Use of NJSA's for Risk Mitigation in Trusts with a focus on holdings of Closely Held Business Interests

The Starting Point:

1) OCC's Handbook Guide - Requirements for the effective management of Closely Held Business Assets

   The OCC's requirements for the management of Closely Held Business Assets as stated in the OCC's Handbook for Unique and Hard-to-Value Assets are summarized below. In some instances, it becomes difficult, at best, to comply with these requirements due to lack of cooperation from a closely held entity to obtain general information related to the entity and other information needed to value the asset. In addition, the conflicting interests of beneficiaries or other parties that have the ability to direct the trustee as to the management of the asset can cause hurdles to the effective management of the asset. Although these guidelines relate only to National Banks as regulated by the OCC, these provide guidance for any entity that manages closely held business assets.

2) Evidence of Ownership - Management should maintain documentation that establishes the bank's legal capacity as bank fiduciary of any closely held business assets. This documentation must reflect the form of a company's incorporation, such as a stock certificate registered with the Secretary of State in the state where the corporation is located. Partnership interests also need to be registered to reflect the bank's ownership interest held in its fiduciary capacity.
3) Valuations - The bank should have a sound process to determine when a formal valuation is obtained. The need to determine the value of ownership interests in closely held business assets arises in a number of situations. For example, the following all require that a value be placed on the business as an ongoing concern: the sale of the stock of a closely owned company; the sale of interests in a partnership business; diversification into more liquid assets; tax calculations; marital and corporate dissolutions; buy-sell agreements; stock option plans; recapitalizations; and succession planning. The bank fiduciary must be able to demonstrate that a reasonable approach was taken in valuing these assets.
4) Insurance - Insurance coverage required for closely held business assets depends on the type of business. The bank fiduciary is responsible for determining what type and amount of coverage is needed based on the nature of the business and its fair market value. A perspective for the fiduciary relates to whether they have a control interest in the interest, are managers or have other means of control. Otherwise, the fiduciary's ability to impact or have a right of inquiry are minimal.
5) Risk Management - Administering these types of assets requires an effective risk management process. This process should include:
   - Have a strong pre-acceptance legal review of documents to assess the risk exposure to the bank and to identify any real or potential conflicts of interest.
   - A review of the standards addressing the retention and, on a rare occasion, a possible purchase of a minority ownership interest in a closely held business and a means to communicate those standards to appropriate bank personnel.
   - Review documentation to support retention of closely held companies, including letters of direction, when appropriate, and confirmation that any proposed purchase of closely held stock is permitted by the governing instrument.
   - Understanding the approval process that involves the trust committee or senior management for any purchase and retention decisions regarding investments in ownership interests in a closely held business.

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- Identification of potential BSA/AML issues that need to be addressed, depending on the type of business the entity is engaged in.
- What do you do if these standards at acceptance or during administration are not met? You may have some options. An NJSA!

What is an NJSA? An NJSA is a Non-Judicial Settlement Agreement. Other terms include a Release and Indemnification Agreement; Consent Agreement, etc.

Issues that arise in connection with the Management of CHB Assets and NJSA's/Release and Indemnification Agreements

When to consider the use of an NJSA/Release and Indemnification Agreement.

- Concentrations
- Lack of cooperation from an entity for valuation or any information related to an asset
- Conflicts or differences among beneficiaries as to an asset
- Unequal distributions of assets to beneficiaries, for instance where a closely held entity is distributing to only some of the beneficiaries
- Desire of the beneficiaries to retain an asset when the trustee believes that a sale is preferred
- Desire to direct the trustee as to an asset, for instance when a family wishes to maintain complete control of the asset after transferring the asset into a trust for estate planning purposes
- Failure of the governing document to protect and/or provide clear direction to the trustee
- The beneficiaries do not wish to value the asset (due to cost, etc)
- Dispositive provisions do not align with the documents of the underlying entity
- Change of circumstances that makes the asset difficult to administer
- The trust document provides that the trustee can be directed by a beneficiary or an advisory committee for valuation, review, and sale, but the document does not provide clear authority to the advisory committee.

There are several options to address these situations when the use of Release and Indemnification Agreements are beneficial. Those options include obtaining a Direction Release and Indemnification Agreement (DRI), a Consent Release and Indemnification Agreement (CRI), and a Non-Judicial Settlement Agreement (NJSA). Depending on State law, the fiduciary may also be able to seek court direction.

These are similar types of agreements. Use of a DRI is appropriate when a beneficiary or other person has the ability to direct the trustee as to a closely held asset. Use of a CRI is appropriate when the beneficiaries do not have the ability to direct the trustee but all of the beneficiaries agree to a course of action and are willing to consent to the trustee taking that course of action. A NJSA has a similar effect to DRI’s and CRI’s, but under a NJSA the underlying governing document is amended by the terms of the NJSA. Most States have Trust Code provisions related to when a NJSA can be utilized. Those code provisions and requirements vary by State.

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<u>Essential provisions and examples of DRI's, CRI's, and NJSA's language</u>.

Identity of the Trust, the governing instrument for the Trust, the Trustee and Co-Trustees, and all of the beneficiaries of the Trust:

> "This Agreement is among the Trust Beneficiaries, individually and in their capacities as virtual representatives for others (individually a "Beneficiary" and collectively the "Beneficiaries") and the Bank, in its separate corporate capacity and in its capacity as Trustee and any other Co-Trustees."

Detailed description of the closely held business Asset:

> "The Trust currently holds the units and/or shares of the entities as shown on Schedule A attached hereto and incorporated herein by reference. These units and/or shares and those units and/or shares of the same entity that may be subsequently acquired in any manner are collectively referred to as the "Asset".

Direction related to the retention, sale and valuation of the Asset:

> "The Trustee shall retain the Asset in the Trust in its entirety, until the Trustee, any Co-Trustee, and each of the Beneficiaries provide the Bank with written notice of the approval of any Co-Trustee and each of the Beneficiaries to sell the Asset."

> "The Trustee shall forgo obtaining a valuation of the Asset until (i) this Agreement terminates; (ii) any Beneficiary or any Co-Trustee requests a valuation of the Asset; or (iii) a valuation is required by court order. Upon the occurrence of any of the events in (i), (ii) or (iii), the Trustee shall be permitted to obtain, at the expense of the Trust, a valuation of the Asset and annual valuations thereafter."

> "During the term of this Agreement, the Bank will not be responsible for reviewing or monitoring the Asset and shall have no obligation to advise any Co-Trustee or any Beneficiary with respect to sale or retention of the Asset."

Acknowledgement of the risk of the direction to retain the Asset:

> "Each Beneficiary and any Co-Trustee agrees and represents that he or she fully understands: (i) the investment risk based on the Trustee's compliance with the terms of this Agreement, and any other risks involved in the retention of the Asset; (ii) the possible effects of those risks upon the investments of the Trust; (iii) the Asset is being retained as a result of the direction or consent of the Beneficiaries and the Co-Trustee(s); and (iv) there may be no readily available market for the sale of the Asset and the Asset may at times be considered a concentration which may limit the diversification of the Trust investments and could create a greater risk of loss because of the lack of diversity."

> "Each Beneficiary and any Co-Trustee in executing this Agreement has relied upon his or her own judgment and has had ample opportunity to seek the advice of investment and legal counsel and such other professional advisors that he or she deems appropriate."

Virtual Representation:

"Each Beneficiary agrees that in addition to representing such Beneficiary's own interest, such Beneficiary also represents and binds (i) his or her minor and unborn children, (ii) any and all persons whose interests, as permissible appointees, takers in default or otherwise, are subject to his or her power of appointment, (iii) any and all persons having a substantially identical interest to him or her and who are not otherwise represented, and (iv) any other person he or she may represent under applicable law."

Release and Indemnification Provision:

"Release and Indemnification

1. For good and valuable consideration, the receipt and sufficiency of hereby acknowledged, each of the Beneficiaries hereby fully releases and indemnifies any Co-Trustee and the Bank in both its corporate and fiduciary capacities, and its/their respective successors, assigns, directors, officers, and employees; and,

2. Each Co-Trustee hereby fully releases and indemnifies the Bank in both its corporate and fiduciary capacities, and its respective successors, assigns, directors, officers, and employees,

from and against any and all liabilities, claims, causes of action, damages, or expenses (including attorneys' fees and other legal costs), which he or she, his or her heirs, personal representatives, successors and assigns or any person he or she may represent or any third party claiming by, through or under any one or more of them may now or in the future hold in connection with the compliance of the Trustee with the terms of this Agreement. The releases and indemnifications under this Agreement shall survive any termination of this Agreement."

Provision related to Assets received from a predecessor fiduciary:

"In situations where the Asset is being received from a prior fiduciary, the Bank and any of its predecessors are released for all acts or omissions of prior fiduciaries without the need for the Bank to investigate or determine if there are any potential acts or omissions of a prior fiduciary. The Bank and any of its predecessors are released for all acts or omissions for the Asset prior to the effective date of this Agreement."