



## Trust Owned Life Insurance

### *Issues Faced By Trustees with Existing Life Insurance*

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Life insurance is often central to many clients' plans. It can help them provide for surviving family, build cash values and, where there is an estate tax problem, help provide a source of funds for family liquidity. In many situations a client chooses to not directly own the life insurance. Instead, their planning is executed through a trust which, among other assets, might own a life insurance policy on the client or the client's spouse. Why would a client utilize a trust rather than own a policy outright? Often it is to keep the life insurance outside of the estate. In other cases it is for professional management to assure that the survivors are cared for. In still other situations, a client might want the privacy offered by some trusts.

Where clients have a trust, they must rely on the skills and knowledge of the trustee to assure that their trust meets its objectives. However, increasingly, concerns are being expressed that trustees are not living up to their obligations – putting both the trust objectives and the protection of the trust beneficiaries at risk.

We'd like to explore the various items that trustees need to be sensitive to. In particular, focus on the areas where trustees might be exposed to potential lawsuits and suggest some ways in which they might be able to better protect themselves. This article draws from the Uniform Prudent Investor Act, which varies from state to state, but offers a broad standard of care that is increasingly recognized by the courts. We will then consider some recent court cases that should be of concern to all trustees.

Many trustees are in need of quality advice regarding trust owned life insurance. We'll first discuss the standards of care that trustees are normally held to regarding the purchase and management of trust owned life insurance.

### The Uniform Prudent Investor Act and Other Standards of Care

Just as a trustee might monitor the investment assets in a trust, reviewing the trust portfolio to see if performance is meeting expectations, a trustee should also consider monitoring and reviewing the life insurance assets in the trusts that they are responsible for handling. In recent years a series of mechanisms have evolved that offer standards of care for life insurance as well as other assets. Particularly applicable are the Uniform Prudent Investor Act (UPIA) and recent standards for the purchase of life insurance set out by the Office of the Comptroller of the Currency (OCC). Although both evolved for different reasons, the standards of care are similar.

The Uniform Prudent Investor Act sets standards for trustees in the duty of managing and investing trust assets as any prudent investor would. It holds them to a standard of reasonable care, skill and caution. This uniform proposed law, first proposed in 1994, is currently adopted, in one form or another, by 48 states. Several key areas addressed by the UPIA are noted below. While these have not always influenced court decision in cases involving a trustee's judgment or lack of judgment, over life insurance, the themes of the UPIA set a standard that should be considered a minimum threshold for trustees.

It is important to keep in mind that the UPIA sets a basic standard that may vary from state to state. Moreover, a client can always draft a trust that holds a trustee to a higher or lower standard. The ability to reduce standards has helped trustees in some of the court cases, discussed below. Nevertheless, the trend in holding trustees to a high standard and enforcing that the standard is clear.

First, trustees must act in what is known as a fiduciary capacity, in effect bearing the burden of carrying out the trust's objectives for all beneficiaries. The UPIA specifically notes: "If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking in to account any differing interests of the beneficiaries."

This model act holds all portfolio assets to the same standard and requires that trustees not only monitor assets, but also assess risks and quality of assets given to the trust. Two key provisions note both:

- "... the trustee's continuing responsibility for oversight of the suitability of investments already made, as well as the trustee's decisions respecting new investments..." and,
- "Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets [and] implement decisions concerning the retention and disposition of assets..." "

Although life insurance is never specifically mentioned, it appears to clearly be covered by the scope of the uniform act, which states: "In the trust setting the term 'portfolio' embraces the entire trust." The UPIA sets out many standards for trustees to follow. Among these, the ones that are particularly relevant for life insurance are:

- Assessing risk tolerance taking into consideration "the purposes of the trust and the relevant circumstances of the beneficiaries,"
- Taking into consideration
  1. General economic conditions;
  2. expected tax consequences of investment decisions or strategies;
- Adequately diversifying the trust assets; and
- Considering an asset's special relationship or special value, if any, to the purposes of the trust.

Trustees are allowed to delegate decisions and investment selections to agents; however, the trustee is ultimately responsible for monitoring the agent.

These standards parallel those applied in much of the banking community regarding the purchase of life insurance. In recent years the Office of the Comptroller of the Currency (OCC) imposed fairly stringent due diligence requirements, on the banks it regulates regarding the purchase and monitoring of life insurance for banking and benefit purposes. In 1996 they imposed a ten-point pre-purchase assessment analysis. Although the focus of these guidelines primarily concerns use of life insurance relative to the bank's operational needs, the standards are similar. Among the items that banks need to consider, prior to the purchase of life insurance, are:

- Determining the need and quantification of the life insurance death benefit amount;
- Vendor / Agent selection ;
- Review of the appropriate types of life insurance;
- An analysis of the bank's ability to monitor the life insurance; and
- Carrier selection.

In the last several years the OCC has further honed their guidelines relative to variable life insurance. Clearly, the trend is towards setting standards relative to the monitoring of life insurance, and assuring that there is both a pre-purchase and on going review of the policies.

## Areas Where Trustees Need to Review Trust Owned Life Insurance

With these newly imposed standards, are trustees exposed to potential lawsuits involving trust owned life insurance? Quite possibly.

Consider that many trust owned life insurance policies were purchased five or more years ago and consider what has happened with the economy and within the life insurance industry in recent years. These changes involve many items that may cause a trustee to review their existing life insurance:

- Policies that are not performing as illustrated – it was not unusual to have policies in a trust that were illustrated assuming very high dividend rates or UL crediting rates. Even just a few years ago it was not unusual to see variable life insurance policies illustrated at 10 or 12% assumed gross rates. Small decreases in rates of return can have a significant negative effect over time.

- [Policies that are not sufficient for current needs](#) – a client’s needs may have changed and a different amount of death benefit might be needed. This ties in with the next item.
- [Newer products that may be more cost efficient](#) – although there seems to be no formal study, an often quoted factoid is that the majority of trust owned policies could be restructured to provide the same death benefit for a 40% lower cost, or 40% more death benefit for the same cost. Better mortality, better underwriting and the streamlining of expenses among major insurers have driven much of this.
- [New products that may offer better guarantees](#) – many of the new generation of products offer secondary guarantees, with potentially more security to a client than may have existed a few years ago.
- [New riders that may offer more appropriate features](#) – allow a trustee more options in designing a policy that meets a client’s needs. These include
  - Return of premium riders; and
  - Guaranteed death benefit protection riders
- [Some policies are scheduled for a jump in premiums](#) – this could be a matter of policy design (as in the case of older graded premium policies) or simply a function of poor underlying policy mechanics.

The jump in premiums is a particularly sensitive area. Many trustees may find a longer premium paying period or larger than expected premium payments. In many cases trustees may also face grantors that are not in a position to make these gifts. Why might a grantor not be able to make these gifts? There could be the death of a spouse, effectively halving a client’s annual exclusion gifting power. Other clients may be hesitant, or unable, to utilize their exemption equivalent because of other estate planning. Still others may stop premiums simply out of frustration at the added cost. Because the grantor has no obligation to make gifts to the trust, the trustee is left trying to meet trust purposes in the face of lower than expected financial policy performance. While many trusts do not require a trustee to maintain a life insurance policy, refusing to make premium payments may undercut the original purpose of the trust at a point when the planning is critical.

An often quoted statistic is that, based on today’s life insurance rates, the majority of existing trusts could obtain a 40% reduction in premium costs for the same amount of insurance, or conversely, could obtain 40% more death benefit for the same premium cost. The year 2000 study from which those values are derived, which entailed 45 trust companies, is actually much more involved than that statistic might indicate.

However, it is clear from the study that many trusts could obtain significant cost savings. In fact, the overall statistics from that survey indicated that approximately 74% - 79% of the trust companies could obtain a larger death benefit for the same premium and of the trust companies involved 8%-34% could obtain a greater death benefit while reducing the premium outlay from 55% to 82%. The policies involved in these trusts dated from pre 1980 through 1999, although the majority of the policies in the survey dated from 1990-1999, so even in these more recent policies presumably trustees could obtain savings. Add to this, changes in the financial stability of many life insurance companies along with the management changes many companies have seen in recent years. These financial or management changes would normally cause an otherwise investment savvy trustee to re-examine a particular asset in their portfolio.

## Are Trustees Living Up to the Task?

With all of these external pressures, are trustees rising to the challenge as it concerns life insurance? Surveys reported in Trusts and Estates would indicate that this is not necessarily the case. Several surveys over the years have indicated that anywhere from 70 – 95% of trust owned life insurance policies have no current servicing agent. Without a servicing agent, one would expect that a trustee would be closely monitoring the life policies. However, one recent survey, from the May 2004 Trusts and Estates, is particularly telling. The survey involved professional trustees as well as family and friends acting as trustees. While you might expect professional trustees would monitor their trust assets more closely than individuals acting as a trustee, as a favor for a close family friend or relative, both groups produced fairly similar results.

Of professional trustees, fully 83.5% indicated that they had no guidelines and procedures for handling trust owned life insurance. An even higher percentage, 95.3 %, had no guidelines for handling the asset allocation components of variable life insurance.

For non-professional trustees, 71.2% indicated that they had not reviewed their trusts' life insurance policies in the last five years. As with professional trustees, few non-professionals had any methods for handling the asset allocation component of variable life insurance with 94.7% indicating that no procedures were in place.

Why is it that life insurance is not managed as actively as other assets? Why is it that the dealings with life insurance tend to deal primarily with the day-to-day trust duties of accepting gifts, sending out Crummey Notices and paying premiums? There could be many reasons. It could be that life insurance is viewed as a long-term asset, not intended to mature for many years, or decades. As a result, it may not be viewed as an asset to be actively managed. It could be that trustees are dealing with a complex asset that requires the support of insurance specialists to which they may not have ready access.

Are professional and non-professional trustees held to different standards? Possibly yes. The UPIA notes: "Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals..."

In other words, this is a case-by-case determination. Even some of the court cases noted below seem to indicate different standards may apply in different circumstances. Nevertheless, nothing would appear to relieve a trustee in all circumstances.

## How a Trustee Might Be Sued

There appears to be increasing evidence that trustees are being sued for their lack of adequate conduct relative to life insurance. While there is little by way of specific court cases involved with the on going review, or lack of a review, over trust owned life insurance, other cases show a trend towards suits in other, related, circumstances. Moreover, as detailed below, there is a general sense within the professional community that many cases are being settled out of court, and away from the public eye, either because of the close relationships among trustee and non-trustee family members or because professional trustees are concerned with the negative publicity.

In many cases beneficiaries brought the suits. Typically, the client who established the trust and is the insured will not have the legal standing to bring suit because they are deemed to have no interest in the trust after it is established. However, in a few particularly extreme negligence cases, the trust's grantors were given the right to sue trustees even though they held no interest in the trust.

Areas where trustees have recently seen lawsuits are:

[Negligence in Maintaining the Life Insurance Policy](#) – In one case the beneficiaries sued a CPA acting as trustee for failing to pay premiums. In a second case a corporate trustee, over a period of years, accepted gifts but failed to pay the life insurance premiums. Ultimately the policy failed and the trustee could only obtain a new policy that was less favorable and at a higher premium cost. The grantor refused to pay to make these larger gifts to the trust. This case should emphasize the need to be sensitive to client/grantor gifting capacity. In this second case the grantors of a trust were given the standing to sue the trustee.

[Bad Investment Decisions](#) – there are numerous cases where trustees have been sued due to investment decisions, loans or other decisions that failed. In these cases the courts have been fairly evenly split, weighing a trustee's educated judgment against a beneficiary's disappointment.

[Poor Life Insurance Design or Improper Policy Selection](#) – There are several cases, including one against a major wirehouse, where the life insurance trust was set up with the anticipation of a specific premium paying pattern, after which the policy cash values were expected to support the death benefit. In several cases trustees or advisors were sued when actual policy performance required additional premium payments (and additional gifts). In one case beneficiaries sued because they believed that the death benefit purchased was lower than might have been obtained from different policy design at the same company. This latter case was settled out of court.

On a related track, a rush to implement a policy resulted in a policy placed with a trust that contained different terms than presented in the design process. A decision in that case held that the agent should be held to the same standard as the trustee because of their expertise and the relationship with the family.

Poor Selection of a Vendor – the trustees knowingly purchased the life insurance from a felon whose life insurance license had been revoked (the court held that the trustees breached their fiduciary duty in their choice of policies). It should also be noted that in many cases the beneficiaries did not win their suits. These include:

- The beneficiaries sued for improper accounting (the case was dismissed because of the close relationship between the beneficiaries and trustees);
- The trustee making loans to a business owned by the deceased 's estate (the court determined that the loan was reasonable);
- The trustee failing to adequately supervise investment activities (the court concluded that the beneficiaries were actively involved in the process with the trustees);
- The trustee purchasing an annuity as the primary asset despite the beneficiary being well below age 59 1/2 (the trust explicitly allowed such an investment); and
- In a case mentioned above, the trustee failed to make premium payments and the policy failed. The court determined that the clients had no legal standing, in part, due to the fact that the trust did not require the trustee to maintain the life insurance policies.

## Conclusion

Clearly, trustees are exposed to many potential suits regarding trust owned life insurance. Life advisors can help trustees by making them aware of these issues. There are several steps that trustees can take, with the help of life advisors, to assess their risks and correct potential issues. Among these are:

- Setting goals and standards regarding their trust owned life insurance. This includes:
  - Examining existing life insurance policies and comparing alternatives. There are several tools available to help with this work,
  - Examining client goals and beneficiary needs,
- Examining policy funding and determining if additional or alternative funding is necessary. This includes considering whether or not a client's gift giving capacity is able to support future premium needs,
- Considering a life insurance performance review:
  - Will universal life policies or participating whole life policies perform within a reasonable tolerance of the original illustrations or new client goals?
  - With variable life insurance, do the sub-accounts need to be re-examined based on evolving client needs and sub-account performance?

While even a thorough life insurance review will not uncover every problem, taking the necessary steps today can help trustees avoid potential problems down the road.