By Barry D. Flagg & Steven S. Zeiger

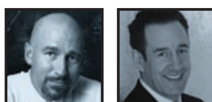
A Shot Across the Bow

A recent court ruling provides valuable guidance for ILIT trustees on the best way to serve their clients while steering clear of litigation

Last year, a ruling by the Indiana Court of Appeals, *In Re Stuart Cochran Irrevocable Trust*,[1] sent a shot-across-the-bow warning to trustees trying to navigate the changing irrevocable life insurance trust (ILIT) environment. In ruling for the trustee, the court provided valuable guidance as to how courts may apply the Uniform Prudent Investor Act (UPIA) to cases involving ILITs.

The court examined the prudence of an exchange of trust-owned life insurance (TOLI) holdings in accordance with the principles of the Indiana Prudent Investor Act. In so doing, it clarified the steps trustees should take to fulfill their fiduciary responsibilities and manage TOLI more effectively. If trustees follow a "prudent process" that incorporates information from "an outside, independent entity with no policy to sell or any other financial stake in the outcome,"[2] then courts shouldn't second-guess a trustee's decision regarding an ILIT's holding.

Trustees of ILITs had previously lacked guidance on how the courts would apply the UPIA to TOLI. Consequently, these trustees struggled to manage TOLI holdings with confidence while fulfilling their administrative duties. By following a prudent process prescribed by the UPIA, heeding the guidance provided by the court in *Cochran* and supplementing it with relevant parallel authority, ILIT trustees can better serve their clients, reduce litigation risk and potentially generate new fees and revenues.



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Poster-child Case

Though similar claims involving alleged breach of fiduciary duty by a TOLI trustee have been settled out of court, *Cochran* is the first such adjudicated case. It's a poster-child case because it concerns many issues ILIT trustees commonly face, namely:

- The agent and insured grantor appeared to have made policy selection and management decisions without involving the ILIT trustee.
- The ILIT trustee was asked to function as a custodian after the broker selected policy holdings, but the trustee nonetheless had fiduciary liability for product suitability.
- The life insurance agent/broker appeared to have sold flavor-of-the-day products to the same client three times in 15 years, but wasn't liable for those recommendations.
- Since the grantor had stopped making premium payments, the cost of the ILIT wasn't the premium (as is commonly believed) but rather the amount deducted from the account value.
- TOLI holdings were underfunded due to declining interest rates on universal life and whole life and/or stock market declines in variable life.
- The policy in question was projected to lapse prior to the grantor's life expectancy.

Legislative Context

The core of this case is the 1994 UPIA, which was adopted in 46 states and the District of Columbia and increased the responsibilities of all trustees, including

those of ILITs. Prior to the enactment of the UPIA, the duties of ILIT trustees revolved mainly around sending *Crummey*[3] notices, collecting gifts and paying premiums. Many states statutorily exempted ILITs from any standard of care regarding the suitability of current holdings. That responsibility changed as state legislatures adopted their own versions of the UPIA. The state laws generally apply to TOLI the same basic financial principles for minimizing costs and maximizing returns relative to risk that apply to other trust-held assets.

Ironically, the *Cochran* court observed that the replacement was intended to protect assets from further stock market declines, when in fact the trust realized a loss due to the exchange.

Trustees worked hard to comply and took considerable steps to monitor financial strength, claims-paying ability and lapse risk. However, not knowing how courts would apply the UPIA to the duty to investigate suitability, many trustees struggled to determine whether current holdings were suitable and what to do if they weren't.

After the UPIA was adopted in 1994, there was a period of uncertainty as litigation regarding the law made its way through the courts. During that time, trustees knew of the potential for liability but were unsure what to ask or were afraid to ask for fear that the answers would be beyond their ability to perform practically.

Case Seeds Take Root

The facts leading to the *Cochran* ruling began to take shape even before the UPIA was introduced. In 1987, Stuart Cochran created an ILIT to own $4.75 million of universal life, whole life and fixed annuity policies. The National Association of Insurance Commissioners' risk-based capital regulations[4] require cash values of these type of policies to be invested predominantly in high-grade corporate bonds and government-backed mortgages, both considered conservative asset classes.

In 1999, the stock market was booming, and variable life products gained in popularity. The insurance agent recommended replacing the original $4.75 million policies with an $8 million variable universal life (VUL) policy and allocated cash values predominantly to aggressive asset classes.

Then, the stock market correction in 2001 caused VUL cash values to decline by $37,000, a 7 percent *unrealized* loss. A 7 percent decline in cash values isn't unexpected from an aggressive asset allocation. We now know that the stock market rebounded, and policy cash values would have recovered if left alone.

The stock market decline also precipitated a decline in the popularity of VULs. So in 2003, the agent recommended replacing the $8 million VUL with a $2.5 million guaranteed universal life policy. Ironically, in reaching its conclusion, the court observed that this replacement was intended to protect trust assets from further stock market declines. In fact, it resulted in the trust realizing a 20 percent loss of assets due to a $107,000 surrender charge Cochran had to pay to exchange out of the VUL.

An independent consultant hired by the trustee to review the portfolio questioned the proposed replacement and surrender charge. The consultant pointed to the drastic decrease in death benefit and asked if it was what Cochran wanted. Once the trustee confirmed that it was, the consultant agreed to the recommendation, and the death benefit was reduced from $8 million to approximately $2.5 million.

This was the third exchange of Cochran's trust holdings pursuant to the agent's recommendations, whose methodology more resembles flavor-of-the-day marketing than sound trust investment policy. No surprise, the agent's changing recommendations reflected changing market trends in what were the most popular policies at the time, namely universal and whole life in 1987, variable universal life in 2001 and guaranteed universal life in 2003. This pattern is all too common in the absence of an investment policy statement.

Seven months after the 2003 policy change to

Cochran's trust, Cochran died at age 53. As a result of the trustee's change to the ILIT, its beneficiaries were entitled to only the reduced death benefit and quickly sued the trustee for breach of fiduciary duty and violation of Indiana's version of the UPIA.

Clarification Provided

The trial court noted that the ultimate question was whether the trustee's actions were consistent with the grantor's intent. Given that death benefits changed over time, the court framed the question: Was it prudent for the trustee to move from policies with higher death benefits but significant risk of lapse to one with a smaller but guaranteed death benefit?

Emphasizing the process more than the product or result, the trial court ruled in favor of the trustee, because it determined that the trustee had followed the material elements of a "prudent process." In making that ruling, the trial court also considered the potential dangers of a fluctuating market and the likelihood that the policy would lapse if it were left unchanged. The Indiana Court of Appeals upheld the trial court's ruling. It noted that the trustee's use of information from an independent entity with no stake in the outcome was a key factor to consider in determining whether the trustee met its fiduciary responsibilities.

> A key factor in the appeals court's ruling was the trustee's use of information from an independent entity with no stake in the outcome.

Indeed, both courts' rulings might have been different had the trustee been unable to demonstrate that it followed a prudent process by performing all three duties related to the management of TOLI holdings and incorporating independent, third-party information.

Easy as 1, 2, 3

According to UPIA Sections 7 and 2, managing trust assets begins with ensuring that costs are "appropriate and reasonable in relation to the assets" and "the purposes of the trust," and the trust has an "overall investment strategy [with] risk and return objectives reasonably suited to the trust" that considers the "total expected return." Investment trusts often include an investment policy statement that documents these objectives. ILITs, too, increasingly use these policy statements.

With these objectives in mind, the prudent process that trustees of ILITs and other trusts must follow, as conveyed in the UPIA, involves three duties: to monitor, investigate and manage the trust.

1. **Duty to monitor.** This is largely a recordkeeping function involving the trustee's continuing responsibility to observe the suitability of current and future investments. It doesn't mean making any changes to the trust. The trustee must monitor factors such as default risk and lapse risk. Most trust recordkeeping systems lack fields to account for life insurance values, death benefits and premiums and have no direct data feeds from insurance companies. Third-party administrators are helpful in collecting and monitoring necessary information.

2. **Duty to investigate.** This means "to examine information likely to bear importantly on the value or the security of an investment" according to the UPIA. Investigating whether a given policy held in trust is appropriate involves identifying strengths and weaknesses of the current policy relating to trust objectives and alternative peer group products.

   The appeals court in *Cochran* noted that a key factor in its decision was that the trustee showed reliance on information from "an outside, independent entity with no policy to sell or any other financial stake in the outcome."[4] However, the court based its understanding of suitability solely on the outside consultant's comparisons of illustrations of hypothetical policy values, which the chief regulatory body for the financial services industry "strictly prohibits" because such comparisons are "misleading."[5]

   Illustrations of hypothetical policy values commingle undisclosed TOLI expenses and arbitrary performance assumptions. Thus, they don't meet the requirements of the UPIA to justify TOLI expenses and consider what rate of return can reasonably be expected on invested assets underly-

ing TOLI cash values. The trustee may have avoided litigation by examining TOLI expenses and considering what would be a reasonable rate of return on invested assets.

For instance, both the trustee and the court considered the cost to exchange out of the VUL, indicating costs are relevant to suitability determinations. However, both the trustee and the consultant engaged by the trustee failed to examine other larger TOLI expenses for cost-of-insurance charges, fixed administrative expenses, cash-value-based "wrap fees" (for example, VUL, mortality and expense (M&E) risk charges[6]) and premium loads. Keeping costs low is critical because every dollar spent on expenses is one less dollar available to purchase more death benefit.

Though the plaintiff didn't pursue the minimizing expenses argument in *Cochran*, the trustee's failure to justify TOLI expenses provides beneficiaries with a reason to claim they should have received greater death benefits. Also, by measuring expenses, a trustee can reduce and justify them, thereby adding value to clients and avoiding litigation.

Both the trustee and the court also considered the potential dangers of a fluctuating market and a potential lapse of the policy due to aggressive asset allocations. So the overall investment strategy and risk and return objectives reasonably suited to the trust are also clearly relevant to suitability determinations. Maximizing the return on invested assets underlying policy cash values is just as important as minimizing TOLI expenses, because every dollar of return represents a dollar not needed in premiums.

Because the consultant calculated lapse risks by simply comparing illustrations of hypothetical policy values and failed to measure the risk of lapse under a more conservative asset allocation or a lower death benefit for the existing policy, the trustee lacked the information needed to consider reallocating cash values from volatile, aggressive-type funds to a guaranteed account. Allocating to a guaranteed account would have eliminated the dangers of a fluctuating market and saved the $107,000 surrender charge.

This case shows how comparing illustrations of hypothetical policy values can be misleading. Indeed, had the trustee had the information necessary to measure actual costs and actual performance instead of comparing hypothetical illustrations, it may have prevented litigation instead of having to defend itself against it.

When attempting to fulfill the duty to investigate, trustees should be careful about relying on providers offering TOLI reviews. "Check the fine print," warns Patti S. Spencer of Spencer Law Firm and Spencer Fiduciary Services in Lancaster, Pa. about the "policy review reports" offered by these providers.[7] Some of these providers advertise "complete policy review" but don't actually measure TOLI expenses or actual performance. Instead, they protect themselves by disclaiming the reliability of their suitability determinations at the potential expense of the ILIT trustee.

The court said a wait-and-see approach could have been equally prudent.

3. **Duty to manage.** This involves using information gathered in the monitoring and investigation phases and taking appropriate steps to minimize costs and maximize benefits relative to acceptable risk. The court in *Cochran* considered the following steps to be appropriate TOLI management options:

   Increasing the premium. The trustee considered increasing premiums to make up for the $37,000 decline in cash values due to stock market losses, but Cochran was unwilling or unable to make gifts to the trust to pay such premiums.

   Decreasing the death benefit. This option decreases cost-of-insurance charges and expenses to levels that cash values can cover. The trustee considered decreasing death benefits as part of the exchange to the new policy but didn't consider decreasing them in the existing holding. Doing so could have saved the $107,000 cost of transferring out of the existing policy and preserved higher cash values that would have supported a higher death benefit.

Changing cash-value asset allocations. The trustee considered changing the asset allocation of investments underlying TOLI cash values, but again only as part of the exchange to a new policy. Had the trustee considered this option for existing policy cash values, the $107,000 cost of transferring out of the existing policy could have been saved while eliminating the dangers of a fluctuating market and potential policy lapse.

Trading/exchanging to products offering lower expenses and/or improved performance. The trustee exchanged the $8 million VUL policy to a $2.5 million guaranteed universal life product. However, it doesn't appear that this exchange reduced expenses. In fact, it lost cash values that could otherwise have supported higher death benefits. While the court concluded it was prudent for the trustee to move from policies with significant risk of lapse to one with a smaller but guaranteed death benefit, the trustee could have preserved a larger guaranteed death benefit had the trustee considered these five management options for existing holdings and new alternatives.

Using a wait-and-see approach. If the first four options aren't deemed advantageous, the court said a wait-and-see approach would have been equally prudent.

Finally, because the above TOLI management options often require grantor cooperation/consent, a trustee who considers all five options but lacks grantor cooperation/consent would likely be protected against future claims of breach of fiduciary duty relating to policy suitability under the legal doctrine of estoppel.

Moving Forward

The days of trustees simply accepting gifts, sending out *Crummey* notices and paying premiums appear over. Trustees must now take a more proactive approach to managing ILITs to comply with the UPIA. One way to be more proactive, mentioned in *Cochran,* is to delegate investment and management functions to a prudent delegatee. That delegatee can serve as sub-advisor to the trustee and make TOLI trades and exchanges, but, to avoid conflicts of interest, should be separate from the entities doing the monitoring and investigation.

Delegating in accordance with UPIA Section 9 removes trustee liability for decisions or actions of that delegatee and helps trustees identify suitable trades and better serve clients. Pleased clients lead to more work, more fees and more revenue sources for the trustee. Delegating also aligns the interests and liabilities of the agent and trustee in a way that clients better understand, reconciles conflicts of interest and provides a framework for in-sourcing life insurance expertise that a trustee might lack.

Of course, the process should revolve around its core—a trust investment policy statement that lays out the overall investment strategy of the trust in relation to risk and return objectives suitable to the trust. By keeping with trust objectives and grantor intent, and by following a prudent process for monitoring, investigating and managing based on independent research, trustees can steer clear of the kind of trouble Cochran's trustee surely many times wished had been prevented, and enjoy a substantial competitive advantage.

Endnotes

1. *In Re Stuart Cochran Irrevocable Trust,* 901 N.E.2d 1128 (Ind. Ct. App. 2009).
2. *Ibid.*
3. Notice to a beneficiary of his right to withdraw his gift to the trust, usually within 30 days of making the contribution. The name comes from the case, *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968).
4. National Association of Insurance Commissioners created risk-based capital (RBC) ratio regulations in response to increasingly frequent and severe insurance company insolvencies in the late 1980s. These RBC regulations require an insurance company to hold an amount of capital adequate enough to protect customers against adverse developments, according to a risk assessment. As a practical matter, they result in insurers investing that capital predominantly in high-grade bonds and government-backed mortgages.
5. Financial Industry Regulatory Authority, Rule 2210.
6. Mortality and expense risk charges are found in most variable universal life products, and are more commonly understood as a cash-value-based wrap fee.
7. Barry D. Flagg and Patti S. Spencer, "*Cochran v. KeyBank*—TOLI Case Law Guidance (Part 2 of 2)" published in *LISI Estate Planning Newsletter* #1486 (Aug. 5, 2009) at *www.leimbergservices.com.*