

Hedging Your Bet: Advising Fiduciaries on Alternatives Investments

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by

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What rules govern investing by trusts?

- prudent investor rule
- due diligence
 - re: CDs
 - money market funds
 - mutual funds
 - bonds
 - stocks
 - real estate
 - life insurance policies
- re: taxes, see David R. Nave,
The Good, The Bad, and The Ugly of Trusts
Investing in Partnerships, Journal of Passthrough
Entities, May-June 2006
- tax rules re: foreign investments
- SEC rules re private investments

What are prudent investors doing, and why are they doing it?

§ 7202. Default rule.

(a) **General rule.**—Except as otherwise provided by the governing instrument, a fiduciary shall invest and manage property held in a trust in accordance with the provisions of this chapter.

(b) **Exception.**—Where the instrument establishing a trust contains a restriction on the fiduciary's power of investment and the court having jurisdiction over the trust finds that adherence to the restriction is impractical or that the existing or reasonably foreseeable economic conditions are so far different from those prevailing at the creation of the trust that adherence to the restriction might deprive the respective beneficiaries of income and principal of the full benefits the testator or settlor intended them to enjoy, the court may release the fiduciary from the restriction to the extent and on conditions, if any, as the court may deem appropriate.

(c) **Court direction.**—A fiduciary appointed by the court and not acting under a trust instrument, in addition to or in place of the investments authorized by this chapter, may make, and retain without liability for resulting loss, investments as the court, upon petition of the fiduciary or of any party in interest, after notice as it shall direct, aided by the report of a master if necessary, shall authorize or direct, subject only to the conditions and limitations as shall be fixed by the court in the decree authorizing or directing the investment.

§ 7203. Prudent investor rule.

(a) **General rule.**—A fiduciary shall invest and manage property held in a trust as a prudent investor would, by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust.

(b) **Permissible investments.**—A fiduciary may invest in every kind of property and type of investment, including, but not limited to, mutual funds and similar investments, consistent with this chapter.

(c) **Considerations in making investment and management decisions.**—In making investment and management decisions, a fiduciary shall consider, among other things, to the extent relevant to the decision or action:

- (1) the size of the trust;
- (2) the nature and estimated duration of the fiduciary relationship;
- (3) the liquidity and distribution requirements of the trust;
- (4) the expected tax consequences of investment decisions or strategies and of distributions of income and principal;
- (5) the role that each investment or course of action plays in the overall investment strategy;
- (6) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries, including, in the case of a charitable trust, the special relationship of the asset and its economic impact as a principal business enterprise on the community in which the beneficiary of the trust is located and the special value of the integration of the beneficiary's activities with the community where that asset is located;
- (7) to the extent reasonably known to the fiduciary, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument; and

(8) to the extent reasonably known to the fiduciary, the income and resources of the beneficiaries and related trusts.

§ 7204. Diversification.

(a) **Requirement.**—Except as provided in section 7205 (relating to retention of inception assets), a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.

(b) **Applicability.**—Subsection (a) does not apply to any of the following:

(1) A trust which became irrevocable prior to December 25, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.

(2) A trust created by a revocable instrument executed prior to December 25, 1999, if such instrument is not amended after December 24, 1999. This paragraph applies even if the action of the trustee occurs after December 25, 1999.

§ 7205. Retention of inception assets.

A fiduciary, in the exercise of reasonable care, skill and caution, may retain any asset received in kind, even though the asset constitutes a disproportionately large share of the portfolio.

§ 7206. Delegation.

(a) **Permissible delegation.**—A fiduciary may delegate investment and management functions that a prudent investor of comparable skills might delegate under the circumstances.

(b) **Duties of fiduciary.**—A fiduciary shall not be responsible for the investment decisions or actions of the investment agent to which the investment functions are delegated if the fiduciary exercises reasonable care, skill and caution in selecting the investment agent, in establishing the scope and specific terms of the delegation and in reviewing periodically the investment agent's actions in order to monitor the investment agent's performance and compliance with the scope and specific terms of the delegation.

(c) **Duties of investment agent.**—The investment agent shall comply with the scope and terms of the delegation and shall exercise the delegated function with reasonable care, skill and caution and shall be liable to the trust for failure to do so. An investment agent who represents that he has special investment skills shall exercise those skills.

(d) **Jurisdiction.**—An investment agent who accepts the delegation of a fiduciary's function from a fiduciary who is subject to the jurisdiction of a court of this Commonwealth shall be deemed to have submitted to the jurisdiction of that court even if the delegation agreement provides for a different jurisdiction or venue.

(e) **When cofiduciary may delegate to another cofiduciary.**—A cofiduciary may delegate investment and management functions to another cofiduciary if the delegating cofiduciary reasonably believes that the other cofiduciary has greater investment skills than the delegating cofiduciary with respect to those functions. The delegating cofiduciary shall not be responsible for the investment decisions or actions of the other cofiduciary to which the investment functions are delegated if the delegating cofiduciary exercises reasonable care, skill and caution in establishing the scope and specific terms of the delegation and in reviewing periodically the other cofiduciary's actions in order to monitor the cofiduciary's performance and compliance with the scope and specific terms of the delegation.

(f) **Mutual funds.**—Investment in a mutual fund is not a delegation of investment function, and neither the mutual fund nor its advisor is an investment agent.

§ 7208. Life insurance.

A trustee may acquire or retain a contract of life insurance upon the life of the settlor or the settlor's spouse, or both, without liability for a loss arising from the trustee's failure to:

- (1) determine whether the contract is or remains a proper investment;
- (2) investigate the financial strength of the life insurance company;
- (3) exercise nonforfeiture provisions available under the contract; or
- (4) diversify the contract.

§ 7212. Degree of care.

A fiduciary shall exercise reasonable care, skill and caution in making and implementing investment and management decisions. A fiduciary who represents that he has special investment skills shall exercise those skills.

§ 7213. Judgment of fiduciary's decisions.

The rules of this chapter are standards of conduct and not of outcome or performance. Compliance with the rules of this chapter shall be determined in light of the facts and circumstances prevailing at the time of the fiduciary's decision or action and not by hindsight. A fiduciary is not liable to the extent the fiduciary acted in substantial compliance with the rules of this chapter or in reasonable reliance on the terms and provisions of the governing instrument. A fiduciary's investment and management decisions respecting individual assets shall be considered in the context of the trust portfolio as a whole and as part of an overall investment strategy, and not in isolation. No specific investment or

course of action, taken alone, shall be considered inherently prudent or imprudent.

§ 7214. Language invoking chapter.

The following terms or words or words of similar import in the provisions of a trust, unless otherwise limited or modified, shall authorize any investment or investment strategy permitted under this chapter: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their own funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule" and "prudent investor rule."

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Key Terms and the Questions You Need to Ask When You Purchase a Bond
(Copyright, Hildy Richelson, 2006)

Ask each of the *italicized* questions and you will have the basic information for a bond purchase. Keep in mind that the broker has a conflict of interest because the broker not only is your advisor in the transaction, but is also a principal. The broker owns the bond that he sells you and earns a fee called a spread, the difference between the broker's cost and the price at which he sells to you.

Issuer	The entity which issues the bond. <i>Who is the issuer? Who is responsible for the payment of interest and the repayment of the principal?</i>
Basis Point	There are 100 basis points (BP) in 1 percentage point. The difference between a 5% yield and a 6% yield is 100 basis points. The difference between 5.2% and 5.4% is twenty basis points. <i>How many basis points difference between bond x and bond y?</i>
Calls	The right of the issuer to redeem the bond prior to maturity. <i>Does this bond have any calls?</i>
Coupon	The contractual interest obligation that the bond issuer agrees to pay to the bond holder annually. If the coupon is 5% and the face amount of the bond is \$1,000, then the interest payment for the year is $\$1,000 \times .05 = \50 . <i>What is the coupon?</i>
Face Amount	The dollar amount of the bond payable at the due date. <i>What is the face amount?</i>
Insurance	Support for credit worthiness if the issuer cannot pay. <i>Who is the insurer and how is the insurer rated?</i>
Maturity	Ending date of the bond, the due date. <i>What is the maturity of the bond?</i>
Price	How much you pay for the bond. The price is set in relation to the yield. <i>Is the bond priced to the call or to maturity?</i>
Rating	Estimates the riskiness of the bond, indicating how likely the issuer is to pay the interest and face value of the bond when due. <i>What is the rating?</i>
Yield	A percentage that is the basis of comparison of all bonds to each other. The yield sets the price. You pay the price associated with the worst yield possible if the bond is called. <i>What is the yield? To what date is it priced?</i>
Unit Cost	Another way to describe the price as if the bond had a face value of \$100 instead of \$1,000. <i>What is the unit cost?</i>
CUSIP	The bond fingerprint – Your key to all bond details and pricing. <i>What is the CUSIP number?</i>



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Evaluating Life Insurance Policies Due Diligence Before and After Putting the Policy in Force

Life insurance policies are complex financial instruments. Illustrations are the columnar depiction of how insurance policies are intended to operate under a given set of assumptions. While NAIC guidelines have been designed to create a greater level of disclosure and consumer awareness, the flexibility and versatility of today's life insurance software in addition to the pages of disclosure language and disclaimers can often leave the advisor no closer to understanding what has been presented. This section provides an extensive list of questions and observations that one should consider when reviewing a proposal for life insurance. Often, the answer to one question will lead to more questions, and the advisor will gain comprehension while progressing through each answer.

Due diligence for a life insurance contract begins in the proposal stage as the advisor must determine the validity of what has been presented as well as the applicability to a given situation. And due diligence does not end at the time the policy is issued. The advisor is obliged to determine that the policy as issued mimics what has been presented and to explain any and all variances. Finally, with each policy anniversary that passes, actual policy performance moves further and further away from the original illustration, obviating the need to view and analyze in-force illustrations at least every three years.

Pre-Issue Due Diligence

- What kind of policy is illustrated?
- What is the policy designed to do?
- What are the guarantees?
- What assumptions were made for illustrating how the policy is supposed to work?
- Are the assumptions realistic?
- What factors may impact a divergence from illustrated values?
- What underwriting classification(s) are illustrated?
- Are any riders included in the illustration?

Post-Issue Due Diligence – Policy Review

- Does the policy *seem* to be what was originally illustrated?
- Are the guarantees in the policy comparable to what was illustrated?
- Was the policy issued with the same underwriting classifications as when it was originally illustrated?
- Are there riders on the policy?
- Are the riders comparable to those shown in the illustration?
- Do the "billed" premiums match the illustrated premiums?
- Have you been presented with an "as issued" illustration?
- Are policy cash values allocated as intended?

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In-Force Due Diligence

Do the differences in the in-force illustration as compared with the original illustration make sense?

Are the owner and beneficiary accurately recorded at the insurance company?

Have all premiums been paid as scheduled?

Has policy performance been sub-par?

Are there significant changes in the economy, capital markets and or the client's situation that warrant revisiting the original intent and design of the policy?

Are there loans on the policy?

Other Considerations

The applications of using life insurance contracts to meet various financial challenges are limited only by the creativity of the client's advisors. In the last five years, we have seen the proliferation of premium financing, life settlements and investor-owned life insurance to meet the individualized needs of our clients. Additional questions need to be answered if one of these scenarios is present:

Premium Financing

What was the assumed interest rate at the time of sale?

What is the current interest rate?

What is the effective interest rate since inception?

What earnings rate was assumed for collateral?

What actual rate of earnings has occurred on the collateral?

Has proper reporting been provided to the lender?

Life Settlements and Investor-Owned Life Insurance

Has more than one offer been secured?

Do buyers know the identity of the insured?

Does the insured have any intention of ever securing additional life insurance?

*

Your experience in evaluating life insurance policies will likely create an opportunity to add your own questions to these. As the insurance industry and its products evolve, so too, will the list of questions.

Please contact Andrew J. Barnett, CLU, ChFC, for more information.

This LIMITED PARTNERSHIP AGREEMENT of

_____ Partners, L.P. is entered into by the following:

- (1) as General Partner - _____
- (2) as Limited Partners:

Trust under Deed of _____

Dated: _____

Trust under Deed of _____

Dated: _____

Trust under Deed of _____

Dated: _____

Recitals

The partners wish to form this partnership in order to permit the general partner to make venture capital and other investments on their behalf.

The partners intend that at all times the partnership will have net assets in excess of \$5 million.

The partners do not have any particular investment in mind at the time of creation of this partnership. Rather they intend that from time to time as the general partner sees opportunities he will have a fund in place from which to make investments.

Formation

This partnership is created pursuant to the Pennsylvania Revised Uniform Limited Partnership Act, title 15 of the Pennsylvania Consolidated Statutes, section 8501 et seq.

Except as provided to the contrary in this Agreement, the rights and obligations of the partners with respect to the partnership, and the administration of the partnership, shall be governed by the Act.

Restrictions on Who May be a Partner

Only _____, his direct lineal descendants, his wife, her direct lineal descendants, and trusts established by or for the benefit of any such person may become a partner.

Term

The partnership shall terminate on December 31, 2046 unless it is terminated earlier.

Name

The partnership shall conduct its business under the name
“_____ Partners, L.P.”

Office

The principal office and the registered office of the partnership shall be _____, Pennsylvania.

Management of Partnership

The general partner shall have the sole power to manage all the affairs of the partnership.

The limited partners may not participate in the management of the partnership.

Economic Rights

Each partner's rights shall be proportional to his interest in the partnership, without regard to his status as a general or limited partner.

Additional Capital

No partner may contribute additional capital to the partnership unless all partners contribute additional capital in proportion to their initial capital.

Allocations and Distributions

All allocations and distributions to partners shall be made in proportion to each partner's initial capital.

Tax Matters Partner

_____ shall be the tax matters partner for the partnership pursuant to section 6231 (a)(7) of the Internal Revenue Code.

Disability or Death of General Partner

If the general partner ceases to act because of death, disability or other reason, the partnership shall dissolve.

Transfer of General Partner's Interest

Upon the voluntary or involuntary assignment of the general partner's interest, the partnership shall dissolve.

Amendment of Partnership Agreement

A majority in interest of all the partners may by written instrument amend this partnership agreement.

IN WITNESS WHEREOF, the parties have signed this Agreement as of _____.

<u>Name</u>	<u>Initial Capital Contribution</u>
_____ General Partner	\$ _____
Trust under Deed of _____ Dated _____ _____, trustee _____, trustee	\$ _____
Trust under Deed of _____ Dated _____ _____, trustee _____, trustee	\$ _____
Trust under Deed of _____ Dated _____ _____, trustee _____, trustee	\$ _____