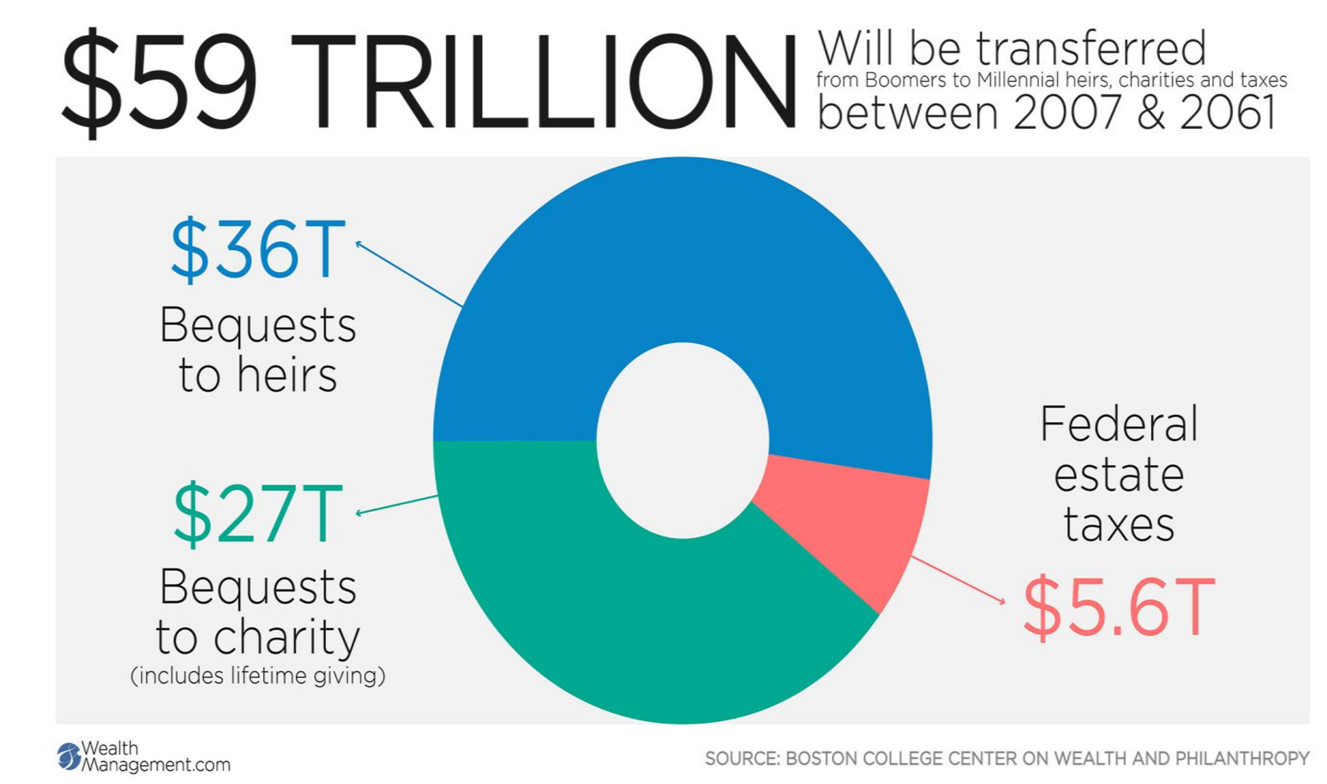
The Great Wealth Transfer - What

Over the next several decades, baby boomers — the wealthiest and one-time largest, generation in U.S. history — will pass down their assets to their children and grandchildren.

The Great Wealth Transfer - What

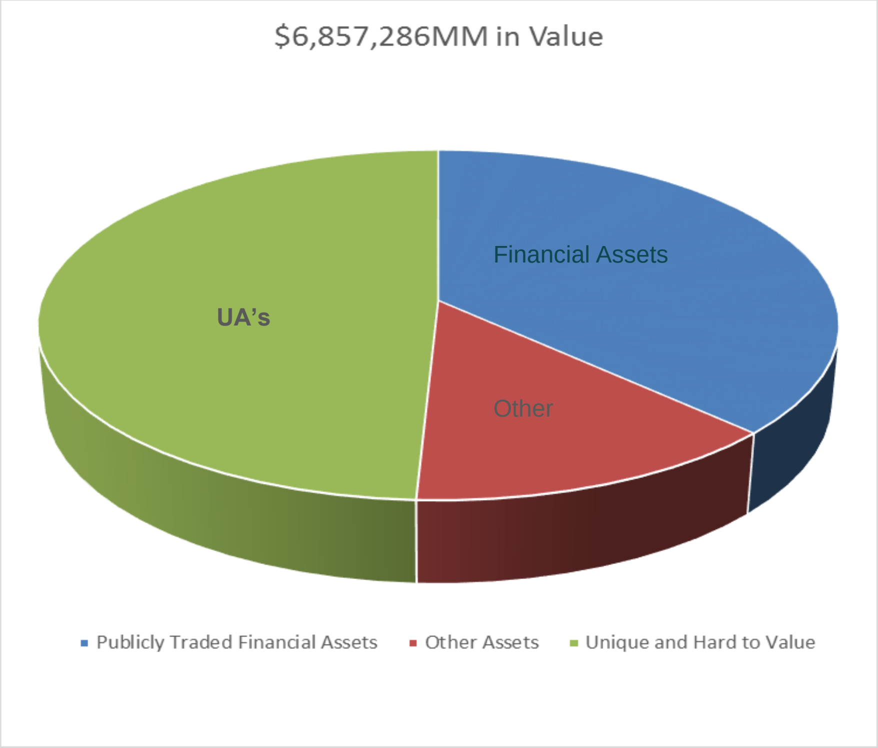


The Great Wealth Transfer – How Much



The Great Wealth Transfer – Unique Asset Component

Personal Wealth 2013: Top Wealth Holders with Gross Assets of $5 Million or More, Type of Property by Size of Net Worth



Publicly Traded Financial Assets
Publicly traded stock
State and Local Government Bonds
Federal Bonds
Corporate and Foreign Bonds
Bond Funds
Diversified Mutual Funds
Cash
Other
Private Equity and Hedge Funds
Retirement Assets
Cash Value Live Insurance
Unallocated Investments
Art
UA's
Personal Residence
Closely Held Stock
Mortgages and Notes
Noncorporate Business Assets
Farm Assets
Other Limited Partnerships
Other Assets

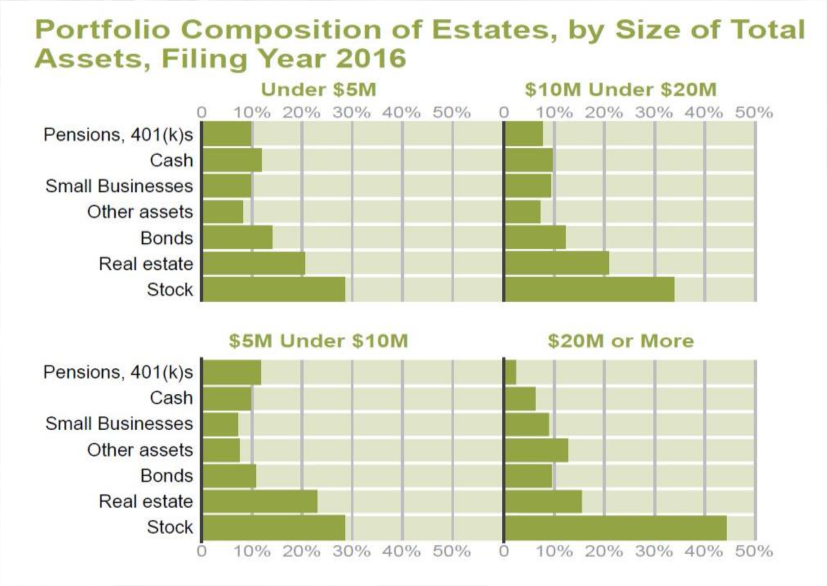
The Great Wealth Transfer – Unique Asset Component

Publicly Traded Financial Assets	$2,718,550	39.64%
Publicly traded stock		
State and Local Government Bonds		
Federal Bonds		
Corporate and Foreign Bonds		
Bond Funds		
Diversified Mutual Funds		
Cash		
Other	$981,893	14.32%
Private Equity and Hedge Funds		
Retirement Assets		
Cash Value Live Insurance		
Unallocated Investments		
Art		
UA's	$3,589,176	52.34%
Personal Residence		
Closely Held Stock		
Mortgages and Notes		
Noncorporate Business Assets		
Farm Assets		
Other Limited Partnerships		
Other Assets		

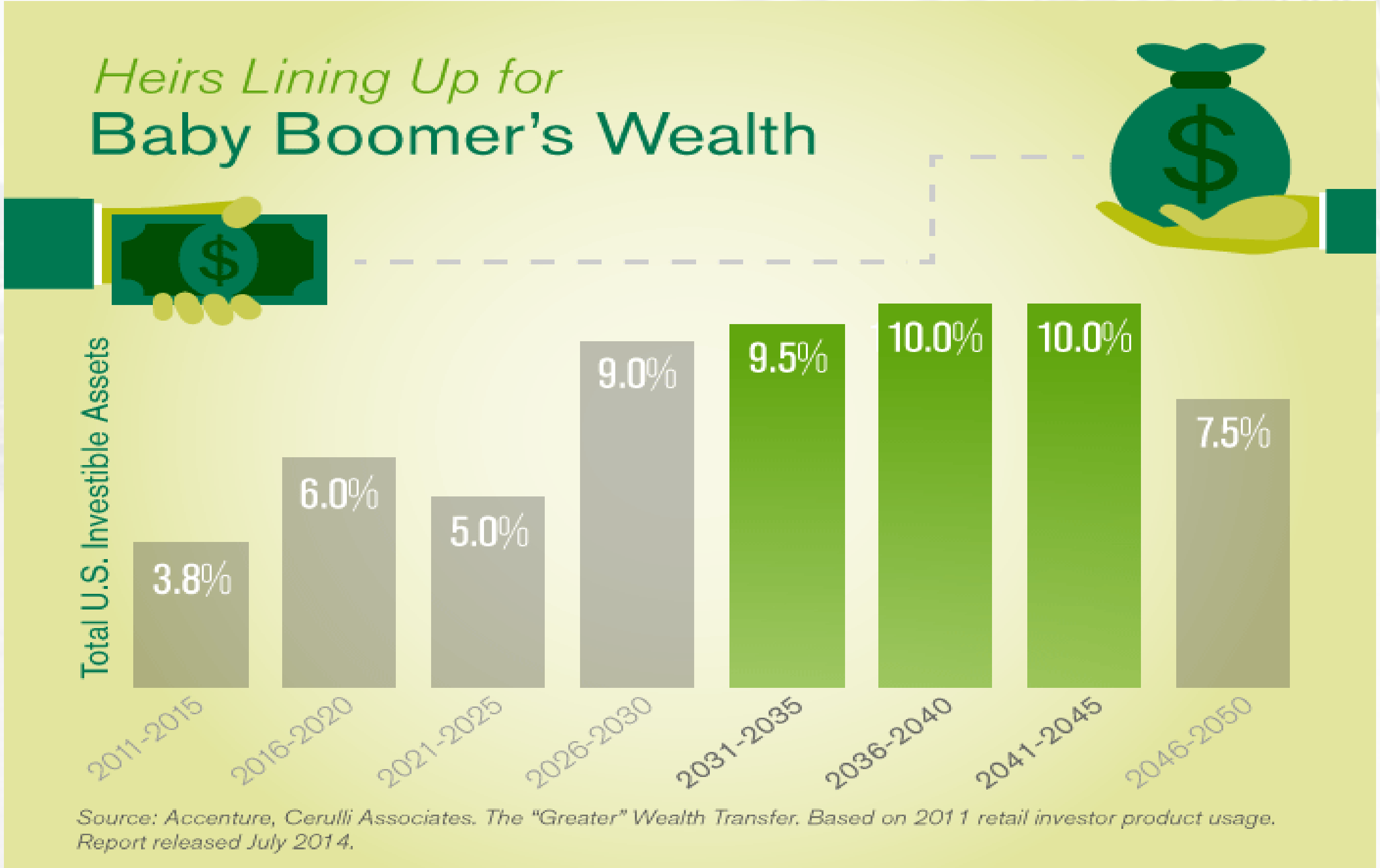
The Great Wealth Transfer – Unique Asset Component

OK – Calm down a little

Estate tax decedents with total assets of $20 million or more held a greater share of their portfolio in stocks (over 44 percent) and lesser shares in real estate and retirement assets than decedents in other total asset categories. *IRS 2016 Estate Tax Statistics*



The Great Wealth Transfer - When



The Peril

Risk

- Compliance
- Reputational
- Financial

Risk – Compliance

Governed by the OCC U&HTV Handbook each of the principal asset classes has its own set of guidelines, critical tasks and requirements

- Oil and Gas – Valuation, leasing, accounting, inspection, insurance
- Real Property – Valuation, sale, leasing, inspection, taxation, insurance (and a whole special section on farm and ranch properties)
- Loans and Notes – Collection, review of collateral, late payments
- CHB's – Financial reporting, valuation

Risk - Reputational

- Each of the principal asset classes has its own idiosyncratic way to ruin your life and the reputation of your institution.
- Oil and Gas – They can explode, poison innocent cattle and foul your drinking water.
- Real Property – They could be the site of a meth lab (these explode too), a shady used car dealer or a vacant lot complete with 55 gallon drums that ooze and glow in the dark.
- Loans and Notes – If collateralized by some of the real property noted above…. Well you get the picture
- CHB's – All of the above plus a nest of employee's siphoning off every cent they can.

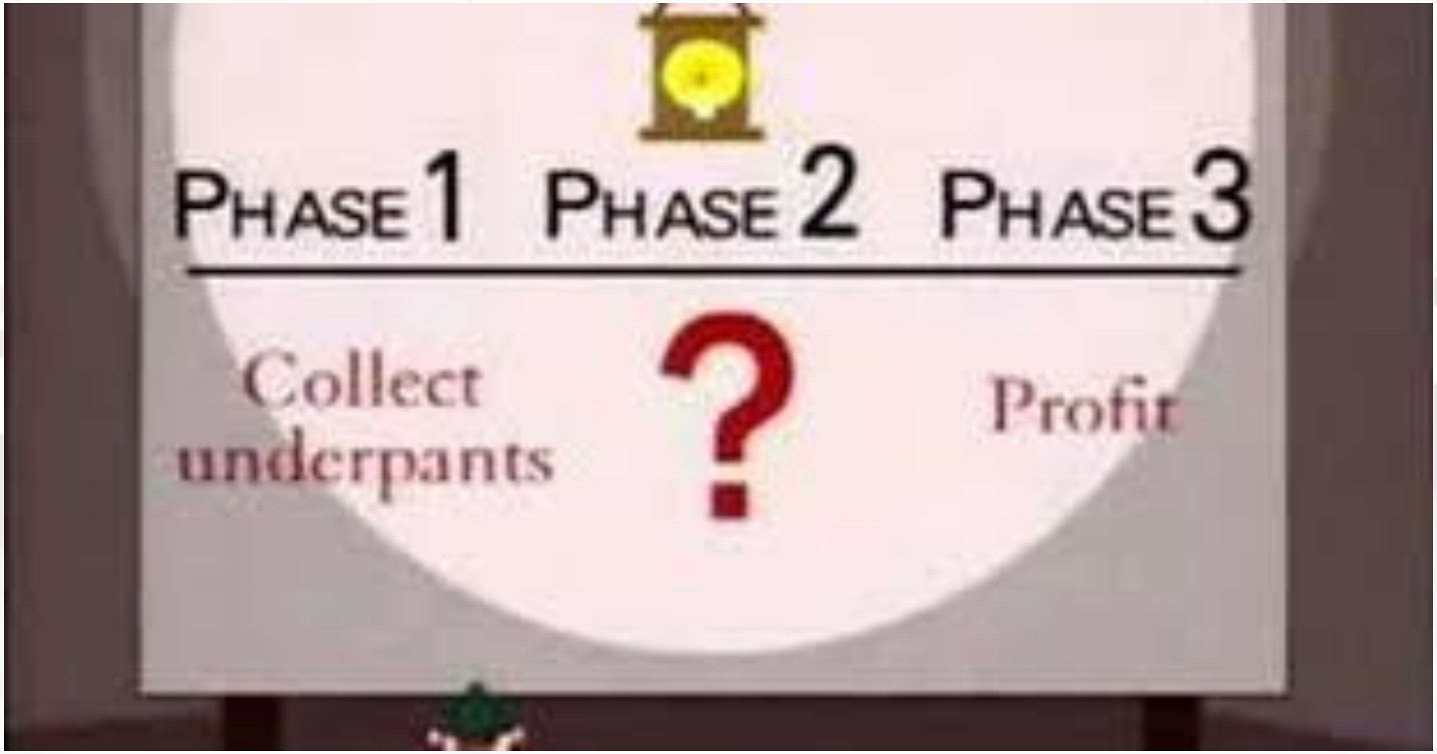
Risk – Financial

- Financial risk is inherent in all the aforementioned Reputational Risk scenarios with the added bonus of the lack of an effective statue of limitations.

- Attempts at management of this risk by the directed trust model are meeting some resistance. “The relief provided to a directed trustee by even the most protective statute is not unlimited. A directed trust statute is a state-law creation and will protect a directed trustee only from state-law claims. Specifically, it will not shield a directed trustee from claims arising under federal law (e.g., tax laws, anti-money laundering penalties).” *Directed Trusts: Making Them Work by Richard W. Nenno, Esq. Wilmington Trust Company 3/14/13*

- Further UA’s such as CHB’s or oil and gas interests are often illiquid and difficult and expensive to value leading to over concentration claims or retention of unproductive assets.

What is the next step?



The Process – Embracing the Promise & Taming the Risk

The Process

- Phase 1
- Risk Management
- Profitability

The Process – Phase 1

- Recognize and be able to quantify the value of UA's in the new business cycle
- Sensitize your sales and marketing team to potential of the assets
- Manage the prospects expectations both as to the time it takes to analyze these assets and the potential that they my not be acceptable
- Have an alternative risk containment mechanism: the Special Trustee, the LLC/LLP vehicle.

The Process – Risk Management

That’s a good idea. I’ll run it by my lawyers and if they like it, I’ll get some new lawyers.

Groucho Marx

The Process – Risk Management

"Risk controls are policies, procedures, processes, and systems that help control and mitigate risk." *OCC Unique and Hard to Value Assets Handbook 8/2012*

Documentation – The lesson of the witness stand.

Process, Process, Process – Procedures Manuals

Systems & Recordkeeping

When you need to think out of the box

"Never, ever, think outside the box."

The Process – Risk Management

The critical moments – "In preparing for battle I have always found that plans are useless, but planning is indispensable." Gen. D.D. Eisenhower

- Pre-acceptance review – You will never get this chance again.
- Valuation – What it will cost you and your client.
- Asset type specific deadlines – property tax payments (RE and MOG), Tax and financial filings (CHB's), late charges & escalations (Notes)
- Distribution – Doing it right the first time.

The Process – Profit

The shareholders of a bank operating a trust department have the right to expect a reasonable return on their investment. This requires profit motivation from the board of directors, and a fee structure which covers the costs of providing trust and fiduciary services ***and provides a reasonable return***. *FDIC Trust Examination Manual Section 9- Earnings, Volume Trends and Prospects (emphasis mine)*

- Fee Schedules – Balanced for compensation for the risk tail and the day to day effort.
- Bundled or Unbundled? By Asset Class?
- Ordinary vs. Extraordinary – The particular importance of this distinction when dealing with UA/s
- The Market Value Fee and the trap you've set for yourself.

Thank You.

Admiral William H. McRaven Commencement Address at UT 2014
https://www.youtube.com/watch?v=pxBQLFLei70