<u>The Evolving Responsibility of the Trust Fiduciary and how Hedge Funds Play a Role</u>

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Over the last two decades, the fiduciary duties of Trustees in the management of trust assets continues to evolve. We have seen the standard of investments shift from that of the "Prudent Man," to that of the "Prudent Investor," with more and more pressure being placed upon Trustees. Given an increasingly litigious environment, today's Trustees are now not only accountable for actions that they take, but also for actions that they do not take. Trusts are often established with friends or family members as Trustees, who may not fully realize the extent of their new responsibilities, particularly in the investment arena. Within this piece, we will focus on the changing responsibilities of Trustees, and their obligation over the assets with which they are entrusted, with a focus on the role that hedge funds are playing in trust portfolios, and the appropriateness of such assets as trust investments.

While the topic of taxes, and estate taxes in particular, will no doubt be a prominent discussion point during the upcoming elections, one thing remains clear; estate taxes will continue to be a source of income for the US government for the foreseeable future and are unlikely to go away. With that, individuals continue to design estate plans that minimize their estate tax obligations, and trusts continue to be the principal vehicle with which these estate plans are carried out. Moreover, alternative investments such as hedge funds are becoming significantly more prominent in the asset makeup of these trusts.

Generally, a Trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the "Prudent Investor" standards established under the laws of the state that governs the trust. In contrast to the old "Prudent Man" rule, with its emphasis on preserving trust principal at all costs, the new Prudent Investor rule gives Trustees much broader authority to make investments. The emphasis on a Trustee's duty of caution and avoidance of speculation in the old Prudent Man rule has been replaced by a more modern approach to trust investment in which the Trustee's central concern is balancing acceptable risk against increased returns, based upon the overall purposes of the trust. The Prudent Investor rule reflects the trend in the law of fiduciary investment in response to changing economic conditions, modern investment vehicles and strategies, modern portfolio theory and an evolving regulatory environment for fiduciaries.

Today's Prudent Investor acts require a Trustee to diversify the investments of a trust unless there are compelling circumstances that indicate otherwise. It is important for a Trustee to choose an appropriate combination of assets and asset classes that optimizes the identified risk and return objectives, consistent with the trust's time horizon. Most state statutes provide that the

Prudent Investor Standard is a “standard of conduct, not of outcome or performance.” So, while a Trustee is not a guarantor of performance, he must exercise reasonable care, skill and caution in making and implementing investment and management decisions.

The current Prudent Investor rule is designed to accommodate modern portfolio theory, where specific investments are evaluated for both their expected return and their expected risk. Additionally, and importantly, these individual investments are viewed within the context of the overall portfolio, and how inclusion of this new investment will impact the return and risk characteristics of the portfolio overall. Unlike the Prudent Man rule, which deems “risky” assets inappropriate for a trust, the Prudent Investor standard allows for the inclusion of risky assets if their inclusion is expected to improve the expected risk/return profile of the portfolio overall, because the determination of whether a Trustee has fulfilled his or her duties focuses upon the <u>manner</u> in which the Trusts has made investment decisions. The analysis leads away from the labeling of any asset as inherently prudent or imprudent, per se. Instead, the behavior of the Trustee is judged in relation to circumstances, not in a vacuum.

A Trustee can regulate market risk by selecting a level of risk and return and by selecting investments that are consistent with that level. A Trustee can only protect against non-market risk by diversifying, i.e., acquiring assets whose risk/return profiles have a low or negative correlation to one another. Therefore, the Prudent Investor rule generally imposes a duty upon the Trustee to eliminate the risk that is unique to each asset by diversifying the portfolio. The duty to diversify for the purpose of eliminating non-market risk could be considered the centerpiece of the Prudent Investor rule. It is this duty that requires the Trustee to focus on each asset as an integral part of a portfolio and not in isolation, which should reduce the problems associated with non-market risk. The Prudent Investor rule focuses instead on the importance of market risk and leads to the conclusion that the primary duties of the Trustee are to determine and implement the mix of market risk that is appropriate for the trust.

The courts have in recent years taken a closer look at Trustees' investment decisions. Whereas Trustees were once responsible only for actions taken, today, liability can be incurred for actions not taken. One of the more publicized cases in recent years is <u>In re Will of Dumont</u>, sometimes referred to as the "Kodak" case. In this influential decision, a New York State's Surrogate's Court found that a Trustee has the duty to diversify investments unless the Trustee reasonably believes that because of special circumstances the purposes of the trust are better served without diversifying. In this particular case, the Surrogate's Court held that, despite the testator's express wishes that the Trustee not dispose of Kodak stock held by a trust, the Trustee was nevertheless liable to the beneficiaries for failure to diversify. In other words, a Trustee was being held accountable for not only those actions that it took, but also for those it did not. Although this decision was overturned for other reasons on appeal, it still has greatly influenced the drafting of trusts and investment of trust assets.

Much is on the line for a Trustee who has failed in his fiduciary duty, since the Trustee can be found liable personally for damages. In cases where the Trustee fails to diversify out of a concentrated stock position, the damages might be based on the value of the stock on the date it should have been sold, reduced by the proceeds from the actual sale of the stock, plus interest. Courts may also compare the actual trust performance to what would have been achieved in an S&P 500 Index Fund. Hence, plaintiffs are afforded a look-back to see what the performance would have been had the trust been diversified.

Unfortunately, even exculpation clauses in trust documents may not adequately insulate a Trustee from liability. In one case, a general exculpation clause that relieved the Trustee from liability except in the event of malfeasance was insufficient to prevent the Trustee's liability for failure to diversify out of a concentrated stock position. In Re Trusteeship of Williams, 591 N.W.2d 743 (Minn.Ct.App.1999), aff'd in re: Trusteeship of Trust of Williams, 631 N.W.2d 398 (Minn.Ct.App 2001).

Thus the best practice in order to ensure that Trustees have full flexibility to invest in particular investments and to provide an additional layer of protection, is to provide specific authorization regarding specific investments explicitly in the trust documents. If the trust has already been funded, letters of guidance from the grantor to the Trustees expressing the grantor's wishes and objectives in establishing the trusts can be helpful

While there is no full-proof answer to how a Trustee can eliminate the legal liability associated with its fiduciary position, it is important that Trustees take their investment responsibilities seriously. The best defense for a Trustee is to make sure that he has placed the right processes in place for making decisions regarding the trust. First, the Trustees should review the terms of the trust document to see if it provides any specific guidance regarding trust investments. Does the trust document relieve the Trustee of the duty to diversify? Does it specifically authorize investment in alternative investments? Second, the Trustee should look carefully at the particular beneficiaries of the trust and determine their financial needs and resources. What is the time horizon for the trust and who is it intended to benefit and when? Will they need any distributions from the Trust in the short term, and how will that affect the liquidity needs of the trust. Finally, based on these factors, the Trustee should develop an investment strategy and then implement it. Then, at least annually, the Trustee should review the trust's investment performance to see if it is performing in a manner consistent with the trust's goals. All of these questions should be addressed when developing an investment strategy.

Hedge funds, given their characteristics, can be very suitable trust investments. Typically, hedge funds require a significant holding period, are generally illiquid in nature, can have a low correlation to the broader equity markets, and potentially can have significant capital appreciation over an extended period. These characteristics work well for trusts, since trusts, particular trusts established as a part of a gift program, often have the flexibility to hold assets for extended periods without the need for immediate liquidity. Additionally, the low correlation to the broader equity markets may increase a trust's risk/return profile if the trust is heavily skewed towards public equities. Lastly, given hedge funds' general investment mandate of capital appreciation, hedge funds can provide an appropriate vehicle for the growth within the trust.

Although hedge funds can be appropriate investment vehicles for trusts, as we have seen with public equities, Trustees still need to be mindful of their responsibilities under the Prudent Investor Act, particularly if the trust investments are heavily weighted in one single hedge fund. Upon initial reflection, Trustees may feel a greater sense of fulfilling their fiduciary duty by holding one single hedge fund position in a portfolio as opposed to a single equity position. Hedge funds by nature tend to hold a varied basket of securities, and hence have diversification inherently built into them. Unlike with traditional equity positions, however, Trustees may not have full knowledge of the nature of a hedge fund's investments. The opaqueness of the hedge fund industry in general creates a lack of clarity for the investor, and hence one can never be completely certain what the underlying portfolio holds. Moreover, while investment mandate guidelines for the fund will set parameters for what a fund manager can and cannot invest in, often these guidelines are very broad in nature. Additionally, hedge funds generally have the ability to leverage their investments, sometimes to considerable levels, and hence investments into the fund have the potential to carry significantly more risk than what was originally expected at the time of the initial investment. In short, Trustees may be incurring more risk than anticipated when hedge fund vehicles are included in the trust investments. As a result, additional care is warranted when considering hedge funds for a trust portfolio.

In those instances where a hedge fund manager is the grantor of a trust, and where the trust's principal, and perhaps sole asset is shares in that hedge fund, Trustees may once again be comforted in believing that the issues raised above are mitigated. This can indeed be true, as the fund manager has the discretion to share position information with the Trustee and remove a significant amount of the opaqueness that encumbers other investors. However, as with any portfolio, a Trustee has to be mindful of the "all the eggs in one basket" adage. Although a hedge fund may carry implicit diversification within the fund itself, the Trustee is no further insulated from the risk associated with a single investment in a hedge fund than with a single equity position. Even in instances where the Trustee has supreme confidence in the fund manager, and his or her abilities to invest appropriately, the fund company, like any company, is exposed to risks that could potentially cause the demise of the fund. Risks such as counter-party risk, key-man risk, internal fraud, external fraud, and various management and operational risks all pose threats to a fund. We have all seen and read about various hedge funds that at one point in their lifecycle are the darlings of the investment community, then one day broadsided by events either within or outside of their control. Hedge fund closures have increased dramatically in recent years. From 2005 through 2007, over two thousand funds have closed in comparison to a current fund population of roughly ten thousand. Long Term Capital Management, Amaranth Advisors and Peleton are some of the more notable failures. All of these funds were highly regarded within in the industry until things went askew, and the firms ultimately failed. While the threat of failure of any given fund may not be great, it does give the Trustee something to ponder when determining if a concentrated hedge fund holding within a trust is appropriate and prudent, as fund failure will surely rise as markets remain sluggish and volatility remains high.

In spite of these issues, hedge funds can be excellent assets to give away in trust as part of an estate plan. This is especially true for Grantor Retained Annuity Trusts (GRATs). A Grantor Retained Annuity Trust, often referred to as a GRAT, operates as follows: the Donor transfers cash, a high income-producing asset or a high growth asset to a trust, from which the Donor will receive a fixed amount annually (an "annuity") for a selected term of years. At the end of the period of years, if the Donor is living at that time, the Donor's children or other beneficiaries or ongoing trusts for their benefit will receive the assets remaining in the GRAT free of gift and estate tax. Depending on the GRAT's cash flow and/or the appreciation of the GRAT's assets (the "total investment return"), substantial estate and gift tax savings may be achieved.

The tax advantage of this technique is derived principally from the way in which the value of the gift to the GRAT is calculated. The value of the Donor's (also known as a grantor) gift for tax purposes is not the value of the assets transferred to the GRAT, but rather the value of the Donor's children's right to receive the assets after a period of years and after payment of the annuity each year to the Donor. If the duration of the GRAT is long enough, or the annuity amount is high enough, the value of the gift is virtually zero. This is called a "zeroed-out" GRAT. The key factor to a successful GRAT is to place an investment into the GRAT that will outperform the IRS "hurdle rate." This is a rate published monthly by the IRS. The Donor will receive back an annuity based on the value of what is placed into the GRAT, plus the IRS hurdle rate. Any performance of the asset over and above that rate will pass gift tax free to the ultimate beneficiaries of the GRAT. In August, the relevant interest rate is 4.2%, and, as recently as May, was at 3.2%. Since hedge funds can often far outperform this interest benchmark, they can be excellent investments for GRATs.

For example, Jane Jones transfers a $1,000,000 hedge fund interest to a two year GRAT. Jane expects this investment to increase by 25% per year for the next two years. Assuming an IRS interest rate of 4.2%, Jane must receive an annual annuity of $532,000 for the two years of the GRAT. If the hedge fund investment increases in value as Jane expects, there will be $366,000 left in the GRAT for her children (or a trust for their benefit) at the end of the two year term.

Another type of trust that is used in estate planning is a "Dynasty Trust." This type of trust is designed to last as long as legally possible. In some jurisdictions, the trusts can last forever. These trusts are designed with very broad discretionary powers to care for Donor's families and descendants, and, with proper planning, will be excluded from the beneficiaries' estates for tax purposes. Since the investment horizon for Dynasty Trusts is so long, Trustees of Dynasty Trusts usually look for long term alternative investments to supplement the trust portfolios.

Finally, another transaction that has been popular is the sale of assets to a trust. This is particularly appropriate for existing trusts that have already been funded. This technique involves the client selling his or her interest in property to a trust at fair market value, in exchange for a note at the relevant IRS interest rate, which is typically lower than the “hurdle rate” of a GRAT. For example, the IRS rate for notes between three and nine years for August is 3.55%. Accordingly, if the property sold to the trust achieves performance over and above this 3.55% hurdle, that performance will inure to the benefit of the trust, since all the seller of the asset receives back is payment for the asset plus the interest on the note.

We have seen over the years the trend towards more litigation. Trustees are being held to an ever higher standard with regard to their roles and responsibilities for trust assets. It is no longer only those acts of commission that are being scrutinized by our legal system, but also acts of omission. Moreover, while we do not know what the future holds, we feel reasonably certain that courts will lean towards increased responsibility. Lastly, while we have not witnessed a case where Trustees were held accountable for the losses incurred by having just one hedge fund as the trust’s asset, we can speculate that the likelihood of such a case is increasing. The number of hedge funds has risen rapidly in recent years given low barriers to entry and fund managers’ prospects for outsized payoffs. With the continued proliferation of funds and a depressed market environment, the chances for increased fund closures, and the possible litigation that could result, will certainly increase.

If a Trustee considers a hedge fund or multiple funds as part of a trust’s investment portfolio, or, should the Trustee take on responsibility for a trust that already has one or more hedge funds, the Trustee should carefully consider the positions and determine if additional diversification is warranted. Seeking expert advice regarding the hedge fund’s position and its attributes is always appropriate. The Trustee needs to ensure that the hedge fund investments are consistent with the risk and return objectives of the trust and that the trust language permits such investments. If constructed properly, a portfolio of hedge funds can significantly enhance the risk/return profile of a trust's portfolio while lessening the fiduciary's legal exposure. A Trustee further can mitigate its legal liability by ensuring that trust documents are written to reflect the objective of the grantor, and the intended investment plan. Appropriate counsel on the legal side as well as the investment side can help strengthen a Trustee's position if ever faced with litigation.

Trusts are typically established when grantor, Trustee and beneficiary are all on favorable terms. However, we have witnessed repeatedly what happens when fortunes are lost and a responsible party is sought out to rectify what has transpired. In those times, relationships, no matter how strong in the past, become tested, and often the courts are asked to intercede. It is unlikely, now or in the future, that a court would rule unfavorably against a Trustee that proactively diversified a trust portfolio. When in doubt, seek professional counsel and diversify, no matter what the investment mandate, grantor goals or relationship between grantor and beneficiary.

Cook Pine Capital is a Greenwich, CT-based registered investment advisory firm that focuses exclusively on the creation and management of customized hedge fund portfolios for high net worth investors. Cook Pine has been featured and/or cited in the Wall St. Journal, Barron's and Bloomberg for its work in the hedge fund industry.

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