

**Introduction to Real Estate Interests**

This section will cover two types of interests: real estate and real estate loans. While holdings of these assets do not typically constitute a large percentage of total account holdings, their specialized nature and often complex characteristics make them deserving of special attention. In order to properly administer real estate interests, the savings association must have specialized and expert knowledge and must pay particular attention to operational and administrative duties. These requirements should be carefully considered prior to making any decision to retain or purchase real estate interests.

**Real Estate**

Various types of real estate can be held in fiduciary accounts, including personal residences, residential income properties, commercial properties, unimproved acreage, vacant lots, timberland, farm or ranch land. Management should be familiar with all aspects of real property administration, including purchasing, leasing, improving and repairing before undertaking the administration of significant holdings. Due to the variety and complexity of these assets, the savings association should have policies and procedures addressing real estate interests. There are several basic steps that should be followed to assist in minimizing any potential problems that can arise in connection with the administration of real estate. These steps are outlined below:

- The savings association should ensure that it possesses valid and clear title to any property held, whether received in kind or purchased. The best time to remedy defects in the title is when the interest is being acquired. Defects in title can delay a proposed sale and possibly defeat the transaction.
- The savings association should have a program of appraisal and periodic inspection of all real estate held in accounts where it has investment responsibility.
- The savings association should ensure that purchase or retention of real estate is appropriate for meeting the account objectives.
- There should be an effective process for the administration of real estate. Such a process would ensure that adequate insurance is kept current, property taxes are accurate and paid when due and that special requirements are monitored, such as collecting rents, inspecting crops or conducting repairs.

In all but a few states a fiduciary is prohibited from holding title to real estate unless it is qualified to do business in that state. In those cases, a fiduciary holding real estate in an account should appoint an ancillary fiduciary or agent to administer the property. Therefore, the department should have procedures to address any local law requirements in other jurisdictions regarding title to and management of real estate with an out-of-state location.

The savings association should have a program of appraisal and inspection of all real estate held in accounts where it has investment responsibility. It is an accepted fiduciary principle that the fiduciary should possess current information as to the value and condition of properties for which it is responsible. This information is needed in order to make an informed purchase, sale or retention decision. Prudent investment policy would dictate that appraisals and inspections be performed prior to or promptly after acceptance of real estate, and prior to any purchase. Thereafter, appraisals should be made at least every three years for properties held in personal trust accounts. Properties held in employee benefit accounts should be appraised annually to satisfy the regulatory requirements of ERISA. A savings association should use discretion within

these parameters. For example, appraisals or inspections for some types of property should be made more frequently, such as commercial office buildings, while appraisals or inspections for other types may be done less frequently, such as the grantor's residence or vacant land. Similarly, property under active management should be appraised or inspected more frequently than fractional interests in real estate where the savings association has no effective control.

Qualified and independent personnel should perform appraisals and inspections. Such personnel can be either internal or external. In either case the appraiser/inspector should be knowledgeable and have expertise in the type of property being appraised. The appraiser must also be independent from the transaction and property being appraised.

Where the savings association has investment responsibility, real estate should only be purchased or retained when it is appropriate for an account. The following is a partial list of the factors that should be considered in making an investment decision pertaining to real estate:

- Authority in the governing instrument or elsewhere to purchase, retain or sell real estate
- Suitability of the investment for the particular account
- Current appraisal of value, its future marketability, prospects for future appreciation/depreciation in value and cash flow
- Yield potential
- Tax benefits
- Assessment of risk factors, including environmental liability
- For leased property, terms of leases and creditworthiness of tenants
- Costs associated with real estate (taxes, insurance, maintenance, etc.) compared to other investment alternatives

### **Environmental Liability**

Management should ensure that environmental risks are assessed prior to asset acceptance, including compliance with federal and state environmental law. Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986, to govern financial responsibility for cleaning up toxic waste. CERCLA is generally considered to be the primary environmental cleanup and liability law. Savings association should note that the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 affords to lenders and fiduciaries liability relief from Section 107 of the CERCLA. Under §2502(a) of the Act, the liability of fiduciaries is limited to the assets held in their fiduciary capacity. Trustees will be found liable for the costs of environmental cleanups only if their negligence "causes or contributes" to the release of a hazardous substance on properties they hold in trust. Under new §107(n)(4) of CERCLA, fiduciaries do not face personal liability if they stay within the enumerated "safe harbors" of subsection (4) of Section 502. The legislation added a section to 42 U.S.C.A. §9607.

## Real Estate Loans

Real estate notes and mortgages are most often received in kind as a result of the settlor having used them to facilitate the purchase and/or sale of real property. These interests may also be acquired as a result of the sale of real estate from an account in return for a mortgage or purchased outright. Most real estate loans are held in personal and employee benefit accounts which also hold a substantial portion of real estate itself or in employee benefit accounts where residential loans are made to participants in the account, up to their vested interest.

There are both advantages and disadvantages to investing in real estate loans. Real estate loans that are appropriate for the account and adequately secured are considered to be prudent investments and can be used to enhance a portfolio's overall yield. In most instances real estate loans are considered to be safe investments because of adequate collateral coverage. On the other hand, individual real estate loans usually are not readily marketable. In addition, it is not unusual for the quality of loans received in kind to be below that which a fiduciary would make on its own. Therefore, it is very important to have full documentation for all actions pertaining to real estate loans. Also, a major source of concern regarding real estate loans is when these assets become delinquent. Losses due to delinquencies are not limited to financial loss but also include the loss associated with expending resources to attempt to collect on loans and/or initiate foreclosure proceedings. To protect against possible loss, the savings association should have written policies and procedures that address the administration and supervision of delinquent real estate loans. Such policies should address the following:

- monitoring timely payment of outstanding balance;
- ensuring that delinquencies are tracked and corrected in a timely manner;
- reporting delinquencies to an appropriate level and/or committee;
- inspecting the property to forestall unknown deterioration and preserve value if foreclosure appears necessary; and
- establishing a plan for foreclosure.

The institution should have a system of internal controls to sufficiently monitor periodic but recurring activities such as loan, tax and insurance payments. These controls should consist of a tickler system and management information reports. Also, the discussion in the real estate subsection above concerning ancillary administration, insurance, appraisal and inspections is also relevant to real estate loans.

A fiduciary may also invest and participate in pools of real estate mortgages. Participation in mortgage investments enables the fiduciary to maintain portfolio diversity and reduce administrative costs. The individual fiduciary account and aggregate interest in these investments must be properly controlled. In the event of default, the savings association should determine that the participation agreements provide that each account bears only its pro rata share of loss. If such investments are purchased from an affiliate, the savings association should make sure that the inherent conflicts of interests involved are addressed, that the investment is prudent for the account and that the OTS's transaction with affiliates regulations are considered.

When making investment decisions concerning real estate loans, the institution should consider:

- value of the underlying parcel of real estate held as collateral;

- acceptable ratio of loan amount to current appraised value of the real estate;
- ability of the borrower to repay, including an analysis of the credit history;
- adequacy of the interest rate;
- documentation necessary to establish priority of lien and validity of loan; and
- adequacy of current insurance on the underlying real estate.

### Mineral Interests

Mineral interests can be broadly defined as the property interest created in oil, gas or other minerals after severance by deed or lease and may exist for a fixed number of years, for a certain life or forever. Owners of mineral interests have the legal right to enter the property in order to explore, drill or carry on other similar activities. They also have the right to grant leases and assign all or part of their interest to others. There are different types of ownership interests in these types of assets that may be held in fiduciary accounts, including working interests and royalty interests. Trustees must properly manage oil, gas and mineral properties just as they administer all other types of assets held in fiduciary accounts. In most cases these assets would have been deposited in kind, rather than purchased by the savings association. The trust department must be fully familiar with these interests and employ outside expertise when necessary.

A mineral interest can be defined as the sum of all rights to oil, gas or to minerals on a property. Owners of mineral interests have the right to explore and drill on the property. They also have the right to grant oil and gas leases and are entitled to any lease bonus or delay rental that may be payable in connection with the lease. Mineral interest owners may assign all, a segregated portion or an undivided fractional share of their interest. When such assigned rights are limited in duration they are called “term minerals” while an assignment that is not limited is referred to as “perpetual minerals”.

A royalty interest is an interest in the underlying oil and gas reserves which is retained when an owner of land grants to another the right to determine the existence of commercial quantities of oil and/or gas on the property. In other words, a royalty interest is a mineral interest that does not have the rights and responsibilities of developing the property. A working interest is a mineral interest minus the royalty interest. The working interest is burdened with the cost of developing the property and the responsibility of operating the activity. The breakdown of ownership interests and payments is outlined in the division order. The most generally accepted fraction of mineral interest production is 1/8 to the royalty interest and 7/8 to the working interest. The fiduciary should carefully review and understand the provisions of the division order.

In the administration of oil, gas and mineral interests, the savings association should have written policies and procedures for proper supervision and administration. As is the case with other types of specialized assets, the potential for increased risk, liability or loss is directly related to the degree of experience and expertise available. Detailed and adequate record keeping is essential for proper administration. Each interest held in a fiduciary account should be thoroughly reviewed and documented. Important provisions should be very closely monitored to provide assurance that no event will occur without prior knowledge of the fiduciary. A monitoring system should include:

- type of interest owned;
- fractional share of interest owned and division orders;
- title records;

- description of the type of property leased;
- terms of the lease, including expiration date;
- name and address of lessee;
- amount of delay rental;
- date rent is due; and
- bonuses.

Due to the unique nature of mineral interests, the fiduciary may have problems properly monitoring such assets. Since valuations of mineral interests can be difficult, the savings association may wish to employ outside consultants, such as qualified geologists, landmen, engineers and accountants to determine the valuation and tax treatment of the mineral interest. Also, the savings association should keep in mind that mineral interests are considered illiquid and provide irregular income so it may be difficult to base income payments to beneficiaries on this type of asset.

Significant costs may be incurred by the fiduciary in the administration of mineral interests. The savings association should take additional costs into consideration when charging fees for their administration. These fees should be reviewed and approved by the board of directors and be disclosed in the fee schedule for fiduciary services.