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Alternative Investments in The Wake of Covid-19: Fiduciary Duties to Be Considered

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INTRODUCTION

In the wake of Covid-19, are your high net worth investment advisory clients seeking investments not tied to the vagaries of the stock markets? Are clients in communication with you as to the status and prospects of their portfolio? Is the allocation appropriate for the roller coaster economic ride that has been and might be experienced in the future? ''Alternative investments,'' broadly speaking, are those expected to provide a counter-cyclical aspect to a portfolio from the stock market and particularly came to the forefront after September 11, 2001, and during the 2007/2008 market crisis. Today, ''noncorrelated investment strategies are a necessary part of the fiduciary portfolio,'' and ''mainstream,'' rather than ''alternative'' investments.[1] Clients who do not require a high level of liquidity and are willing to undertake greater risk in order to obtain an opportunity for a higher level of return, or to simply balance their portfolio with investments presumed to perform counter to exchange-listed equity and debt securities, may be appropriate for consideration of alternative investments. This article will describe best practices and an investment professional's fiduciary duties in the context of advising such clients, and discuss alternative investments and how they might fit into an overall investment strategy, taking into consideration such factors as the reasonably known needs of the beneficiaries and their financial resources.

Alternative investing directs investment dollars away from traditional investments in fixed income and publicly traded equity securities, and instead into investments such as private equity, venture capital (early stage), real estate, natural resource exploration, and certain tangible property, like art and wine. These investments, although riskier, carry the potential for greater returns, and can help to reduce the role played by market direction and the volatility of a portfolio as a whole, even in tumultuous markets.[2]

Inherent in the nature of investing in alternatives, however, is that there will be winners and losers. That is to be expected. The idea is to diversify the industries in which alternative investments are made, thereby further spreading an investor's risk. In doing so, however, the professional fiduciary must act as a reasonably prudent investor would in developing an overall investment strategy for the portfolio, making investment decisions based on the information available at the time the decisions are made.

Typically, a limited liability company or limited partnership is created to pool investors together in or-

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[1] Phillip J. Ruce, *The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard,* So. Tex. L. Rev., vol. 53, No. 4, 653, 657 (2012).

[2] See Ruce, Note 1, above, at 658.

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der to make an investment in a company at a level greater than most investors alone would be able to make. The investors generally own equity only in the pooled investment vehicle, while the pooled investment vehicle owns the equity or debt securities of the company. This type of an arrangement can also provide a group of investors greater bargaining power than any would have individually and can protect individual investors from personal liability for the actions of the company through a ''corporate veil.''

Often there are numerous rounds of funding, which may involve different types of securities. Each round has its own preferences, convertibility features, seniority and the like. Typically, existing investors have a right to participate in future rounds, and rounds offering the same type of security act as an anti-dilution measure, protecting earlier investors with the ability to maintain their percentage of an investment relative to all investors. Initial investing does not automatically serve as a license or mandate for subsequent investing, but future opportunities should compel their own analysis of the pros and cons involved in the decision to invest additional sums, in light of the impact of the investment on the overall portfolio.

Alternative investing is not appropriate for everyone. Risk appetite varies among clients. Alternatives are often riskier, long-term investments, that can take years and several rounds of capital infusion before the financial objectives come to fruition. There is no public market for resale, and there are usually restrictions on resale. Investors are thus generally invested for the long haul. A client's liquidity needs will have to be met through other means, such as from the income generated by the sale of other investments. All of the risks, including the liquidity risk, require analysis by the investor/fiduciary and informed communication of the risks and potential rewards to the settlor and/or beneficiaries, as appropriate.

Venture capitalists realize their profits at a strategic exit point, such as a sale of the company or a public offering, and their strategies should be directed to that end. An investment memorandum, described below, should map out that strategy from the get-go and be used to track progress toward the intended exit, which hopefully comes to fruition for all of the early investors.

The fiduciary duties that particularly come into play when talking about alternative investments are the duty of loyalty, the duty of administration, the duty to inform and report, and the Prudent Investor Rule. The duty of loyalty is generally thought of as the duty to avoid conflicts of interest and to anchor administrative decisions in the best interests of the beneficiaries. This can be sticky if a fiduciary is co-investing alongside of the client. Administration encompasses conducting due diligence, record-keeping, and valuations. The duty to inform and report material facts, including the risks of the investment and internal relationships, which might create or appear to be conflicts, is critical, and is normally fulfilled by upfront disclosure and by sending periodic account statements and performance reviews. This article will touch further on all of these duties, but will begin with an examination of the Prudent Investor Rule, which is anticipated as possibly being a source of claims against a fiduciary, founded or otherwise, in a Covid-19 (and post-Covid-19) world, and therefore worth examining.

THE UNIFORM PRUDENT INVESTOR ACT

Many (but not all) states have enacted the Uniform Prudent Investor Act (UPIA). It materially shifted the focus of a trustee from evaluating the merits of an individual investment standing alone, to a more holistic approach to portfolio management — evaluating ''the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.''[3] This requires a trustee to follow ''Modern Portfolio Theory'' (MPT), which Mark Rubinstein described in his 50-year retrospective on Harry Markowitz's landmark paper in the 1952 *Journal of Finance* as ''the mathematical formalization of the idea of diversification of investments: the financial version of 'the whole is greater than the sum of its parts.' ''[4] The trustee is also required to consider ''the purposes, terms, distribution requirements, and other circumstances of the trust'' using ''reasonable care, skill and caution.''[5] Consideration of ''purposes, terms and distribution requirements'' includes examination of the needs of the beneficiaries, both presently and in the future, as well as the income and resources of the beneficiaries, to the extent reasonably known by the fiduciary steward. A trustee can make any type of investment consistent with the Act, an allowance intended to abolish the ''legal lists'' of approved investments adopted by some state legislatures and to ''disavow the emphasis in older law on avoiding 'speculative' or 'risky' investments.''[6] The Prudent Investor Act establishes an objective standard, but, of course, a professional trustee is held to ''the standard of a prudent investor similarly situated,'' in other words, of a prudent professional, and must make use of its special skills or

[3] UPIA §2(b).

[4] Mark Rubinstein, *Markowitz's ''Portfolio Section'': A Fifty-Year Retrospective,* 57 J. Fin. 1041, 1042 (2002).

[5] UPIA §2(a).

[6] UPIA Cmnts. to §2(e).

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expertise.[7] Thankfully, compliance with the Prudent Investor Act is determined based upon the "circumstances existing at the time" the investment was made, "and not by hindsight."[8] "Trustees are not insurers."[9]

Among the many factors that trustees are required to consider under the UPIA when investing, as well as managing trust assets, are the general economic conditions, the possible effect of inflation or deflation, the role that each investment plays in the overall trust portfolio (which the UPIA expressly says may include interests in closely held enterprises), and the expected total return from income and the appreciation of capital.[10] Not all states mandate consideration of these same factors.

The Pennsylvania Prudent Investor Rule,[11] for example, although taken from §2 of the Uniform Act, omits the words "risk and return" found in §2(b) of the Uniform Act's reference to an overall investment strategy having "risk and return" objectives reasonably suited to the trust, and does not mention economic conditions, inflation, deflation, interests in closely held enterprises, or expected total return.[12] The Joint State Government Commission Comment to 20 Pa. C.S. §7203 states that these references were deleted "because they are too imprecise." Like the UPIA, however, Pennsylvania permits investment in every kind of property and type of investment consistent with its statute.[13] Further, the Joint State Government Commission Comment explains that, in Pennsylvania, "a fiduciary is not restricted to modern portfolio theory but instead can follow any reasonable theory of investing" including "investments previously considered speculative if appropriate in the circumstances."

Duty to Diversify

Section 3 of the UPIA requires a trustee to diversify the investments of a trust "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." Ideally, a portfolio is invested in hundreds of issues.[14] The degree of risk associated with high-risk alternative investments "can be materially reduced through diversification."[15] As stated by Professor John Langbein at Yale University:

> Modern Portfolio Theory has taught us that the game of stock picking is costly and futile for most investors, especially small investors, while emphasizing the large and essentially costless gains that are to be had from maximizing diversification. These twin insights point the fiduciary investor—that is, the prudent investor—strongly toward the use of pooled investment vehicles that are large enough to achieve high levels of diversification at reasonable cost.[16]

Reasonable Care, Skill and Caution

Best practices

Demonstrating the use of "reasonable care, skill and caution," particularly when it comes to making alternative investments, includes conducting due diligence, to the extent possible, engaging in a risk/reward analysis, even in Pennsylvania, documenting key decisions contemporaneously with the making of the decisions, to avoid later second-guessing by others, and proactively monitoring investments after they are made.

Due Diligence

Due diligence is more difficult with alternative investments because there is not as much information available about private companies as there is about public companies. But a prudent trustee should in good faith gather and review as much information as possible, including by researching the applicable industry and trends, reviewing all financial information about the company that is available, visiting the premises and examining the product (if there is one), vetting the management and the board regarding their knowledge of and experience with the industry or space, speaking with other investors or potential investors, interviewing any involved venture capitalist and other sources of financial infusion, as well as the documentation regarding the interests and rights being offered to those funding the investment and the like. The goal is to assess the company's probability of achieving its sales and revenue projections and to evaluate how much capital will need to be invested for a successful exit and whether the investment will produce an acceptable return over the course of the investment's duration. All of these efforts and conversa-

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[7] UPIA §2(f) and Cmnts.

[8] UPIA §8.

[9] UPIA Cmnts. to §8.

[10] UPIA §2(c)(1), §2(c)(2), §2(c)(4), §2(c)(5).

[11] 20 Pa. C.S. §7203 *et seq.*

[12] 20 Pa. C.S. §7203(a), §7203(c).

[13] 20 Pa. C.S. §7203(b).

[14] John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing,* 81 Iowa L. Rev. 641, 648-649 (1996).

[15] Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing* at 649.

[16] Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing* at 658.

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tions should be documented, all documentation about an investment should be preserved, and an ''investment memorandum'' should be prepared to describe how the investment fits into the portfolio's investment policy and strategy and is expected to yield the desired return.[17] If there is insufficient information available to determine whether the investment is consistent with portfolio strategy and to determine an expected return, perhaps the investment should not be made.

Risk/Reward Analysis

Three types of risk are associated with owning a security. Market riskf is the risk associated with factors like economics, political climates, and interest rates.[18] Industry risk, as the name implies, is specific to a particular industry or space that is the target of the investment.[19] And firm risk is associated with only the particular firm in which an investment is being made.[20] Market risk cannot be eliminated, but industry and firm risk can be minimized.[21] Industry and firm risk are ''diversifiable'' risks and should be avoided.[22] In a portfolio of 10 companies with the same expected risk/return profile, as opposed to a concentration of investment in a single company, there will be less variance in the actual return of the portfolio because losers will be offset by winners.[23]

As explained in the Comments to §3 of the UPIA, under MPT, a prudent investor looks at whether these risks inherent in an investment are ''compensated'' or ''uncompensated.'' Owning shares in a start-up high-technology venture is cited as an investment that needs to pay an investor for bearing such high risk. An investor expects a higher rate of return because it bears that greater risk. This is described as taking a ''compensated'' risk. A cited example of an ''uncompensated risk,'' on the other hand, is a portfolio comprised of investments in only one industry. ''[N]o one is paying that investor to take on the additional risk of sinking all the investor's funds into one company or industry.''[24] That risk could have been easily eliminated by adding investments in diverse industries to the portfolio. ''Risk tolerance,'' it is said, is ''antithetical to successful investing:''

> When people aren't afraid of risk, they'll accept risk without being compensated for doing so . . . and risk compensation will disappear. When investors are unworried and risk-tolerant, they buy stocks at high price/earnings ratios and private companies at high multiples of EBITDA.[25]

Although a fiduciary in Pennsylvania is not required to follow MPT, it is required to diversify a portfolio, and a portfolio of compensated risk alternative investments is one way to do so. If choosing to invest in private equities, for example, a prudent investor should conduct a risk/reward analysis and memorialize it in the investment memorandum. Could the investment dollars return a greater reward in a less risky investment? Of course, making several private equity investments in different firms, in diverse industries, can mitigate the risk of any one such investment. For example, an investor in start-up firms can utilize a venture capital fund to spread the risk of failure of any single firm across a ''basket'' of such securities, which offers the likelihood of a high net return on an expected return basis.[26]

Documentation

A trustee should always document the decision-making process in which they engaged, and the important decisions made, including its decision to make an alternative investment and its reasons for doing so. When investing for a revocable trust, where the assets are portable, as a practical matter, the settlor is making the investment decisions with the guidance of the trustee. With each private equity investment, it should be disclosed to the settlor in writing that private equity investments are inherently high risk and illiquid. They should be told in plain language that they could lose their entire investment and that, in any event, they will not be able to sell their investment and get any of their money back for a long time. The importance of informed, consensual, acknowledgement cannot be understated. Following these written disclosures, the settlor's signed and written consent to each and every private equity investment should be obtained.

An article discussing two psychological phenomena — hindsight bias and the curse of knowledge, observes that both increase the odds of a trustee being sued because of a losing investment and that, while a trustee's decision is supposed to be evaluated on the basis of information available at the time of the decision, what matters in the courtroom is evidence. ''Trustees who understand both the power of hind-

[17] Toon Nagtegaal, 8: *Post Investment — Venture Management,* in *The Venture Capital Handbook,* 183-184 (William D. Bygrave, *et al.* eds. 1999).

[18] See Langbein, Note 14, above, at 647.

[19] See Langbein, Note 14, above, at 647.

[20] See Langbein, Note 14, above, at 647.

[21] See Langbein, Note 14, above, at 647.

[22] Jesse Dukeminier and Robert H. Sitkoff, *Wills, Trusts And Estates,* 9th Ed. 2013, 626.

[23] Jesse Dukeminier and Robert H. Sitkoff, *Wills, Trusts And Estates,* 9th Ed. 2013, 626.

[24] See Ruce, Note 1, above, at 682-683.

[25] Howard Marks, *The Most Important Thing Illuminated,* 58, 59 (2013).

[26] See Langbein, Note 14, above, at 649.

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sight bias and the weakness of uncorroborated testimony will document every potentially important decision clearly, completely and contemporaneously.''[27] Stated differently, ''[f]eed the file; the file is your friend.''[28]

Monitoring

Once made, the performance of alternative investments should be monitored. The investment memorandum should be updated on a regular basis to track progress toward performance goals, or failure to reach them, modify the goals as appropriate, and evaluate the desirability of making changes to management, staff, or business processes, a highly useful analysis if considering participation in future funding rounds or faced with hold/sell decisions. Monitoring necessitates frequent contact with the start-up entity, and touch points should include monthly, quarterly, and annual income statements, balance sheets and cash flow statements, year-end audited financials, an annual budget, detailed monthly sales reports, and monthly timelines detailing progress toward goals. If invested through an LLC, such that the trust is one of many investors, the managing member of the LLC should be obligated to get this information and share it with all members. If the start-up will not grant full access to all such information and persons, perhaps the investment not be made in the first instance, and certainly not without disclosure to the settlor or beneficiaries, as appropriate, of the limitations on available information imposed by the start-up.

Another good way to monitor performance and even to influence business strategy and affect change, as appropriate, is through a board seat and/or representation on a board committee, if available, but at a minimum, regularly scheduled calls and status reports on performance. The negotiated terms of the investment should include the reporting and information requirements and board/committee positions. As much information as possible should regularly be passed along to the trust settlor and/or beneficiaries, whichever is appropriate. Communication, if prompt and accurate, can go a long way toward avoiding claims of breach of fiduciary duty. A trustee should also consider filing an accounting periodically, which can serve not only to provide information about the trust's overall performance, but also to start the running of the statute of limitations against any claims (or bar the claims if not contested) of settlors or beneficiaries who have a change of heart or suffer memory loss regarding their original support and consent for the investments and the risks inherent therein.

[27] Randall W. Roth, *Hindsight Bias and the Curse of Knowledge: Forewarned Is Forearmed,* ABA Tr. & Inv., Jan./Feb. 2011, 30, 33.

[28] Dukeminier and Sitkoff, Note 22, above, at 648.

Fiduciary Duties

The best practices around alternative investing, as discussed above, are also part and parcel of a trustee's traditional fiduciary duties. To the extent not already discussed above, fiduciaries should also adhere to the following duties when making alternative investments:

Duty of Loyalty

A fiduciary has a duty to administer a trust solely in the interests of the beneficiaries. Uniform Trust Code (UTC) §802. This duty is violated if they engage in self-dealing. Good faith and fairness are irrelevant when it comes to self-dealing. With few exceptions, the only available defenses are that (a) the settlor authorized the self-dealing; (b) the beneficiaries consented after full disclosure; or (c) the trustee obtained advanced judicial approval.[29] Claims of self-dealing often arise in situations when a corporate trustee or its principals with equity ownership in the corporate trustee are co-investing with a trust. While clients may be impressed that a trustee is so enthused about an investment that the trustee's principals themselves are investing, care must be taken to assure that clients are not induced to invest in order to allow a pooled investment group to meet a minimum investment threshold set by the private company in which they intend to invest, or to keep the private company afloat for the benefit of other investors. For example, a co-investing fiduciary should not continue to invest trust funds in future financing rounds if the fiduciary is not also investing for itself in those later rounds. Likewise, it could be problematic if the fiduciary invests, but decides not to do so for the trust. In either scenario, the situation should be disclosed to the settlor and/or beneficiaries, as appropriate, and in any event, co-investing should always be disclosed in writing. In fact, in addition to sending a written notification, best practice at the outset would be to have the settlor or beneficiaries acknowledge receipt of that communication in writing to avoid the ''I never got that letter'' issue.

Duty of Administration

Due diligence and record-keeping, as discussed above, are only part of the duty of administration[30] when it comes to alternative investments. The tricky part is often valuing the investments. One method is to use carrying values (cash in/cash out), rather than to attempt to obtain an independent fair market value, which may be costly to obtain. Using carrying values is difficult to argue with under these circumstances, especially if the values are adjusted promptly when

[29] See Dukeminier and Sitkoff, Note 22, above, at 591, 593.

[30] UTC §801.

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there is a later up or down round of financing, and certainly when an entity fails.

Duty to Inform and Report

As the Comment to §813 of the UTC notes that, with some exceptions, ''a trustee may be required to provide advanced notice of transactions involving real estate, closely-held business interests, and other assets that are difficult to value,''[31] a trustee considering the sale of a real estate asset has the option to seek court approval of said transaction. In addition to the advanced disclosure and typical reporting of market conditions and trust performance, periodic updates should also be provided as to the status of each alternative investment. Both good news and bad news should be disclosed to the settlor and/or beneficiaries, whichever appropriate, in writing, and if an investment did not perform as expected, a solid explanation given in a timely fashion might serve to dissuade a claim of breach of fiduciary duty. Unlike wine, bad news does not get better with age.

DELEGATION

If anything should be gleaned from this article, it is that an individual or unsophisticated trustee might be well-served by delegating the investment function to a skilled, professional investment advisor. Prior to the UPIA, while trustees were permitted to take advice from outside specialists, they were required to evaluate the advice and form an independent judgment about whether or not to follow it, resulting in a de facto delegation.[32] The new approach under the UPIA allows a trustee to use professional advisors and delegate ''investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.''[33] The trustee must use care, skill, and caution in selecting an investment advisor, formulating the terms of the delegation, and reviewing the advisor's performance and compliance with the terms of the delegation.[34] A non-professional trustee would be well-served by using a reputable professional investment advisor to be sure the trust's portfolio is properly and sufficiently diversified for a better overall return.

CONCLUSION

Fiduciaries and their clients looking to steer investment funds away from the volatility of the stock markets and who are not averse to taking greater risk, if compensated with a potential greater reward, should consider alternative investments. For the right client, alternative investments can be a prudent part of an overall investment strategy, and may perform differently than the markets, thereby blunting the negative effects of catastrophic events, and their fallout, on global markets. Well-diversified, prudent portfolios, including alternative investments, are ''the new rule,'' rather than an aberration, and ''a permanent part of a professional trustee's portfolio model.''[35] And if the alternative investment is made by a fiduciary consistent with the best practices and fiduciary duties described in this article, after conducting reasonable due diligence, and making an informed decision, substantiated by documentation, and monitored on an ongoing basis, the liability of the fiduciary for an alternative investment gone sour should be minimized. Fortunately, even if an investment fails, a court is not to substitute its judgment for that of the trustee and evaluate the investment decision with the benefit of hindsight.

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[31] *In re Green Charitable Trust*, 431 N.W.2d 492 (Mich. Ct. App. 1988); *Allard v. Pacific National Bank*, 663 P.2d 104 (Wash. 1983).

[32] Langbein, Note 14, above, at 651.

[33] UPIA §9.

[34] UPIA §9.

[35] Ruce, Note 1, above, at 692.

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