

CHOOSING LEGAL *and* INVESTMENT ADVISORS

FULLY AWARE THAT EVERY FAMILY FOUNDATION must have sound legal and financial advice, the Tow Foundation of New Canaan, Connecticut, looked to trusted employees of the family company. The company's long-time general counsel sits on the foundation's board as secretary and general counsel. The company's long-time chief financial officer serves as foundation treasurer and manages the investment portfolio of about \$20 million.

Two of the most important aspects of family foundation life are ensuring that all philanthropic activities are conducted within the framework of federal and state laws and that operating and grantmaking funds are available and adequate to meet the goals of the donor and foundation board. Many family foundations have legal and investment advisor resources at hand, but just as many do not. This chapter reviews the legal and investment requirements of family foundations, suggests possible resources for obtaining these resources, and details the processes for hiring, retaining, and evaluating individuals from the outside.

Choosing LEGAL ADVISORS

By Jerry J. McCoy, Esquire

IF A FAMILY IS TO CREATE and operate a formal philanthropy safely, it needs the guidance of a legal advisor who understands the applicable rules. Advisors should be able and willing to communicate these rules effectively and establish a good working relationship with the donor family. Families that have the resources to create a family foundation and the motivation to do so should understand and take very seriously the need for legal counsel and the unique nature of the services needed.

This section examines the considerations a family should take into account and the roles that legal counsel might (and should) be called upon to serve. Also explained is what the family should do in hiring, retaining, and (yes, it does happen) firing legal counsel for the family foundation.

I. THE ROLES OF THE LEGAL ADVISOR IN FAMILY PHILANTHROPY

Legal counsel may serve as a legal advisor, a board member, a friend and confidant of the donor and his or her family, or in other roles. It is important to distinguish at the outset between lawyers serving as legal advisors and persons serving in other functions who just happen to be lawyers. For example, a lawyer may hold a position as a foundation trustee, but may not render this service in a strictly legal capacity. Even if the lawyer/trustee was selected as a board member because of his legal experience, his role as a director or trustee and that of a lawyer are separate and distinct. The legal experience of such a person may prove beneficial to the board, but this benefit is secondary to the general oversight that is the board's primary concern.

In some instances, a lawyer will be a long-time associate of the donor and a trusted family friend and advisor. This too is a role separate from the foundation's needs for legal guidance. One of the most important requirements for legal counsel is that the client must have confidence in counsel's ability and therefore be willing to trust his judgment and accept the advice that is (or should be) sought. Donors most likely have confidence in a long-time legal advisor. The long-time legal advisor and family friend may ultimately prove to be a good choice for foundation counsel, but this decision should be made on the basis of merit. Such an individual may be asked to choose between serving as a trustee and serving as counsel; it may be difficult for the same person to serve both roles simultaneously. Upon considering the roles it envisions for counsel, the donor family quickly finds that this process of selecting foundation counsel is serious and should not be left to the circumstances of whatever lawyers happen to be on hand and familiar.

The first step, then, should be to compile a list of just what sorts of guidance are expected to be needed. In a moment, we will review some of the possible items to be included in that list. After the initial review of available sources is assembled,





appropriate advisors can be entered for each category of need, and potential candidates will soon emerge.

The donor family should delineate just what is expected of counsel as a means of beginning its search for appropriate and qualified counsel. This all-important step is worth reviewing in detail, because it is the heart of the foundation-counsel relationship. A typical approach here is to consider the role of counsel at various foreseeable aspects of the foundation's development and operation:

1. *Foundation and mission.* Counsel will be responsible for actually bringing the foundation into existence, by preparing and processing its articles of incorporation (or trust instrument). Bylaws will be necessary to prescribe the foundation's internal procedures and rules. Less obvious is the fact that these documents should be reviewed and updated periodically as the foundation evolves. Another initial step is the preparation and filing of Form 1023, Application of Recognition of Exemption Under Section 501(c)(3), and its processing by the Internal Revenue Service. Errors and improper documentation will cause delay and unnecessary conflict with the IRS. Experienced counsel can complete these tasks easily and efficiently.
2. *Other baseline functions.* There may be tax issues, and potentially complex ones, to be worked out in connection with the initial funding of the foundation. The foundation should consider and review openly various legal issues that will have to be confronted as the foundation commences operations. These include the need for rules governing internal housekeeping functions, the legal and fiduciary responsibilities of the board, and policies to avoid (and deal with) conflicts of interest and potential self-dealing. Counsel should also help the donor prepare a statement of his or her intentions in creating the foundation suitable to serve as a mission statement that will eventually be discussed, perhaps amended, and endorsed by the board. Finally, this phase should consider the long-range expectations of the donor and the family for the foundation. Will it be funded more fully pursuant to the older generation's estate plan? Will it be designed to last in perpetuity, or will it spend out its endowment by a certain date? What is anticipated in the way of generational succession and board structure?
3. *Grantmaking procedures.* The foundation should develop procedures and guidelines for the types of grants it intends to make. These procedures and guidelines may require coordination with the applicable tax rules. In some cases, it may be necessary to pursue a letter ruling from the IRS.

4. *Ongoing legal matters.* The foundation will need legal guidance for various actions. The foundation must consider the need for insurance. If office space is rented or other realty is leased or purchased, leases and contracts must be negotiated and prepared. The foundation may enter agreements with other organizations or it may pursue collaborative arrangements. Disputes with contractors or grantees can lead to litigation. Employee agreements and volunteer arrangements carry consequences. Family foundations often share facilities with the donor family, and such an arrangement calls not only for legal supervision but also for a familiarity with the self-dealing rules. All of these subjects merit attention.

5. *What legal counsel should not be used for.* A temptation may arise to use legal counsel for a variety of functions, perhaps because counsel may be more familiar than others with the manner in which a foundation operates. Once working procedures are in place, the foundation should have access to staff or clerical personnel for routine work such as initial processing of grant applications, preparing internal communications, and the like. This work is separate from that of counsel, and the two should not become confused.

Another area in which counsel to the foundation must be careful not to enter is the rendering of services on behalf of the donor family members, all of whom will normally be "disqualified persons" for purposes of the self-dealing rules. Counsel may work for them as well as the foundation, but not in the course of services for which the foundation is paying the compensation of counsel. Careful records should be kept so that the parties can establish that the foundation is not paying the costs of services rendered to or for the benefit of the family; if benefits are shared, the costs should likewise be shared.

II. KEY QUESTIONS FOR THE FOUNDATION BOARD

The actual search for legal counsel should begin with a careful analysis of the foundation's legal needs. What does the family want to accomplish and what does it need to get there? This process requires the consideration of different factors for every situation because no two foundations or families are the same. Here are some of the things the board might ask itself to sharpen the job description for its counsel and the review of available resources.

Question #1: What Legal Issues Do We Anticipate?

This question relates to the garden-variety concerns shared by every foundation, such as compliance with applicable tax rules, as well as the special and unique concerns raised by the circumstances of the particular family.

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1. General Needs

- Handling basic tax issues of tax-exempt organizations;
- Explaining and monitoring private foundation excise taxes (self-dealing, minimum distributions, etc.);
- Apprising the board of fiduciary and other responsibilities;
- Minimizing the liability of directors and officers; and
- Ensuring compliance with state nonprofit corporation (or trust) laws.

2. Examples of Specialized Needs—The unique nature of the foundation, the family that creates and operates it, or the property used to fund it may dictate special considerations:

- What unique contribution issues exist? Examples might include ongoing contributions of artworks, appreciated investments, or closely held business interests.
- What secondary offerings might be necessary to market securities transferred to the foundation?
- What about technical structural issues? Should the family consider a supporting organization? A private operating foundation?
- What considerations would be raised by foreign grants or operations?
- Does the foundation support scholarships, academic travel, etc.?
- Will the foundation have business operations?
- Will there be lobbying activities? Political involvement?
- What need is there to review compliance with any special governmental or regulatory rules (food and drug law, specialized facility permits, etc.)?
- What other specialized legal issues exist? Examples might include health care issues, intellectual property, litigation, free speech/first amendment issues, civil rights, and civil liberties.

Question #2: What Do We Want in Our Legal Counsel?

Every foundation will want a top-flight person who can handle all of the anticipated issues effectively and economically. But there may be other considerations. Does the board prefer a silver-haired attorney with many years of experience, or a younger attorney who can be around to provide the foundation with vigorous advice for many years to come? Would trustees prefer an independent attorney or a large (and thus more diverse) law firm? How important is it to use counsel based in the foundation's home city? Might a connection in New York (or Los Angeles, or Chicago, or Salt Lake city, or ...) be important for any reason?

The family or the donor may have thoughts about the sort of person to be engaged. Because the relationship will be a personal one and may continue for many years, it is important that the donor and family be comfortable with attorney selection and be able to work closely with counsel. Any traits that may annoy or otherwise complicate the working relationship should be carefully considered. The older

generation of the family might learn something useful from the views of younger family members in this regard, for this is a choice that, properly made, may have effects that last for many years.

Question #3: What Resources Are Available Within the Family or Its Business?

Before striking out to hire new counsel, the family should evaluate the legal resources already at its disposal. Available options might include any of the following:

- Current counsel to the family or the family business;
- The family office (or related connection); and
- Family members.

If a family business or family office exists, the family should consider whether the foundation can and should be made a part of this arrangement. A family business or office usually has access to such counsel. Likewise, the family may have a long-standing relationship with a full-service law firm that can provide counsel.

Such possibilities should be examined and evaluated but need not be accepted at face value. Special considerations may dictate a particular approach. Assume, for example, that members of a younger generation create a foundation expressly to serve their own fields of interest and thereby distinguish their interests from those of their parents and grandparents. In such circumstances, the younger generation will often be intent on finding new advisors, including legal advisors, who reflect and share their own viewpoints and values.

In the absence of such a determining factor, the family should consider and evaluate carefully the available legal resources. Savings in time and expense may be expected if legal counsel is familiar with the family's situation and need not spend time assembling information and evaluating that situation. Possible problem areas may be identified sooner, or even avoided altogether, if counsel has a head start on learning about the family's situation and details concerning its makeup, values, goals, and internal structure.

On the other hand, available counsel may not have the specialized knowledge that a foundation assignment demands, and this deficiency can be more easily determined when the family is already familiar with the prospective counsel. By calling the prospect's other foundation clients or asking him or her directly, the family can establish whether available counsel has experience with nonprofit and foundation legal and tax issues.

What about family members themselves as counsel? Perhaps a son or daughter is a recent law school graduate and proud parents propose to designate him or her as foundation counsel. Or the donor family may include mature and experienced attorneys who may offer, personally or through a law firm, expertise in line with what the foundation's board expects to require. Although not necessarily a bad idea, this approach does raise several potential concerns. First is the question of competence



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and experience. A young lawyer from within the family may be a good choice if engaged in a practice that offers training and experience in the areas in which the foundation expects to need counsel. This may not be the case, however, if the young lawyer is headed toward a career in antitrust or securities law and is not independently trained (or even interested) in the areas needed to guide the foundation.

Another concern involves the possible application of the self-dealing rules. A foundation may hire a member of the donor's family to render necessary services, provided the amount paid is demonstrably reasonable. Many legal advisors recommend that family members serve without pay and view their employment as a pro bono service for which payment should not be expected. This approach is not necessary, at least insofar as Internal Revenue Code rules on self-dealing by the foundation are concerned, but it may be worth considering as a "high road" means of ensuring that the problem will never arise. The donor who sees pay as a way to provide income to an offspring should be cautioned, because this approach can easily give rise to a questionable situation over time. Also, even if a family member can be hired under the self-dealing rules for federal tax purposes, applicable local law may be a factor. Several states impose limitations on such arrangements, and these must be complied with.

Question #4: What Other Legal Resources May Be Needed?

Once the family has outlined what it needs and wants, and readily available legal resources have been considered, what next? Turning to the sources already identified, the family can choose promising candidates to comprise the initial roster of possibilities.

Here is where the process often turns from internal considerations to an examination of what is available in the larger world. The qualifications, advantages, and disadvantages of every candidate on the original roster should be compiled, compared, and contrasted. The strengths and weaknesses of local law firms must be examined. The family will need to determine which firms hold themselves out as specialists in representing nonprofit organizations and private foundations. Because no certification or other credentialing process exists to aid in this part of the process, the family will have to be prepared to resist sales pitches from lawyers and law firms. There are no universal guidelines here, but the following potential questions may help distinguish among the candidates under consideration:

- *Do you have other family foundation clients? Will you give us the names and addresses of clients comparable to us?* For privacy reasons, the candidate will probably wish to secure the clients' permission before giving out their names and/or addresses, which is a legitimate concern.



- *What other relevant training or experience do you have?* The candidate may have attended continuing legal education courses, worked pro bono publico for a nonprofit organization, or attended conferences on philanthropy—all of which indicate professional interest in the subject.
- *What articles have you written or what professional talks have you delivered relating to private foundations, charitable contributions, or other nonprofit organizations?* This question is designed primarily to elicit indications of how deeply the prospect is interested in the subject. A professional who has lectured or written on foundation topics is able to offer at least one objective indication of interest. A negative response should not be regarded as prejudicial because not all attorneys engage in professional speaking or writing, but a positive one is a good sign.
- *What are your other relevant professional memberships or activities?* Here again, the candidate can show a larger scope of interest beyond the prospective engagement by your family foundation. Professional memberships might include the local affiliate of the National Committee on Planned Giving. Pertinent committee memberships might be in national groups, such as the American Bar Association or the American College of Trust and Estate Counsel, or in state or local bar groups. Look for committees whose names imply concern with nonprofit organizations, private foundations, or charitable planning. Other relevant activities include service on the board of a foundation or nonprofit organization, the Council on Foundations, or regional associations of grantmakers.
- *Are you in a position to take on this family foundation as a client and provide the services needed, without delegating to inexperienced lawyers?* A lawyer may accept a role as counsel without adequately considering the time required and available. The result can be inadequate preparation for or inadequate attention to the needs of the foundation. In some cases, various tasks may be delegated to junior lawyers who may not have the background and experience the donor family sought to retain. This point can be discussed in advance. Although a client is not entitled to demand exclusive attention, the point is worth raising if the issue appears to be important under the circumstances.
- *What contract and fee arrangements would you propose?* Fees should be discussed at the outset, after the scope of the services to be rendered has been worked out and reviewed with prospective counsel.





Fee Arrangements in General

The compensation to be paid for legal advice is an important part of the selection process, and here the family may either set its own requirements or ask the candidates what they envision as appropriate. In some instances, a flat fee may be appropriate. Hourly charges at standard rates may be preferable for other tasks. A monthly or annual retainer, covering all routine services, may be worth considering. In many cases, some combination of these methods will best fit the bill.

A retainer arrangement may offer at least two advantages. First, this arrangement permits the foundation to budget in advance for its routine legal needs and even out the flow of these expenses. Second, if the foundation pays counsel on retainer, its staff (if any) and officers are more likely to consult counsel regularly and in advance of trouble, when problems can be more easily averted. By contrast, foundation personnel may be reluctant to call counsel if every call generates a bill.

A flat-fee arrangement is more appropriate for specific, well-defined projects, such as the creation of the foundation and processing of its exemption application. If a shared responsibility arrangement is used, the specialist may be relied upon for these tasks and for guidance on operations. Later, local counsel can be responsible for day-to-day guidance, with the specialist available as needed. Under such circumstances, the two attorneys would normally be compensated on different bases.

Whatever method is ultimately selected, the family should bear in mind that a foundation or nonprofit specialist is just that—a specialist whose charges may be somewhat higher than the average of attorneys' fees in the region. Also remember that, although the foundation is a charitable undertaking from the standpoint of the donor family, it is probably a fee-for-services project for counsel. This perception can be to the advantage of the foundation, which will be a professional client and not a favor-seeking suppliant when legal services are requested.

Many foundations and other nonprofit organizations make the mistake of relying entirely upon volunteer counsel, whose main attraction is the lack of fees, only to realize too late the inherent shortcomings in such a relationship. Those shortcomings result primarily from the fact that a non-remunerative task is likely to be assigned a lower priority, be assigned to less-experienced junior attorneys, and be given only cursory attention from supervising attorneys. In short, a "free" legal counsel arrangement may result in all of the things one might expect from a relationship that the participants do not value highly.

Shared Responsibility?

The optimum solution will sometimes be the obvious one—a single attorney or firm capable of serving all the legal needs of a family foundation. In certain circumstances, the legal needs of a foundation will call for more than a single source of legal counsel. This is an area where the family's preparation can help simplify things by dividing the tasks into several areas. For example, a local and thus easily accessible attorney may be well able to serve the routine tasks of corporate housekeeping,



preparing minutes, complying with local licensing and employment regulations, and the like. Items such as Internal Revenue Service compliance, contribution issues, and other more technical points might be handled by another attorney who specializes in these areas. Together, these two can serve all of a new foundation's needs and, over time, the local attorney might grow more proficient in the areas initially served by the out-of-town specialist.

Shared responsibility has often proven useful to family foundations. Everyday services can be obtained from a convenient source who is familiar with the donor family and its legal and financial background. A trusted attorney who has an in-depth knowledge of the family's overall situation is uniquely qualified to provide guidance that helps build the family's confidence and simultaneously provides the information that allows the specialist to serve his function more expeditiously.

The specialist in such a shared-responsibility arrangement provides guidance on issues that are unique to the family foundation. These would include compliance with the private foundation rules under the Internal Revenue Code, review of tax returns, guidance on any new categories of grants or other activities, and most important, an ongoing review and monitoring of foundation activities to ensure compliance with the applicable standards. The specialist should be able to provide references to other families served in a similar capacity, and those other families may prove to be a valuable source of information regarding their experiences when they were at a comparable stage of their own voyage into organized philanthropy.

Is it realistic to expect that the family will be able to find two capable attorneys who are willing to work together, share responsibility, and give the client the guidance called for? The answer should be "yes." Candidates should be asked if they foresee difficulties in sharing responsibility and working together effectively as colleagues and not as competitors. The donor should be involved personally in choosing this team, because success depends on the parties' ability to cooperate and to make their contributions unreservedly.

Sensitivities are important here. The donor may have chosen a long-time friend and advisor to help create the foundation. This attorney may regard the donor family as his most important client, or even the only clients served. Naturally, this person will be reluctant to see another attorney brought into the picture, and it will be necessary to spell out the shared responsibility that is envisioned.

The specialist attorney likewise must be made comfortable with the role that is being offered, and it is the responsibility of the client to make clear just what is desired and, even more important, what is not contemplated in the relationship. This clarification may be understood by designating the specialist as "special counsel" or some term that makes it clear that his function will be limited to the family foundation and its unique legal needs. This boundary-setting will both delineate the responsibilities assigned to the specialist and reassure the family counsel that he is not to be replaced, only supplemented, by the arrival of this new counsel.



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III. ENGAGING A LEGAL ADVISOR

A major factor complicating the choice of legal counsel is the bewildering array of potential providers. Recent years have seen upheavals in the legal profession and its provision of legal services. Many law firms have consolidated and evolved from relatively small local establishments into large regional and national enterprises. Accounting firms have grown even more dramatically and displaced law firms for many kinds of advice, particularly in the tax field. These large providers may offer nationally prominent expertise that appears to be just what is needed. This expertise may be available at a distance (such as from an individual or group stationed in an office of the firm located far away, but serviced through the firm's local outlet) or at a great expense. Here again, the family's choice should be made after carefully evaluating the services needed and the full range of options available.

A family foundation needs legal counsel who is familiar with the problems of nonprofit organizations in general, and private foundations in particular, and has some practical experience in this area. Such counsel will probably be easier to locate in an urban or suburban region than in a small town in a rural area, but it would be wrong to assume that such counsel is available only in large cities. Inquiries with existing foundations may help locate such specialists in nonprofit law. The development office of a local college or other charitable institution will usually be able and willing to help find a knowledgeable and experienced specialist. Networking with other family foundations can also be an effective approach, as can inquiries to the Council on Foundations, the National Center for Family Philanthropy, or other interested organizations.

In the final analysis, the selection of foundation counsel is partly subjective, and the donor and family (or the board) should select the person they believe is best qualified on the basis of overall qualifications, both objective and subjective. The relationship may then be reflected in a formal engagement letter or memorandum that spells out the terms of arrangement. This letter should cover as many eventualities as possible, in order to avoid future disagreements and misunderstandings. In addition to the basic terms of engagement and compensation, it should address how expenses are to be handled. Will the foundation be charged for such normal overhead items as telephone calls, faxes, and photocopies? Will travel be limited to coach airfare, or will upgraded travel be permitted on some trips? What manner of communication, response, and reporting is expected of counsel? All of these and similar details can be included in this document.

One matter that may also be included is the question of continuity. How long is the engagement to continue? How will the counsel's performance be evaluated and on what terms might counsel eventually be replaced? The donor may, for example, want the renewal of counsel's contract to be at the will of the board.

A common format for the initial engagement of counsel is a contingent contract of perhaps one year, to be renewed upon mutual agreement. The contract should call



for an evaluation meeting between the foundation's chief executive and counsel at a definite time, perhaps ten months after inception. At that time, each may present views as to how the relationship is proceeding and what modifications might be useful. Even after the initial term, an annual evaluation is a good idea, for it reminds both parties that theirs is a reciprocal arrangement. This arrangement also helps assure the foundation and the family that counsel will remain mindful of their needs.

Ending the Relationship

No matter how carefully the selection process has been conducted, a time may come when the foundation and its counsel come to a parting of the ways. This parting may result from dissatisfaction on either side or from an unrelated event, such as the lawyer's departure or a change in the foundation's needs. Whatever the reason, the ground rules should be clear from the outset and expressed in writing. The engagement letter or memorandum should spell out what will occur if it ultimately becomes necessary to discontinue the relationship. Such points as return of files, payment of final invoices, and transitional arrangements should be described. By so doing, the agreement can help facilitate an amicable and dignified retreat rather than an unseemly scene that all parties will ultimately regret.

The foundation is entitled to the prompt return of its files, minute books, and other records in the departing lawyer's possession. The nature of the transition to new counsel will depend in large part upon the nature of the matters in progress. The old counsel should complete outstanding assignments that are already in progress, while new counsel should commence new matters. Some matters may not fit into such a pattern, particularly in the case of litigation already underway. It may be advisable for old counsel to continue representing the foundation until the matter is concluded or until some convenient cut-off point is reached.

As with any such relationship, it will be easier and more productive for all concerned if the parties are able to deal with such a termination as rationally and professionally as possible. Where this goal is not entirely attainable, the parties should take care that their actions not disrupt or distract the work of the foundation.

IV. CONCLUSION

The process of choosing and working with legal counsel is a necessary and important one and, properly handled, can enable a family foundation to better understand and carry out its mission. The process is simple at the core—the trustees must determine just what the foundation needs from its legal advisor, what help may already be available, and where the needed services may be found. By working with the counsel selected, the donor, the family, the board, and the foundation can then focus on programmatic concerns, confident that their philanthropic enterprise is guided by competent and dependable legal counsel.

Engaging INVESTMENT ADVISORS

By Kathryn McCarthy

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THOUSANDS OF SECURITIES DEALERS, brokers, and investment advisors are available throughout the country, and any one of them would undoubtedly be eager to manage a family foundation's assets. Because of the duties and responsibilities of handling a foundation's investment portfolio, however, investment advisors must be chosen with great care.

"The nuances of tax treatment and spending policies for foundations are not matters to be glossed over. Although many advisers may claim to be knowledgeable, a full understanding of foundation tax law and payout requirements can help an investment advisor take those actions that maximize the potential distribution requirement and perhaps avoid incurring unnecessary foundation excise taxes," says Chicago banker and foundation trustee Arthur Murray. "In the long run, it is desirable if family foundation assets are managed by someone with both experience and current knowledge of foundation regulations in addition to having a good investment track record, of course."

Trustees of endowed family foundations have two fundamental duties with respect to foundation assets. The first is a legal duty: to protect assets at all times and to exercise prudence in investing them. Trustees of a trust may be held to a higher standard of fiduciary duty in this regard than are directors of a corporation, but that is a matter of state law.

The second is a philanthropic duty, and the purpose of this chapter is to help trustees find the assistance they need to invest foundation assets in ways that will produce the revenue needed to carry out the mission and achieve the goals of the foundation. The donor or the trustees may establish the mission and goals, but it is up to the trustees to generate the financial and human resources needed to make grants now and in the future.

These considerations apply regardless of the nature of foundation assets or the degree of control over them which the trustees exercise. Family foundation assets cover a wide range: equities in Fortune 100 companies, stock in closely held family businesses, corporate bonds, real estate, private equity, and even venture capital stakes, and alternative investment strategies like distressed (and sometimes distressing) securities. Some family foundations may also hold positions in program-related investments or social investments. Finally, some family foundations experience no new additions to the endowment; others receive substantial additions at the time of the donor's death.



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A board's active involvement in the investment process depends on its experience and ability to devote time as well as the complexity of the foundation's assets. One board may exercise little or no control over investment of assets because they are held in trust and managed by a bank. Another board may assume full responsibility for the portfolio, however, because it consists entirely of liquid assets such as stocks and bonds. A third may be faced with Internal Revenue Service requirements to divest the foundation of closely held stocks in a family business.

Assets are, in any event, the lifeblood of every family foundation. The energy of the trustees drives the overall program, and their personal involvement and community contacts make things happen. But the assets produce the "juice" that enables nonprofit organization partners to get the job done.

Most family foundation boards are responsible for overseeing investment of foundation assets. Trustees may even take control of managing those assets, probably because a board member is skilled in that arena. Or the trustees may appoint, hire, or contract with someone to manage the assets—regardless of the foundation's size or legal form. In a family foundation, that individual may be a family member, a family friend who is associated with the foundation, or an outside professional hired specifically to accomplish the task. How a family foundation determines who will manage its investments and the responsibilities of the investment advisor are the subjects of this chapter.

WHAT DOES THE FOUNDATION WANT FROM ITS INVESTMENT PROGRAM?

In the philanthropic community, the ultimate goal of every investment program is to provide the funds needed to support the mission of the foundation. Because the Internal Revenue Code requires a minimum payout of five percent of total assets annually, every family foundation investment program must be designed to achieve that requirement. Beyond this basic requirement, however, investment goals vary from foundation to foundation.

For instance, the investment goals of a family foundation that expects to exist in perpetuity will be quite different from the goals of a foundation with a fixed lifespan. A perpetual foundation must be able to meet its payout requirements, pay taxes and administrative expenses, meet any other required financial obligations, and still increase the size of the endowment to keep up with inflation. A foundation that is spending out needs sufficient liquidity to spend down its endowment within the allotted timeframe.

Using Assets to Achieve Program or Social Goals

Some family foundations, like their counterparts in the larger world of philanthropy and the private sector, adopt strategies that link asset use or investment to social considerations. The leading approaches are:



- *Program-related investments.* Designed to further a particular program, these investments generally result in a below-market return in the short run but will hopefully result in the betterment of a community, or individuals within a particular community, over time.
- *Socially directed investments.* These investments are designed either to avoid support for particular products or companies, such as the tobacco industry, or to support a particular cause, such as a manufacturing company that designs energy-efficient products or a pharmaceutical company that is concentrating on finding a cure for AIDs.
- *Alternative assets investments.* This is a more aggressive approach to investing by providing private equity or venture capital to address social issues.

Whether the goal is to improve the economic situation in a particular community, support environmental or medical breakthroughs, or simply maintain or increase foundation assets, establishing goals is an essential first step in managing investments. For more information on this and other areas, please see *Investment Issues for Family Funds*, National Center Journal, Volume II, summer 1999.

WHAT DOES THE FOUNDATION NEED TO ACCOMPLISH ITS INVESTMENT GOALS?

In some ways, family foundation investment portfolios are very much like those of private individuals. Investments tend to accumulate and grow over time. Some are managed by a broker or investment manager, others are followed by a bank trustee, and still others have been filed away in a safe-deposit box to mature over time. Because of the nature of long-term investments, many different individuals and organizations eventually have control over a slice of the investment pie.

Although placing foundation assets in the hands of a number of different investment managers is essential to ensuring a successful program, coordinating the activities of these managers is essential to accomplishing investment goals. Every family foundation needs an individual who will:

- Develop or help foundation board members develop financial policies, and/or ensure adherence to existing policies; and
- Evaluate the performance of specific investments.

Because of the unique dynamics of family foundations, investment advisors frequently take on added responsibilities as mediators, consensus builders, and architects of foundation missions and goals. For instance, because the organizational culture of a family foundation is rooted in the traditions and idiosyncrasies of the original donors, their offspring, and subsequent generations of the family, investment



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DETERMINATION.

advisors must sometimes address the spoken—and unspoken—desires of individuals who are dead or no longer serve a governance function within the enterprise.

Family foundations generally seek investment advice from a variety of sources. Some advice comes from individuals who are formally trained as investment advisors; some comes from persons who are not investment advisors by profession but have shown great aptitude and gained much experience in this area. Individuals and organizations that fulfill the investment advisor functions for family foundations include:

- *General advisor:* A family member, lawyer, accountant, philanthropic consultant, individual investment advisor with a business dedicated to managing money, a trust bank that provides multiple services, or a combination of the above.
- *Investment consultant:* A consultant can help trustees to establish a decision-making structure for investment management, develop a strategic asset allocation plan, and find appropriate investment advisors and managers. Some boards ask their consultant to return from time to time to review investment performance, and comment on the extent to which the foundation mission and investment performance are in synch.
- *Investment committee:* A group formed by the trustees who are charged with overseeing all aspects of the investment program—reviewing the work of a hired consultant, taking on some investment advisor functions, such as developing an investment plan, and sometimes supplementing the work of a hired consultant. Members of the investment committee may include outside professionals as well as trustees and staff.
- *Manager:* A foundation employee or outside investment professional manager who implements the investment program and actually handles the day-to-day activity of the portfolio. The manager may also be responsible for some administration relating to the foundation's philanthropic activities such as disbursing funds.
- *Investment custodian:* A bank or trust company whose duty it is to hold, safeguard, and account for assets placed in its care. For a fee, custodians generally hold securities, collect income, and report on investment activity, income, and holdings.

Should Family Foundation Assets Be Managed By the Family?

Although the majority of family foundations seek investment advice from professionals outside their organization, the amount of assets plays a key role in making that determination. For instance, some foundations with less than \$10 million in assets retain in-house investment management, but most do not. Some family foundations with assets of from \$10 million to \$15 million undertake investment man-



agement with internal personnel and some seek outside assistance. Almost by definition, however, larger foundations (more than \$15 million in assets) have both inside and outside managers.

Family Foundation in Trust Form Uses Bank for Investment Management

The Alfred Bersted Foundation (1998 assets: \$26 million) was created a number of years ago by a Chicago-area based family. Its assets were managed by a bank during the lives of the donor and his widow. Upon the donor's death, a perpetual charitable trust was created to serve as a vehicle to continue the family's philanthropic interests in a certain geographic area, with the Chicago office of Bank of America acting as trustee of the foundation. During her lifetime, the widow advised the bank on grant proposals. The bank now not only manages the portfolio, but also takes care of all of the foundation's affairs, including all grant administration.

"For a bank to be acting as trustee or co-trustee" says Arthur W. Murray, Bank of America senior vice president in Chicago, "the foundation must be organized in trust form. A bank can, however, also be engaged as an investment manager only without being formally named as a trustee. In fact, the investment management relationship is often the more common use of the bank's services. Many banks and investment advisors seek to manage foundation assets because foundations tend to be very desirable, stable, long-term clients. But not every institution or asset manager has the experience in grant administration or wants to be involved in all of the foundation recordkeeping and tax work. So that's a factor too."

WHAT AN INVESTMENT ADVISOR DOES

The role of an investment advisor is generally spelled out in the foundation's investment policy. Such a policy:

- Documents investment objectives, performance expectations, and investment guidelines for foundation assets;
- Specifies the investment strategy that will be employed to manage foundation assets, including the investment time horizon, risk tolerance, and asset allocation;
- Establishes guidelines that will be employed to control risk and liquidity requirements;
- Defines the parameters for periodic performance reporting that will be used to monitor investment results and ensure that the investment policy is being adhered to; and
- Specifies fiduciary, prudence, due diligence, and legal requirements for foundation assets.

If the foundation lacks an investment policy, one of the first orders of business for the trustees is to establish one. An investment committee is helpful in this process. Investment advisors, particularly those with broad investment capabilities, are also



good resources and are helpful in developing an investment policy statement. Without an investment policy, investment managers lack the road map needed to guide investments, and family foundations lack the framework upon which to evaluate the effectiveness of their advisor's efforts. (A sample investment policy statement for a foundation is provided in Appendix G.)

WHAT INVESTMENT EXPERTISE DOES THE FAMILY HAVE IN-HOUSE?

Trustees are one of a family foundation's most precious resources. If one or more trustees has the expertise, the time, and the desire to research and recommend investments, the Internal Revenue Code will permit the foundation to pay for such services. There are, however, a number of pitfalls to in-house investment management:

- Providing advice and managing investments is a time-consuming process. To be successful, the investment advisor must have sufficient time to both manage and report on investments on a regular basis;
- Diversification is the key to effective investing. A particular trustee's expertise and qualifications to buy and sell may be limited to one area of investments;
- If investment goals are not met, family members are likely to place blame on those who have been performing the advisor function;
- Internal disagreements concerning investment decisions are more likely; and
- Evaluating and disciplining a family member or family friend who sits on the foundation board is more difficult, and firing may be next to impossible.

Still, quite a few family foundations have mounted very successful investment programs by putting the expertise and experiences of in-house personnel and trustees to good use.



Wall Streeters Manage Own Portfolio

When should trustees feel comfortable in being their own investment managers? For members of The Mary A. and John M. McCarthy Foundation of New York City (1998 assets: \$5.6 million), the answer was very straightforward and obvious—now. After a successful career as a managing partner and chief investment officer of Lord Abbett & Company (a \$28-billion mutual fund complex), John McCarthy teamed with his oldest son Stephen to set up a small family investment office in 1994 (KCG Capital Advisors) to manage and diversify selected investment assets, including the private family foundation. Given the extensive experience in research, trading, and portfolio management resident within the family (Stephen McCarthy has an M.B.A. and more than twenty years of financial services industry experience, and another son, Neil, manages his own highly successful \$250-million investment firm), the assets of the family foundation have increased significantly under the vigilance of an ad hoc investment policy committee, more than doubling in the past four years of active “value-oriented” equity management.

"While for some, managing family assets well can be fraught with peril—and on occasion truly dangerous to one's wealth—many entrepreneurial donors have the wherewithal to succeed in this arena as well," notes Stephen McCarthy, trustee and day-to-day portfolio manager. "On the other hand, for most small foundations lacking in-house financial expertise, a reasonably diversified portfolio of equity and fixed income mutual funds could provide the necessary performance and professional oversight to meet one's fiduciary responsibility as a trustee." He believes that separate account managers can really add value via sophisticated asset allocation analysis and product diversity (international equities/fixed income, alternative assets, etc.) when a foundation reaches more substantial levels (greater than \$5 million to \$10 million in size).

Another example of a family member with a background in investment management is Jennifer Steans. She is a trustee of the Steans Family Foundation in Chicago (1998 assets: \$25 million), and is also vice president, secretary, and director of the Financial Investments Corporation of Chicago. The company specializes in initiating, structuring, and monitoring performance of investments.

HOW CAN THE FOUNDATION FIND AND RETAIN THE PROFESSIONAL ASSISTANCE IT NEEDS?

Investment advisors come in many shapes and forms: registered investment advisors, managers of mutual funds and mutual fund families, bank trust companies, bank trust departments, financial planners, family offices, insurance companies that have acquired investments firms, and TIFF—The Investment Fund for Foundations. Because investment advice comes from so many different sources and kinds of organizations—banks, brokers, financial planners, etc.—identifying those who have direct experience with family foundations is often difficult and time consuming.

Donors and trustees for many family foundations, particularly start-up foundations, prefer to find an investment manager who has dealt with other family foundations. Such an advisor may be more likely to understand payouts, liquidity, and family dynamics, and may be able to relate general investment strategy to the foundation's mission and goals.

The best way to locate such a person is to:

- Ask others in the philanthropic community—family, private, or community foundations—for recommendations;
- Identify family offices that manage family foundation assets;
- Conduct research in the printed media or on the Internet; or
- Contact professional associations for investment advisors, or ask other professionals like lawyers or accountants who have been instrumental in starting one or more family foundations.

DONORS AND
TRUSTEES *for*
MANY FAMILY
FOUNDATIONS,
PARTICULARLY
START-UP
FOUNDATIONS,
PREFER TO *find*
AN INVESTMENT
MANAGER WHO
HAS DEALT WITH
other FAMILY
FOUNDATIONS.





Entering descriptors such as “institutional+advisors+foundation,” or “investment+advisors” on a search engine will result in a plethora of information on the Worldwide Web. In addition, sources of information for locating investment advisors and other consultants include:

- *Institute for Private Investors (IPI)*. This membership organization comprises 300 individuals and family offices and 125 advisory firms. Its mission is to provide a “safe harbor” for individuals with \$10 million or more who seek to learn how better to manage significant wealth through briefings and programs where members can compare notes with others in similar situations. Although the Institute facilitates communications between members, it does not sell investment products or provide investment-consulting advice, and thus it can act as a neutral facilitator.
- *Association for Investment Management Researchers (AIMR)*. This professional association of professional investment managers can be invaluable in obtaining training on investment management, and other investment management-related tasks, and in the search for candidate investment advisors.
- *Family Office Exchange (FOX)*. Established in 1989, the mission of this membership organization is to provide members with information on industry best practices, help families identify and prioritize wealth management goals, locate strategic financial resources, and find qualified investment advisors. The more than 400 members of this association include family members, family foundations, and investment advisors. Members participate in conferences and forums, and receive newsletters and educational materials.
- *Council on Foundations*. The Council’s Foundation Management Series, 9th ed., Vol. 1, “Finances, Portfolio Capacity, Investment Management, and Administrative Expenses in Private Foundations,” is an excellent resource on this subject.

IPI, AIMR, FOX, and the Council on Foundations all maintain sites on the Internet. (For addresses and additional contact information, see Chapter V.)

Sometimes trustees and foundation managers are found where they are least expected—in the offices of a foundation’s legal counsel, for instance. Such is the case with Hemenway & Barnes, one of the oldest law firms in the city of Boston. For over a century, the firm has offered its clients an unusual blend of legal and fiduciary services, serving as trustees of clients’ trusts and executors of their estates. For decades, partners in this firm have served as trustees and executors for clients. As a consequence, they

have had principal responsibility for managing substantial portions of clients' assets—while also managing their legal affairs—and have come to be relied on as advisor and counselor to families and their foundations as well as foundation trustees.

In addition to these, investment services are also sometimes offered by family offices. For instance, family foundations with a certain minimum asset size can qualify for financial and investment services from Rockefeller & Co., which is part of The Rockefeller Family Office.

Taking the Consultant Route

Consultants often offer an excellent way to put a family foundation on the road toward effective investment management. They can help both in establishing investment guidelines and in asset allocation.

On the positive side, consultants, by their nature, are experienced in providing investment advice for family foundations. They know the market, have a broad view of potential investments, and have extensive experience at producing reports and conducting research on new prospects. On the negative side, consultants are expensive, can be slow to spot problems, do not always think in terms of the long-term, and sometimes lack experience as money managers.

At points of transition, or when the foundation is working with diverse asset classes—venture, nontraditional strategies, etc.—contracting with a consultant may be the best approach. In many instances, however, particularly when the assets are smaller and the investment program is not complex or illiquid, a financial planner or mutual fund consultant may be a better answer.

Finally, an important issue with consultants is cost. Consultant fees vary and will depend on the size and asset classes of investments. Some consultants require as much as \$50,000 up front and do not wish to become involved with a foundation with assets of less than \$10 million. If a consultant's fees are high, but the consultant-foundation match is good, ask for extra reports, discounts on custody fees, and other considerations.

Hiring a Manager

Successful funds management requires a combination of informed, intuitive decisionmaking and carefully calculated analysis. Hiring the appropriate investment advisor requires the same kinds of skills. The hiring process should always involve an investigation of the candidate's "three Ps":

- *People skills.* Successful managers have strong leadership skills. The workforce they manage is stable. They provide incentives for employees to excel. They are able to articulate the elements that go into a successful investment program. They have integrity.

CONSULTANTS OFTEN
OFFER AN *excellent* WAY
TO PUT A FAMILY
FOUNDATION ON THE
ROAD TOWARD *effective*
INVESTMENT
MANAGEMENT.





- *Process skills.* Successful investment portfolios do not occur by accident. They require expertise in investment opportunities and an ability to tailor the plan to meet the specific needs and goals of the foundation. It is critical to understand how decisions are made—by committee, by consensus, by fiat from the chief investment guru or individually, portfolio manager by portfolio manager. In assessing the qualifications of a candidate and how well the candidate's experience and investment philosophy fits with the foundation, it is important to determine:
 - What valuation methods or models would be employed;
 - What kind of research (in-house or using more generally available street research and databases) would be undertaken before making specific investments;
 - How investment opportunities would be identified—by taking a macro (top-down) or bottom-up (stock-by-stock) view;
 - How many asset classes would be followed;
 - What considerations would be given to capitalization—large companies, small ones or a mix;
 - What would be the style of investments—growth or value, a blend;
 - How would the foundation portfolio be constructed (how would buying and selling occur, number of securities, cash position); and
 - What, if any, conflict of interests would result from the firm's organizational structure of investment practices.
- *Performance/investment returns.* In many areas of foundation life, performance review can be a somewhat subjective process. In the case of investment advisors, however, objective criteria do exist which can give some indication of whether the foundation's investment objectives and goals can be met. During the hiring process, it is imperative to determine the candidate's performance as compared with peers as well as the appropriate market indices. Find out the reasons behind obvious successes as well as failures. Look at the long-term results as well as the short-term ones.

Six Tips for Successful Interviews

Manager interviews are a critical part of the process of selecting an investment advisor. In addition to measuring basic skills, here are six tips for successful interviews:

1. Establish the same agenda for all candidates and then be sure to follow that agenda;
2. Conduct interviews in the candidate's office;
3. In a small firm, probe beneath the marketing persona to the genuine, thoughtful person beneath. If you are dealing with a larger firm, make sure that you meet the actual portfolio manager or team, not just the marketing person;
4. Ask for and review carefully reports that the candidate has prepared for other clients;

5. Understand the program that the candidate proposes and ask for clarifications on any points that are confusing; and

6. Ask for the names of clients and competitors.

Finally, it is essential that potential candidates be clear on any special requirements of the foundation. For instance:

- How many written reports are required each year (quarterly reports are fairly common);
- How many meetings will be devoted to investment issues and necessitate attendance by the investment advisor (between one and four per year are common);
- Who from the foundation will work directly with the advisor (investment committee, executive director or lead staff person, or full board); and
- Who will be responsible for evaluating the advisor and by what means.

Discussions regarding compensation will likely focus on various approaches, but it is important to understand the various ways investment managers are compensated—as a percentage of assets under management, commissions, flat fee, incentive fee, or a mixture. Candidates should be asked to submit written proposals that cover the basics for compensation, expenses that are reimbursable, and other terms of engagement.

Family Foundation Finds Resources Close to Home

Trustees of the Cudd Family Foundation of Monroe, Louisiana, have managed the assets internally since the foundation's inception in 1987. A substantial portion of the foundation's \$5 million in assets is invested in one concentrated stock position, explains Blair Naylor, a trustee and daughter of the donors. The other portion has been invested in a diversified portfolio of common stock. The assets have risen in value and have needed little tending.

Now, the outlook has changed. "After recently selling a large portion of our concentrated stock position," Naylor says, "we are now allocating the proceeds among various asset classes and styles."

"Recently, we've been looking at the possibility of finding an investment manager," Naylor says. With ten years of experience in the investment business herself, Naylor knows the field and many expert managers. "In addition to placing a portion of our assets with outside investment managers, we have a family member who runs a hedge fund and to him we are allocating a portion of the assets."

What is the foundation looking for in its first-ever outside portfolio manager? "We want to look at investment styles that will complement the existing stock portfolio and the hedge fund," Naylor says. "We will consider managers within those investment styles who can exhibit long-term track records and above-average performance relative to their peers and to appropriate benchmarks."

MANAGER

INTERVIEWS *are*

A CRITICAL PART

OF THE PROCESS

OF *selecting* AN

INVESTMENT

ADVISOR.





How One Large Family Foundation Selects Its Investment Managers

With seven domestic and two international investment advisors hard at work, trustees and senior staff of the Meadows Foundation, located in Dallas, might seem ready for an occasional breather. But Meadows doesn't take a breather; staff constantly sweeps the horizon for new investment advisor talent, constantly evaluates the team in place, and regularly briefs the board's investment committee on outcomes and possible future moves.

"We continually talk with investment managers," says foundation vice president and chief investment officer Michael Patrick. "We maintain files. We look at the services they offer, and the results they produce."

Patrick's office prefers long-term performance in its advisors. "We recently asked potential managers for their quarterly results back ten years," he says. "We measured their outcomes against various indexes. The temptation is to use recent performance, but we want long-term results."

"We also look for intensity of discipline. If a manager is committed to following one style of investing, but changes because of market swings, that's not discipline. We want discipline."

For serious candidates, Patrick's staff conducts due diligence: a visit to the candidate's office, questions about the candidate's research and administrative staff, analysis of the firm's decisionmaking style (individually? by committee?) and confirmation procedures (must a second firm principal approve an investment?), and an assessment of the firm's consistency of style. Overall, is the staff appropriate to the firm's style and level of assets under management?

"When we look for a manager, it's like a football team looking for a good tight end," Patrick says. "We want performance, but most importantly we are trying to provide a specific and controlled exposure for the portfolio. Results from newly hired managers can be disappointing in the short term. We keep our eye on long-term results."

Getting the Most Out of the Relationship

Successful relationships with investment advisors are honed through clear, timely communications. In this arena, communications are a two-way street. The foundation's investment policy statement sets specific expectations and goals. Still, achieving those goals will require some interpretation on the part of the investment advisor. The foundation should expect communications from the investment advisor to be prepared in the specified time schedule and to include:

- A report that details portfolio investments, including cost and market value, on a quarterly or monthly basis;
- Investment returns achieved over various periods, compared with an appropriate benchmark and peer group by asset class;
- Brief and understandable information concerning the investment strategy; and
- The advisor's view of the markets and the economy as it relates to investment policy decisions.

These reports should be delivered to a predetermined group, including staff, consultants, trustees/donor, and the investment committee as appropriate. In addition, the investment advisor should be asked to produce special reports if:

- Investment performance has not achieved expectations;
- Changes in the money manager or key staff have occurred;
- Changes in economic conditions warrant reconsideration of investments; or
- New trustees have joined the board.

For the foundation's part, trustees must provide feedback to the investment advisor in a timely, productive fashion. Such feedback is critical to maintaining the investment advisor/foundation relationship.

Evaluating and Compensating the Advisor

Investment advisor performance should be evaluated on a regular basis: semi-annually, annually, or at other times agreed upon at the time of hiring. Evaluations can, and perhaps should, place a high value on long-term professional relationships. Evaluations are generally accomplished by comparing asset performance against industry benchmarks selected at the time the investment strategy was finalized. Examples of such indices include: the S&P 500, the Russell 2000, and the Lehman Brothers Aggregate Bond Index. Other issues to be considered during this evaluation include whether the advisor has adhered to the specifications of the investment policy, whether investment goals have been achieved, and whether communications requirements have been met. If the advisor is found lacking in any of these areas, the relationship should be reconsidered.

CONCLUSION: ASSET MANAGEMENT AND PHILANTHROPIC GOALS

A family foundation's trustees, directors, or investment committee would likely be delighted to report to the full board that investment goals had been met or exceeded, that principal was intact and had grown modestly, and that sufficient revenue was generated to meet federal payout requirements and support the grantmaking program. That's a fairly tall order, but one that most foundations should be able to meet most of the time.

Good judgment, common sense, and sound trustee decisionmaking and performance evaluation processes will protect the foundation's assets. Trustees can be confident that they will have fulfilled both their legal fiduciary duty and their philanthropic duty to the institution.

INVESTMENT ADVISOR
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BE EVALUATED ON
a REGULAR BASIS:
SEMI-ANNUALLY,
ANNUALLY, *or* AT
OTHER TIMES
AGREED UPON AT
THE *time* OF HIRING.

