Case Law Guidance (Finally) for Trust-Owned Life Insurance (TOLI)

"This case is a must-read for any individual or corporate trustee of an ILIT."

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EXECUTIVE SUMMARY:

While many trustees are facing increased scrutiny of their investment performance in these difficult economic times, trustees of trusts holding life insurance (often referred to as irrevocable life insurance trusts, or "ILITs")[1] face additional challenges in their management of this "special asset". Acknowledging the potentially serious trustee liability, a few states have passed legislation that reduces the trustee's fiduciary responsibility for life insurance as an investment.[2] However, such protective statutes do not help a trustee to determine how to manage life insurance to maximize the benefit for the trust beneficiaries.

Outside the few states with protective statutes, the Uniform Prudent Investor Act ("UPIA") and similar statutes require as rigorous a management model for life insurance as for other types of assets.[3] However, until now trustees have had no court guidance regarding the application of the UPIA to life insurance. A recent Indiana Court of Appeals case appears to provide some comfort to ILIT trustees (and perhaps some consternation to ILIT beneficiaries) in UPIA states by setting a low bar for investment due diligence with respect to life insurance.

However, this case is the first such case involving a claim of breach of fiduciary duty for ILIT trustees, at least the first such case known to these authors. As such, it can hardly be considered evolved case law. The cautious trustee will also recognize that the actions of KeyBank were considered by the court to be less than ideal. In addition, it appears that this case could easily have gone the other way on the issue of "prudent process". Any standard for trustee due diligence should, therefore, consider the actions of KeyBank to be a bare minimum which cautious trustees will strive to improve upon if faced with similar issues .

This case is nonetheless instructive as to the various claims dissatisfied beneficiaries may make. It is also instructive to examine the appropriate steps taken by the trustees and the possible additional actions they could have taken so as to provide a road map for trustees intent on avoiding future lawsuits. For instance, under the Indiana version of the UPIA, a trustee is required to "exercise reasonable care, skill, and caution" in managing trust assets as a prudent investor would.

In this case, KeyBank considered only the existing life insurance and one other policy. The court did not shed any light on any examination of underlying costs and performance assumptions that might or might not have been performed. While admitting that "of course it could have done more," the court found this due diligence adequate. It is difficult to imagine the court reaching the same conclusion had a trustee considered one mutual fund to replace two existing funds, without discussing the trustee's examination of fees, expenses and historical performance for either the universe of possible alternatives or at least a relevant benchmark. It remains to be seen whether other courts will be similarly satisfied by this level of review in the future.

While this case is silent on the issue, it would be interesting to know whether other life insurance portfolio management activities (such as changing the asset allocation of cash values in existing policies,

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[1] For a general discussion of ILITs, see Patrick J. Lannon, Planning Opportunities With Irrevocable Life Insurance Trusts, Estate Planning Volume 34, Number 5 (May 2007).

[2] LISI Estate Planning Newsletter #1342, Patrick J. Lannon.

[3] LISI Estate Planning Newsletter #1287, Barry D. Flagg, LISI Estate Planning Newsletter #1343, Richard M. Flah and Lori W. Denison.

reducing the death benefit of the existing insurance, and/or considering the purchase of other products of the same or different type) would have achieved a better result under these circumstances.

In addition, Indiana's version of the UPIA provides that a trustee may only "incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." While the trustee's consultant did make the trustee aware of new expense charges, including commissions and surrender charges (of $107,764), the court does not tell us whether the consultant or the trustee investigated, measured or justified the various internal costs and expenses in either existing policy holdings or the alternative(s) under consideration. Without such details we cannot know whether it would have been more prudent to simply make changes to existing policy holdings or if the trustee could have gotten a better deal on a similar policy.

FACTS:
In *re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009) ILIT trust beneficiaries alleging violations of Indiana's version of the UPIA and breach of trust sued KeyBank, N.A.[4] as trustee. In that case, beneficiaries challenged the trustee's replacement of two variable universal life insurance policies providing $8,000,000 in death benefits with a $2,536,000 guaranteed universal life policy shortly before the unexpected death of the insured at age 53.

Immediately upon assuming responsibilities as successor ILIT trustee in 1999, KeyBank approved of an exchange of policies in the trust which had been arranged by the insured's insurance advisor (i.e., the agent/broker who appears to have sold the various policies that are the subject of this case).

This exchange raised the collective death benefit from $4,753,539 to $8,000,000.

Due to market losses in 2001 and 2002, KeyBank retained an independent outside insurance consultant to review these replacement policies in 2003.

The review of hypothetical illustrations of policy values suggested that the policies would likely lapse long before the insured reached his life expectancy, but the consultant initially recommended only further monitoring. Even though the independent consultant recommended only further monitoring, the insured's insurance agent/broker/advisor recommended the purchase of a replacement policy with an expected face value of $2,787,624[5] guaranteed to age 100.

KeyBank's consultant also reviewed this replacement policy, noting that surrender charges of $107,764 would be incurred on the termination of the old policies, but nonetheless recommended that the old policies be exchanged in favor of the new policy.

KeyBank, as trustee, subsequently surrendered the old policies and purchased the new policy.

Soon after the purchase of the new policy, the insured died unexpectedly at the age of 53.

The ILIT beneficiaries promptly sued KeyBank as trustee for breach of fiduciary duty. The trial court framed the question in a way that almost assured the outcome:

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[4] Shortly before the complaint, KeyBank replaced Pinnacle Bank as trustee. According to the published opinion, Pinnacle Bank resigned as trustee based on the insured's insistence on having third parties involved in the trustee's decision-making process. In light of subsequent events, Pinnacle Bank appears to have made the right decision.

[5] Due to underwriting considerations the eventual actual face value was $2,536,000.

Was it prudent for the Trustee to move the trust assets from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit?

While admitting that the "process was certainly less than perfect," the trial court focused on the prudence of replacing the old policies in general rather than the prudence of choosing the new policy specifically and unsurprisingly determined that the change in policies was prudent.

The appeals court agreed, first determining that there was no imprudent and improper delegation of decision making functions to the insured and his advisor. Instrumental to this determination was the fact that KeyBank relied on guidance from "an outside, independent entity with no policy to sell or any other financial stake in the outcome" to review the policies and the recommendations of the insured's advisor.

Next, the court determined that KeyBank did not imprudently disregard such independent guidance from its consultant. While the consultant did not initially recommend replacement of the old, higher face value, policies, it eventually recommended purchase of the new policy and KeyBank followed this advice.

The appeals court then examined KeyBank's investigation of the alternatives to the purchased policy, and agreed with the trial court that while "the process was not perfect," it was sufficient that the trustee "examined the viability of the existing policies and at least one other option."

Finally, the court noted that the UPIA prohibits the use of hindsight in determining the appropriateness of investments, dismissing the insured's early death and the subsequent recovery of the economy as factors to consider in determining the prudence of the purchase.

The appeals court also considered several other issues, concluding that:

1) sufficient information was provided to beneficiaries despite the fact that annual reports were sent to the non-custodial parent of the beneficiaries, made documents available to the beneficiaries but did not mail them copies, and failed to solicit the consent or approval of the beneficiaries prior to changing insurance policies,[6]

2) the trustee did not breach a duty of loyalty by its communications with the insured, and

3) that the change in insurance policies was not inconsistent with the grantor's intent.

"Best-Practices" – applying the Uniform Prudent Investor Act (UPIA) to the management of trust-owned life insurance (TOLI)

ILIT Trustees must now manage trusts, which assets include life insurance policies, under just as rigorous a management model as that required for other types of assets[7].

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[6] The court noted that any shortcomings in providing information to beneficiaries were not in any event the proximate cause of any damages.

[7] LISI Estate Planning Newsletter #1287, Barry D. Flagg, LISI Estate Planning Newsletter #1343, Richard M. Flah and Lori W. Denison.

The UPIA provides invaluable guidance as to the specific activities trustees can and should take under such a management model for trust-owned life insurance (TOLI), namely: 1) the "duty to monitor"[8] the performance of trust holdings, 2) the "duty to investigate"[8] the suitability of trust holdings, and 3) the duty to manage trust holdings using the information gathered in duty #1 and duty #2 to minimize costs and maximize benefits relative to acceptable levels of risk[9]. The UPIA also provides that Trustees can delegate such investment and management functions, and when properly delegated are "not liable for the decisions or actions of the agent to whom the function was delegated."[10]

The allegation of breach of fiduciary duty in this Cochran case revolves around the suitability (or lack thereof) of certain existing TOLI holdings that were exchanged/replaced with certain other TOLI holdings. While the trustee prevailed in Cochran, "the cautious trustee will recognize that the actions of KeyBank were considered by the court to be less than ideal" [11] and that "this case could easily have gone the *other* way on the issue of 'prudent process.'"[11] As such, this article examines the "prudent process" prescribed by UPIA as it relates to the suitability of TOLI holdings.

The suitability of any given or proposed TOLI holding is a function of many factors that should at least include consideration of:

1) the financial strength and claims-paying ability of the insurer,
2) the competitiveness of TOLI expenses,
3) the stability of the insurer's pricing representations,
4) the liquidity/accessibility of TOLI cash values, and
5) the reasonableness of performance expectations.

While some of these 5 major factors of suitability were considered in Cochran, both the trustee and the plaintiff failed to consider #2) the competitiveness of TOLI expenses and #5) the reasonableness of performance expectations. In addition, the independent outside consultant hired by the trustee also failed to consider both expenses in and performance expectations for either existing or proposed TOLI holdings, and instead based their findings on certain illustrations of hypothetical policy values common to the life insurance industry but considered "misleading" and actually prohibited by the chief regulatory body of the financial services industry.

As such, while the ability of the Trustee to delegate investment and management responsibility under the UPIA provides an important tool for the Trustee to use in managing ILIT risk, it is essential that any such delegation, whether formal or informal, or in whole or in part, be "prudent" (i.e., conform to the "prudent process"). For instance, certain service providers to the TOLI industry advertize "complete policy reviews" in their marketing material, but then actually disclaim suitability in their reports that go into the permanent trust file.

In that any review of a TOLI holding that does not consider suitability is simply **not** complete under the definition in UPIA, ILIT trustees should "check the fine print" of their policy review reports and adopt

[8] Page 8 of the UNIFORM PRUDENT INVESTOR ACT drafted by the NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS and by it APPROVED AND RECOMMENDED FOR ENACTMENT IN ALL THE STATES at its ANNUAL CONFERENCE MEETING IN ITS ONE- HUNDRED-AND-THIRD YEAR IN CHICAGO, ILLINOIS JULY 29 - AUGUST 5, 1994 (*www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf)*.

[9] See part 3 of 3 of "The Prudent Investor and TOLI" published in the May/June 2007 issue of the ABA Trusts & Investments magazine.

[10] Fiduciary Pitfalls with Trust-Owned Life Insurance, ABA Tele-Briefing, 2006, Christopher P. Cline and Barry D. Flagg, CFP®, CLU, ChFC.

[11] LISI Estate Planning Newsletter #1486, Patrick J. Lannon

alternative means of determining and documenting suitability. The balance of this article discusses how such "best-practices" for determining and documenting both the competitiveness of TOLI expenses and the reasonableness of performance expectations could prevent similar future challenges before they are ever brought.

The duties of the Trustee of an Irrevocable Insurance Trust ("ILIT") have been viewed in the past as merely paying premiums and sending Crummey notices. The insured Settlor often had already selected the insurance product that was either transferred to the ILIT or acquired by the Trustee. Many corporate trustees accepted ILIT's only as an accommodation to clients with whom they had significant relationships, recognizing that the fee potential of an ILIT was small compared to the potential liability, but nonetheless serve as ILIT trustee so as to attract and/or retain other assets under management either during the life of the client and/or upon receipt of life insurance proceeds.

In today's litigious environment, with more regulatory pressure, consumer pressure for transparency, increasing fiduciary litigation, and the passage of legislation like the Uniform Prudent Investor Act ("UPIA"), prior practice needs to change. In most states, it is now clear that the trustee of an ILIT has the same fiduciary responsibilities as a trustee of any other trust.

The *Cochran* case is the first case concerning breach of fiduciary duty by the Trustee of an ILIT (at least the first such case known to these authors). Its holding can hardly be considered evolved case law, but it does give insight that is important for trustees in developing best-practices for the handling of ILITs.

The holding in Cochran was in favor of the Trustee and was driven largely if not entirely by the way the trial court framed the question: "Was it prudent for the Trustee to move the trust assets from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit?" In reaching this result, the court held that while the trustee's "process was not perfect," it was sufficient.

This highlights the standard of the UPIA, which is aimed at the prudence of the process used by the Trustee in evaluating investments, not in a backward looking measure of asset performance. As case law evolves in this area, it remains to be seen whether the courts will still consider the "process" in the Cochran case to be sufficient. It is, therefore, constructive to consider what issues that court may have discussed.

According to the court in Cochran, "[t]he ultimate question. . . is whether the actions of the Trustee … were consistent with the Settlor's intent as expressed in the Trust document and met its fiduciary duties to the Beneficiaries." The actions of the Trustee challenged by the Beneficiaries in this case revolve around the trustee's replacement of existing policy holdings that would have paid an $8,000,000 death benefit with a different type of policy that instead only paid a $2,536,000 death benefit.We can presume that in general, a Settlor would rather give a larger death benefit to his beneficiaries than a smaller one[12].

Thus, the decision in Cochran hinges on the suitability of the different types of policies as the court understood them. In fact, the court concludes "[i]n essence, based on the circumstances facing the Trust in 2003, [it was] prudent for the Trustee to move the trust assets from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit".

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[12] The court concluded that another previous exchange of policies in 1999 that resulted in the $8,000,000 death benefit was consistent with the Settlor's intent and observed "the transaction nearly double the total death benefit available to the trust" as support for its conclusion.

However, will future courts come to the same conclusion if the plaintiff presents/the court considers a suitability analysis that goes beyond the narrow determination of whether existing policy holdings should be maintained **as-is** or replaced (i.e., which policy appears better) to instead determine how the pricing and performance characteristics of a given policy relates to trust objectives (i.e., which policy best measures up to the definition of suitability as determined by the "prudent process")? And if not, then how can trustees meet their fiduciary obligations under the UPIA and manage the risk associated with this type of fiduciary appointment? A trustee may want to adopt one or more of the following approaches:

1. Trust documents can be drafted that exonerate the trustee from liability for retaining policies that have been transferred or for purchasing policies chosen by the grantor or his or her advisors. This language must be carefully crafted so as not to cause inclusion of the insurance policy in the Settlor's federal gross estate.

2. Trust documents can include a provision by which the Settlor indemnifies the trustee for any liability related to insurance policies as trust investments.

3. Delegate some/all of the …

    a. **duty to monitor** the insurers' financial strength and claims-paying ability, the policy's funding adequacy and/or lapse risk, changes in the insureds' health, etc.,
    b. **duty to investigate** suitability, justify expenses and determine the reasonableness of performance expectations for existing and/or proposed TOLI holdings, and/or
    c. **duty to manage** TOLI holdings involving evaluation of financial risks and rewards overall, analyzing policy type, design and options, assessing reasonableness of illustrations, and ensuring appropriate diversification, etc.

4. Subscribe to independent research so as to be able to internally monitor the insurers' financial strength and claims-paying ability[13], and/or internally measure pricing and performance against relevant benchmarks[14], and/or internally document suitability[15], and/or build internal expertise and resources to manage TOLI holdings. Many banks already subscribe to such research services and have such expertise and resources in other areas of the bank. For instance, some ILIT Trustees use licensed insurance agents/brokers working elsewhere in the bank to assist in the management of policy holdings (e.g., exchanging unsuitable holdings for suitable holdings). On the other hand, other ILIT Trustees are understandably reluctant to involve agents/brokers in suitability determinations due to conflict-of-interest issues that invariably arise when a commission is paid on the replacement of an existing policy. However, ILIT Trustees can conceivably elicit the assistance of licensed agents/brokers while maintaining their independence by following a well-defined "prudent process" which incorporates independent research. After all, there is nothing wrong with a bank being compensated for portfolio trades/exchanges provided the bank can quickly and easily demonstrate that such trades/exchanges are in the best-interest of trust beneficiaries.

Some states have recognized the problem of trustees investing in life insurance and have gone so far as to provide statutory protection[16] (albeit likely at the expense of clients and beneficiaries as in the case of Cochran). For trustees who cannot depend on state statutes to protect them, and who are reluctant to rely on exculpatory or indemnification language in the trust document that is untested in the courts,

[13] See http://www.ebix.com/vss_signs_carrier.aspx
[14] See www.PolicyPricingCalculator.com
[15] See http://www.theinsuranceadvisor.com/Confidential-Policy-Evaluator/How-CPE-Works.
[16] LISI Estate Planning Newsletter #1342, Patrick J. Lannon.

there is no alternative but to comply with the terms of the UPIA - either in-house or by appropriately delegating the responsibilities.

The problem is compounded by the fact that ILIT's are usually unfunded except for the policies that they hold. The trustee depends on annual contributions both to pay premiums and to pay its fee. Delegating the investment management function to an outside consultant will require a source of funds to pay for the service. Trustees should, therefore, make sure that they are compensated adequately to pay for such research and/or services either in the form of currently-collected fees or by accruing fees to be collected upon and from the eventual payment of the death benefit (i.e., provided the trustee can demonstrate/document that the TOLI asset is a "performing asset").

Relying on the selling or servicing agent/broker for such advice can be problematic. While many agents/brokers market themselves as independent, most are not and instead have duties to promote their employer's interests and/or are limited by terms of their contracts with some limited number of insurers. They may also have a conflict of interest with regard to policy replacement and are often not trained in financial analysis or fiduciary principles or law.

For example, the agent(s)/broker(s) in the Cochran case first sold in 1987 several universal life (UL) and/or whole life (WL) insurance policies and annuities with death benefits totaling $4,753,539. Then, in 1999 these UL/WL policies were replaced with variable life (VL) policies (i.e., the most "popular" product among agents/brokers at that time[17]) so as to increase the death benefit to $8,000,000 and presumably based on illustrations of hypothetical policy performance for the various policies. Finally, in 2003 the VL policies were replaced with another UL policy (a guaranteed form of UL that was again the most "popular" product among agents/brokers at that time[17]), but this time with death benefits totaling only $2,536,000 and again based on illustrations of hypothetical policy performance for each policy.

The fact that these agents(s)/broker(s) received commissions on these replacements likely equal to 1/3rd of trust assets exemplifies the potential for problems involving conflicts of interest. At the same time, the use of illustrations of hypothetical policy performance as the basis for such replacements which resulted in a "loss" of more than $2,000,000 in death benefits otherwise payable to the trust certainly seems to indicate a lack of training in financial analysis and fiduciary principles/law. Had the trustee simply followed the financial analysis and fiduciary principles discussed below, it is conceivable that the original $4,753,539 in UL/WL policies would not have been replaced, and that the beneficiaries would have received an additional $2,000,000, and that the trustee would not have been sued.

The trustee may delegate investment and management functions as is prudent under the circumstances. The trustee must exercise prudence (i.e. care, skill and caution) in selecting the agent (or "delegatee"), establishing the scope and terms of the delegation, and reviewing the agent's performance. The trustee should document all delegations and the scope and terms of any delegation. To the extent that agents/brokers are interested in serving the TOLI market, and to the extent that an ILIT trustee is interested in working with a particular agent/broker, then potential conflicts of interest must be disclosed, discussed and reconciled in advance. Agents/Brokers should also demonstrate their expertise in financial analysis and understanding of fiduciary law/principles by formally agreeing to serve as "prudent delegatee" under which they become responsible (i.e., liable) for the proper management of TOLI holdings in accord with the "prudent process". Such a delegation also mitigates trustee risk (i.e., liability), as discussed above.

Whether the trustee performs internally the prescribed duties to monitor, investigate, and manage, or delegates some or all of these duties to an independent consultant or agent/broker (subject to the

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[17] Source: Life Insurance and Market Research Association (LIMRA)

above conditions), the trustee should have a well defined "prudent process" that considers at least 1) the insurer's financial strength and claims-paying ability, 2) the expenses charged to the trust by the insurer of the TOLI holding(s), 3) the stability of such pricing representations by the insurer, 4) the liquidity/availability of TOLI cash values to the extent relevant to trust objectives, and 5) the reasonableness of the rate of return expected on invested assets underlying TOLI holdings.

The court in Cochran addressed some of these issues. Below we examine two key elements of suitability as defined by the "prudent process" under the Uniform Prudent Investor Act (UPIA) that were **not** examined in the Cochran opinion.

Justifying TOLI Expenses

Indiana's version of the UPIA provides that a trustee may only "incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." For many years, the premium for TOLI policies was seen by the ILIT trustee as the "cost" due largely to underlying policy expenses not being disclosed and, in the absence of more complete information, the premium was seen as the "cost" of the policy by default. However, the premium does not represent the cost of the policy, any more than a $2,000 contribution to an Individual Retirement Account represents the cost of the IRA. The costs in either case are the expenses deducted from the premium paid or the contribution made.[18]

In fact, this Cochran case makes clear that the premium is not the cost of a TOLI holding since premiums were not being paid and instead cost of insurance charges and policy expenses were being deducted from trust assets that were TOLI cash values. While the trustee's consultant did make the trustee aware of new expense charges, including commissions and surrender charges (of $107,764) that would be incurred on the exchange, there is no evidence that the consultant or the trustee investigated, measured or justified the cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (M&Es) and premium loads in either existing policy holdings or the alternative(s) under consideration. Failure to measure and quantify such trust expenses prevented the trustee from basic management decisions like considering whether it would have been in the beneficiaries' best interest to simply reduce the death benefits under the existing policy holding.

For instance, while we do not know what General American or Manulife were charging the trustee in this case, the average costs per $1,000,000 of face amount for an institutionally-priced variable universal life (VUL) product insuring a 52 year old male that could qualify for at least a preferred-health risk class and where such costs correspond to a Moderate-Conservative investor temperament (more on that below) would be as follows:

Cost of Insurance (COI) Charges	$145,136
Fixed Administration Expenses (FAEs)	$13,923
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps
Premium Loads	7.50%
Total Cost per $1.00 of Death Benefit	18.6¢

Source: www.PolicyPricingCalculator.com

Of course, average costs based on representative industry benchmarks are just that – average. As such, the costs being paid by the trustee could have been as much as 40% lower given findings from a

[18] See part 3 of 3 of "The Prudent Investor and TOLI" published in the May/June 2007 issue of the ABA Trusts & Investments magazine.

Tillinghast Towers Perrin study[19], a third-party administrator (TPA) survey of trust-owned life insurance (TOLI) policy holdings[20] and research from THEInsuranceAdvisor.COM database.

As such, if General American and Manulife were charging costs that were consistent with best-available rates and terms (BART) for an institutionally-priced variable universal life (VUL) product insuring a 52 year old male that could qualify for at least a preferred-health risk class and where such costs again correspond to a Moderate-Conservative investor temperament, then these costs per $1,000,000 of face amount could have been as low as below:

Cost of Insurance (COI) Charges	$101,102
Fixed Administration Expenses (FAEs)	$8,354
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps
Premium Loads	7.50%
Total Cost per $1.00 of Death Benefit	12.0¢

Source: www.PolicyPricingCalculator.com

Unfortunately, because it appears both the trustee and the plaintiff failed to measure such expenses, we cannot know what the trustee was actually being charged, and will therefore use for the purposes of this discussion the above costs of between 12.0¢ and 18.6¢ per $1.00 of death benefit for the existing VUL holdings. On the other hand, the cost under the John Hancock policy purchased to replace the two existing VUL policies in this case was likely 15.2¢ per $1.00 of death benefit and similar to the below per $1,000,000 of face amount:

Cost of Insurance (COI) Charges	$123,876
Fixed Administration Expenses (FAEs)	$21,461
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	0bps
Premium Loads	4.00%
Total Cost per $1.00 of Death Benefit	15.2¢

Source: THEInsuranceAdvisor.COM CPE Research Reports

So while the costs in the John Hancock policy were better than average *before consideration of the costs of the exchange*, to determine which policy options offered the lower costs, the trustee would have to add the $107,764 in surrender charges that were/would have to be incurred on the termination of the existing VUL policies, as shown below:

	VUL Benchmark Averages	Best-Available VUL Rates & Terms	New John Hancock Holding
Cost of Insurance (COI) Charges	$145,136	$101,102	$123,876
Fixed Administration Expenses (FAEs)	$13,923	$8,354	$21,461
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps	55bps	0bps
Premium Loads	7.50%	7.50%	4.00%
Surrender Charge	N/A	N/A	$107,764
Total Cost per $1.00 of Death Benefit	18.6¢	12.0¢	25.9¢

[19] Tillinghast Towers Perrin study referenced in the May 2003 issue of Trusts and Estates.

[20] CASCO survey reported in the April 1999 issue of Trusts & Estates magazine both indicate that trust-owned life insurance (TOLI) death benefits can be increased by 40% or more, or that premiums can be reduced by 40% or more in 65% to 85% of single-life and survivorship trust-owned policies respectively.

In other words, had the trustee simply measured cost of insurance charges and policy expenses for both existing holdings and alternative(s) under consideration, they would have found that the cost to exchange was considerably greater than the average cost to maintain such TOLI and as much as twice the cost of maintaining the current policy holdings. Only when a trustee knows such TOLI costs can they consider other potentially more cost-effective TOLI management decisions, like simply reducing the death benefits of existing VUL holdings in lieu of exchanging to the John Hancock product in this case.

For instance, simply reducing the death benefits of existing VUL holdings could likely have preserved between $3,000,000 and $5,000,000 of life insurance (versus the $2,536,000 under the John Hancock policy), depending upon just how well existing VUL holdings were priced, and upon the allocation of policy cash values appropriate to the risk and return objectives reasonably suited to the trust (more on that in the next section below). While the exchange to the John Hancock policy did provide greater security (in the form of premium and death benefit guarantees), knowing TOLI costs is essential to considering the cost/benefit as it relates to other forms of security (like reallocating existing VUL cash values to a fixed/guaranteed account is generally allowable free of charge).

Accordingly, "prudence" as defined under the Prudent Investor Act is not concerned with whether a trustee is right or wrong in hindsight, and instead requires that trustees follow a "prudent process" which includes "mak[ing] a reasonable effort to verify facts relevant to the investment and management of trust assets." At the risk of stating the obvious, the amount a trustee is paying for cost of insurance charges (COIs) and other policy expenses are clearly "facts relevant to the investment and management of trust assets." If COIs and expenses are high, then the value of the death benefit will be lower (for a given amount of premium and cash value) and/or the security of that death benefit will be less (i.e., the risk of lapse will be greater), and are therefore certainly "relevant to the investment and management of trust assets."

As such, had the plaintiff argued that the trustee failed to justify trust expenses, the court may very well have come to a different decision finding instead that the trustee did in fact breach their fiduciary duty to investigate. Time will have to tell since the courts decision in this case was "based on the circumstances presented", and the plaintiff in this case neglected to present arguments based on the duty to "incur [only those] costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."

As a matter of "best-practices", ILIT trustees should, therefore, simply request that illustrations of hypothetical policy performance include the insurer's underlying representations as to the amounts they expect to charge for cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., VUL M&Es) and premium loads (generally available upon request) and measure such costs against corresponding representative industry benchmarks averages (available free of charge at www.PolicyPricingCalculator.com). As discussed above, doing so here in Cochran may very well have avoided litigation altogether.

Setting Reasonable Rate Of Return Expectations

The Cochran case also fails to mention risk profile, investor temperament, asset allocation, diversification and other considerations generally taken into account under the UPIA. Had the plaintiff presented arguments involving the trustee's efforts (or lack thereof) to ascertain the proper risk profile, investor temperament, asset allocation, and/or diversification, the court may again have come to a different decision. For instance, the plaintiff does argue that the trustee "*violate[d] the Indiana Uniform*

Prudent Investor Act (PIA). Ind. Code § 30-4-3.5-1[21] *et seq. In relevant part, the prudent investor rule, as set forth in the PIA, provides as follows:*

(b) A trustee's investment and management decisions respecting individual assets must be evaluated … as a part of an overall investment strategy having ***risk and return objectives reasonably suited to the trust*** *[emphasis added].*

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are those of the following that are relevant to the trust or its beneficiaries: […]

(5) The expected total return from income and the appreciation of capital."

However, the plaintiff neglects to further any arguments as to the proper risk profile, investor temperament, asset allocation, and/or diversification that would be consistent with "overall investment strategy having **risk and return objectives reasonably suited to the trust**." There is also no mention in the record evidence as to the actual asset allocation of the existing VUL policy holdings, only that "[t]he net investment loss for the policy year ending on January 4, 2003 was $36,672.43" and that the "analysis" prepared by the outside consultant assumed "a hypothetical [emphasis added] gross interest rate of 8%."

Such an 8% gross rate likely equates to 7%+ net rate of return, after deduction of estimated fund management expenses (FMEs). Whereas certain segments of the life insurance industry compare investment performance based on gross rates of return, this is unique to the life insurance industry, and differs from prevailing reporting practices in other sectors of the financial services industry that generally compare performance on the basis of net rates of return. As such, implicit in the use of a 7%+ expected net rate of return is that a Moderate-Conservative asset allocation comprised of 80% fixed-income and 20% equity investments[22] was consistent with the overall investment strategy having risk and return objectives reasonably suited to the trust.

However, if a Moderate-Conservative asset allocation is consistent with the overall investment strategy having risk and return objectives reasonably suited to the trust, then the exchange to the John Hancock guaranteed UL (GUL) product could not have been. Such a VUL to GUL exchange is analogous to exchanging a family of mutual funds diversified across inversely-correlated asset classes to a bank certificate of deposit (CD) where the interest rate is fixed for 40 +/- years. While such an exchange in an investment trust could be suitable, few trustees would make or approve such an exchange without considerable documentation as to the change in the trust's risk profile. That documentation seems to be missing here.

On the other hand, if the trustee had determined that a Moderate-Conservative cash value allocation was not suitable, then they should not have approved the exchange in 1999 from UL/WL policies in which assets underlying policy cash values are required by regulation (as a practical matter) to be invested predominantly in fixed-income investments to VUL policies where cash values can and were allocated to far more volatile equity-type investments. In other words, with no mention in the record evidence that the risk profile had changed between 1999 an 2003, the actions of the trustee could not have been consistent with the overall investment strategy and corresponding risk and return objectives reasonably suited to the trust in both 1999 when they approved the UL/WL to VUL exchange and then also in 2003 when they exchanged the VUL holdings back to UL.

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[21] The court order cites Ind. Code § 30-4-3.5-1 which is Compliance with the Prudent Investor Rule, but the actual Prudent Investor Rule is Ind. Code § 30-4.3.5-2.

[22] Source: Ibbotson® SBBI® 2009 Classic Yearbook, Summary of Annual Returns, Data from 1926 to 2008.

The failure of the trustee to consider the asset allocation and corresponding expected rate of return as it related to the overall investment strategy and corresponding risk and return objectives reasonably suited to the trust again prevented the trustee from considering basic management decisions. For instance, had the trustee concluded that the trust's risk profile had in fact changed, and that the asset allocations within existing VL holdings were no longer appropriate, then they could have approached such a change in this insurance trust in they in same way they would have in an investment trust, and simply re-allocated policy cash values to the fixed account. The fixed account in most VUL products guarantees both against loss of principal and a minimum rate of interest (e.g., typically 4%) and changing allocations within most VUL policies is free of charge.

So, while the court concluded that the trustee's "decision to exchange the VUL policies for the John Hancock policy was eminently prudent" given "a rapidly declining stock market" and that "the Trust had lost progressively more money, [and had] every reason to believe that further erosion would occur every day it held the VUL policies", trust assets could have been equally well-protected against "a rapidly declining stock market" by simply re-allocating cash values to a fixed/guaranteed account for free. In addition, the $107,764 charge certain to be incurred on the exchange to John Hancock actually eroded more trust assets (i.e., a loss of 20%[23]) than the potential for "further erosion" in existing VUL policies (e.g., a loss of 6.7%[23] in the year leading up to the exchange).

As such, had the plaintiff argued that the trustee failed to allocate trust assets in a manner consistent with the risk profile appropriate to the trust, which they could have done at no expense, and instead actually lost as much as 20% of trust assets which could have otherwise been used to purchase more death benefit (i.e., a lesser reduction in the death benefit), then the court may very well have come to a different decision. Time will have to tell since the court's decision in this case was "based on the circumstances presented", and the plaintiff neglected to present arguments based on the trustee's duty to consider "[t]he tradeoff in all investing between risk and return [that UPIA] identifie[s] **as the fiduciary's central consideration** [emphasis added]. UPIA § 2(b)."

As a matter of "best-practices", ILIT trustees should, therefore, avoid comparing illustrations of hypothetical policy values as a basis for making suitability determinations (more on this below), and instead simply request historical returns for invested assets underlying TOLI cash values, and measure such performance against asset class benchmark performance for the asset allocation corresponding to the overall investment strategy having risk and return objectives reasonably suited to the trust. While past performance is no guarantee of future results, justifying expenses and using past performance to set reasonable expectations is a familiar practice in investment trusts, and doing so here in Cochran may very well have avoided litigation altogether.

Reliance on Illustrations of *Hypothetical* Policy Values?

The sole basis for the court's understanding that existing VUL holdings posed "significant risk and likelihood of ultimate lapse" and that the replacement policy provided "a smaller but guaranteed death benefit" was the illustrations of hypothetical policy values presented by the outside consultant. Such illustrations of hypothetical policy performance are a commingling of the insurer's representations as to what they actually expect to charge for cost of insurance charges and expenses intermixed with some usually arbitrary and often unreliable assumption as to the rate of return on invested assets underlying policy cash values. While comparing illustrations of hypothetical policy performance is a common practice in the life insurance industry, it is a practice unique to the life insurance industry, and is actually

[23] While the amount of cash values in existing VUL holdings was not mentioned in the record evidence, such cash values likely totaled approximately $550,000 based the findings of the outside consultant that were included in the record evidence and given product pricing and performance data in THEInsuranceAdvisor.COM database.

prohibited by the Financial Industry Regulatory Authority (FINRA) – the chief regulatory body of the financial services industry.

We have discussed above how such comparisons of illustrations of hypothetical policy performance could leave the trustee vulnerable to accusation of breach of fiduciary duty for failure to investigate and justify trust expenses and/or failure to set and manage to reasonable rates of return. In addition, because these comparisons of illustrations of hypothetical policy performance were the sole basis for the courts understanding of the attributes of the various life insurance policies involved here, it is relevant that FINRA considers such life insurance policy comparisons misleading. While FINRA does not have jurisdiction over the ILIT trustee, their Rules are intended to ensure that "communications … shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service" and may not [emphasis added] "omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading."

As such, while these Rules only apply to the sale of variable life (VL) products, and while a trustee could argue that the FINRA standard does not apply to comparisons of illustrations of hypothetical policy performance for their purposes, a plaintiff attorney could conversely argue that accepting a lower standard of care for certain products just because current (and according to FINRA CEO Mary Schapiro the soon to be changed) regulations allow for the omission of underlying cost and performance disclosures and do not require that communications be fair and balanced is not consistent with the standard for fiduciaries. In addition, to the extent that some comparative analysis for a VL policy holding was used as the basis for replacing such VL policy, then that comparative analysis could be considered "Sales Literature" under FINRA Rules, and could then place the trustee either in violation of FINRA Rules or party to the violation of FINRA Rules depending upon who actually transacted the replacement.

While the use of such comparisons of illustrations of hypothetical policy values happened to produce a good result for the trustee in this case, this case is the first such case, known to authors, involving accusation of breach of fiduciary case in an ILIT that has actually been adjudicated and it remains to be seen whether the courts will make the same determinations in the future. As such, the conservative trustee (or its "prudent delegatee") should take only limited comfort from the precedential value of this case, and should as a matter of "best-practices" examine the standard of care prescribed by the more evolved FINRA Rules governing such comparisons of illustrations of hypothetical policy values, namely:

- FINRA Rule 2210 Communications with the Public[24], Section (d)(2)(B) states that "any comparison … between investments … must disclose all material differences between them, including (as applicable) investment objectives, **costs and expenses** [emphasis added], liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features." Simply comparing hypothetical illustrations of projected premiums, policy cash values and/or death benefits does not disclose any differences (material or otherwise) as to cost of insurance (COI) charges (accounting for as much as 85% of total trust expenses), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and/or premium loads. As discussed above, such cost disclosures are also essential to compliance with Section 7 of the Uniform Prudent Investor Act (UPIA) as adopted by the respective States[25].

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[24] See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3617.

[25] For a list of States which have adopted the Uniform Prudent Investor Act in some form or fashion, see the Table of Uniform Laws in the Legal Information Institute section of the Cornell University Law School web site (http://www.law.cornell.edu/uniform/vol7.html#pruin).

- FINRA Rule IM-2210-1 Guidelines to Ensure That Communications With the Public Are Not Misleading[26] goes on to require that "statements are not misleading within the context in which they are made" and instead must provide "balanced treatment of risks and potential benefits" and "be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments." Of course, the context of the comparative analysis in this case was (supposedly) to evaluate and establish for the trustee the suitability (or lack thereof) of existing and replacement policy holdings. However, simply comparing hypothetical illustrations of projected premiums, cash values and/or death benefits fails to consider "the risks of fluctuating prices [or lack thereof] and the uncertainty of dividends, rates of return and yield inherent to investments" and therefore also fails to provide a "balanced treatment of risks and potential benefits". As such, policy comparisons that use hypothetical illustrations for the purpose (i.e., within the context) of determining the suitability of a given policy are "misleading" under FINRA Rules. Also as discussed above, establishing the reasonableness of the rate of return expected on invested assets underlying policy cash values as it relates to either actual historical performance and/or the historical performance for the asset classes corresponding to the asset allocation appropriate to the trust is also essential to compliance with Section 2 of UPIA as adopted by the respective States[25].
- For these reasons, FINRA Rule IM-2210-2 Communications with the Public About Variable Life Insurance[27] concludes in Section (b)(5)(C) that "it is **in**appropriate [emphasis added] to compare a variable life insurance policy with another product based on hypothetical performance, as this type of presentation goes beyond the singular purpose [emphasis added] of illustrating how the performance of the underlying investment accounts could affect the policy cash value and death benefit." In support of this conclusion, Section (b)(5)(A)(i) states that "illustrations may not [emphasis added] be used to project or predict [future] results as such forecasts are strictly prohibited by the Rules". Inherent in any comparison of illustrated premiums, cash values and/or death benefits for the purpose of determining which product is more/less suitable/competitive is inherently the presumption that such projections are accurate predictions of future results, which is "strictly prohibited by the Rules". While such policy comparisons are common practice in the life insurance industry, they are beyond the allowable "singular purpose", "inappropriate" and "misleading" by FINRA standards. As such, to the extent that FINRA standards provide guidance as to the fiduciary standard to which ILIT trustees may be held, cautious ILIT trustees should consider alternative means of determining and documenting suitability either in addition to or in lieu of such policy comparisons.

CONCLUSION:

Cochran v. KeyBank is the first case involving a claim of breach of fiduciary duty against an ILIT trustee that has worked its way all the way through the courts. As such, this case marks the beginning of a new understanding for how to apply Prudent Investor Act principals to trust-owned life insurance (TOLI). While it provides ILIT trustees with some guidance and comfort, "it appears that this case could easily have gone the other way on the issue of 'prudent process'"[28] giving only cursory treatment to certain elements of the breach of fiduciary duty claim that could well form the main elements of a similar future challenge. As such, ILIT trustees intent on preventing similar such future challenges before they are ever brought should also consider:

1. **Taking steps to demonstrate they investigated and justified TOLI expenses.** For instance, most illustrations of hypothetical policy values can include upon request the actual year-by-year detail for

[26] See http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3618.
[27] See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3619.
[28] LISI Newsletter #1486, Patrick J. Lannon

the cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and premium loads they expect to charge. As such, cautious trustees should simply ensure these detailed expense pages are included in their routine requests for inforce illustrations and so as to then be able justify such TOLI expenses by measuring against corresponding representative benchmark averages (e.g., available for free at www.PolicyPricingCalculator.com).

2. **Ascertaining the appropriate asset allocation and corresponding expected rate of return as it relates to the overall investment strategy and corresponding risk and return objectives reasonably suited to the trust.** Performing this function for a life insurance trust is at least similar to if not the same as that which trustees routinely perform in investment trusts. For instance, the more conservative the asset allocation in an investment trust, the lower the risk and the lower the benefit in the form of income and/or growth, and vice-versa. Likewise in a life insurance trust where the more aggressive the asset allocation, the greater the expected rate of return that can pay for more cost of insurance charges and policy expenses, and thus pay for a higher death benefit, but with a greater the risk of a "premium call" or lapse, and vice versa (as we saw in this case). As such, cautious trustees should set and manage to reasonable expectations as to the rate of return on invested assets underlying policy cash values in the same way they would in an investment trust.
3. **Adopting alternative means of determining and documenting suitability either in addition to or in lieu of policy comparisons using illustrations of hypothetical policy values.** For instance, while certain policy comparison services "advertise" their policy review reports to be "complete", many of these policy analysis reports actually **disclaim** suitability determinations in the proverbial fine print. Having a report in the trust file that purports to ascertain the suitability/competitiveness of a particular policy is an acknowledgement by the trustee of their duty to investigate suitability. However, a report that acknowledges this duty to investigate, but then does not actually demonstrate the exercise of this duty, and instead actually disclaims the performance of this duty, may prove indefensible in future such breach of fiduciary duty cases. As such, cautious trustees should "check the fine print" of their policy review reports and seek out independent research to determine and document suitability by 1) justifying TOLI expenses ,2) setting and managing to reasonable performance expectations, and 3) documenting the delegation of responsibility to the independent researcher in accordance with the Uniform Prudent Investor Act.
4. The court makes clear that in this case the insured died unexpectedly. The unexpected nature of the death is bolstered by the fact that the insured had recently qualified for substantial life insurance. While not discussed in this case, a trustee who does not have the benefit of recent information about the health of the insured may want to take additional steps to determine the health and likely life expectancy of the insured (if the insured is cooperative) before making changes to a policy to extend its coverage.
5. The court notes that KeyBank relied on guidance from "an outside, independent entity with no policy to sell or any other financial stake in the outcome." Presumably a consultant was engaged because KeyBank either lacked the internal resources to analyze the policies or because it wanted to distance itself from the decisions. It is logical to assume that KeyBank would have faced an uphill battle if could not show either sufficient internal expertise or a disinterested outside advisor. Trustees should make sure that they are compensated sufficiently to retain sufficient expert internal or external advice and/or research as they may need.[29]
6. The court determined that the beneficiaries were kept sufficiently informed. A cautious trustee will be attuned to such issues as custody of minors and family dynamics generally. While the court was correct to determine that lack of information was not a proximate cause of any damages in any event, in some circumstances a cautious trustee should consider obtaining releases from

[29] For a discussion of how to apply an assets-under-management business model and corresponding fee structure to life insurance, see Barry D. Flag, "$3 Trillion in Neglected Wealth", LISI Estate Planning Newsletter # 1287.

beneficiaries prior to substantially reducing a death benefit or at least consider a formal or informal accounting that will start the applicable statute of limitations for challenges running. While state's requirements for reporting to beneficiaries varies greatly, in states that require disclosure a failure to disclose can make even innocent actions appear nefarious and perhaps lower the bar for a finding of bad faith.

7. The court in this case found no breach of duty associated with coordination with the insured/grantor. While the court's reasoning appears sound, a trustee should be careful to remember that its fiduciary duties run to the beneficiaries and not to the insured/grantor. In this case, the court ignored such items as the "outside, independent entity" repeatedly referring to the insured as KeyBank's "client." If, for example, the insured/grantor had hired KeyBank to manage his other assets, the court may have investigated the relationship much more closely.
8. However, as a practical matter an ILIT trustee will have to coordinate with the insured/grantor to some extent, since (i) ILITs are often dependent upon continuing contributions to support the insurance policy and (ii) many trustee choices, such as the ability to purchase new insurance, are constrained by the insured's willingness to cooperate.

We hope this article helps make a positive difference.

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In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009)