Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make

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Abstract: *When establishing a trust, clients put their planning and, often, the fate of their heirs in the hands of the trustee. They rely on the trustee's expertise and diligence to maintain the trust. However, often trustees fail to monitor the trust and its assets. Their failure can put the trust and its objectives at risk. This article will examine the risks that trustees face when dealing with trust-owned life insurance, and the impact they can have on client planning. It will show how the Uniform Prudent Investor Act often requires trustees to actively monitor trust-owned life insurance. Finally, it will share some cases where trust-owned policies fell short and how better monitoring a trust's life insurance might help a trust better achieve its objectives.*

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When clients establish a trust, they rely on the skills and knowledge of the trustee to assure that their trust meets its objectives. However, in helping clients achieve their goals, trustees face issues when overseeing trust objectives. These include the need to

- meet trust objectives and respect the rights of all beneficiaries
- handle gifts to the trusts, provide notice of gifts and, for trust-owned life insurance (TOLI), meet premium payment deadlines
- comply with state and federal law
- be aware of the threat of lawsuits if they fail, or are perceived to fail, to meet trust objectives

Balancing these items often makes the role of a trustee difficult. However, the diligence that trustees apply to their responsibilities can vary. For the client who irrevocably gave up control of his or her property, this can be an acute problem, putting both the trust objectives and the protection of the trust beneficiaries at risk.[1]

This may be a problem with all types of trusts. However, it can be of particular concern with a TOLI. Why? Because life insurance can be a complex financial instrument that requires specialized expertise in policy design and monitoring.

What could happen to these policies without a trustee's supervision? In many cases the underlying policy design may be such that it will not support the

desired death benefit despite years of premium payments, or it will support the death benefit only with a steep increase in cost. In other cases, the underlying assumptions may not have held up over time. For still others, it may be that, as they attempt to meet a trust grantor's objectives, they can obtain more efficiently priced coverage or increased coverage for the same price.

This article explores the various items to which trustees need to be sensitive. In particular, it focuses on the areas of exposure to potential lawsuits and suggests some ways in which trustees might better protect themselves. It offers some case examples where proactive work by trustees regarding life insurance helped long-term client plans. This article also draws from the Uniform Prudent Investor Act (UPIA), and certain state-to-state variations, but will emphasize the broad standard of care that is increasingly recognized by the courts.

Many of the issues that face TOLI will be discussed later. However, this article will begin with some statistics that show the widespread lack of review that exists today.

Some Background Statistics

With all the concerns faced by trustees, are they living up to the task? Several recent surveys reported in *Trusts and Estates* would indicate that this is not necessarily the case. A particularly telling statistic indicates that anywhere from 70-95% of TOLI has no current servicing agent.[2] The lack of a servicing agent might occur for any number of reasons. However, without the expertise of a servicing agent, one would expect that a trustee would be closely monitoring the life policies, but another recent survey from the May 2004 issue of *Trusts and Estates* indicates otherwise.[3]

This survey looked at approximately 550 trustees, with a roughly equal split between 1) professional trustees and 2) family members and friends acting as trustees.[4] While a reader might expect that 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 TOLI. An even higher percentage, 95.3%, had no guidelines or procedures for handling the asset allocation components of variable life insurance.[5]

For nonprofessional trustees, 71.2% indicated that they had not reviewed their trusts' life insurance policies in the last five years. As with professional trustees, few had any methods for handling the asset allocation component of variable life insurance, with 94.7% indicating that no such procedures were in place.[6]

These results are echoed by other surveys[7] that showed a number of policies and trust portfolios that were able to increase their trust-owned death benefits at no premium increase, or maintain the current death benefit with overall lower premiums. Sections later in this article discuss the reasons why this may occur and offer several specific examples.

Possible Reasons for a Lack of Monitoring TOLI

Why is it that life insurance is not managed as well or as actively as other assets? And why do life insurance dealings tend to focus primarily on 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 actively manage and supervise. Instead, trustees simply maintain the policy, not realizing what might be occurring with its underlying structure.

It could also be that trustees are dealing with a complex asset that requires the support of insurance specialists to which they may not have ready access. Some statistics and articles often quote a figure as high as 90% of trust-owned policies as orphaned policies.[8] Without a servicing agent, trustees as policy owners may not have the time, focus or knowledge to determine where to turn when searching for quality information regarding their TOLI.

The UPIA and Other Standards of Care

Recently, state legislation and regulatory trends have

raised the standard of care where TOLI is concerned. Just as a trustee might monitor the investment assets in a trust, such as reviewing a trust's portfolio to see if performance is meeting expectations, a trustee should also consider monitoring and reviewing the life insurance assets in a trust for which he or she is responsible. The trustee may wish to examine the insurance from two perspectives. First, to determine whether life insurance is appropriate for the current needs of the trust beneficiaries—much as an adviser might review a client's allocation to determine if a client's portfolio allocation is appropriate for a client's current needs. Second, the trustee may wish to examine the underlying policies themselves—much as an adviser might examine individual holdings within a portfolio sector.

In the past decade, bank regulatory agencies and the states have adopted standards related to the purchase and selection of life insurance policies. Particularly applicable are the UPIA[9] and recent standards for the purchase of life insurance set out by the Office of the Comptroller of the Currency (OCC).[10] Although both evolved for different reasons, their standards of care are similar.

The UPIA 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 code, first proposed in 1994, is currently adopted in one form or another by at least 35 states.[11] Several key areas addressed by the UPIA are noted below. While these have not always influenced court decisions in cases involving a trustee's judgment—or lack of judgment—over life insurance, the themes of the UPIA set a standard for trustees that should be considered a minimum threshold.

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.[12] The ability to reduce standards has helped trustees in some of the court cases as discussed further in this article. Nevertheless, the trend in holding trustees to a high standard, and enforcing that 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 into account any differing interests of the beneficiaries."[13] Moreover, the act is very specific in noting that when acting in such a fiduciary capacity, the trustee must "consider the purposes, terms, distribution requirements and other circumstances of the trust."[14] Clearly, the trustee of an irrevocable life insurance trust must always be aware of the purposes for which the trust was established and undertake all actions to ensure those objectives are met.

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 requirements: 1) "…the trustee's continuing responsibility for oversight of the suitability of investments already made, as well as the trustee's decisions respecting new investments…"[15] and 2) "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 in order to bring the trust...into compliance with the purposes, terms, distribution requirements...of the trust…"[16]

Although life insurance is never specifically mentioned, it appears to clearly be covered by the scope of the uniform act, whose commentary states, "In the trust setting the term 'portfolio' embraces the entire trust."[17]

The UPIA sets out many standards for trustees to follow. Among these, the following are particularly relevant for life insurance:[18]

- Assessing risk tolerance, taking into consideration "the purposes of the trust and the relevant circumstances of the beneficiaries"
- Taking into consideration general economic conditions and expected tax consequences of investment decisions or strategies
- Adequately diversifying the trust assets[19]
- Considering an asset's special relationship or special value, if any, to the purposes of the trust

Central to the uniform act is the duty of the trustee to supervise the trust activities and the trust assets used to achieve trust purposes. The commentary to Section 2 of the act, concerning the Standard of Care, details this.[20] This supervisory standard, when taken with the commentary that the trustee's duty applies to all trust assets, would seem to clearly extend the scope of this uniform act to TOLI in any state where this law has been adopted.

Are professional and nonprofessional trustees held to different standards? Possibly yes. The UPIA notes, "A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills…"[21] Moreover, the commentary for the UPIA notes, "Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals…"[22] In other words, this is a case-by-case determination. Even some of the court cases discussed in this article seem to indicate that different standards may apply in different circumstances. Nevertheless, nothing would appear to relieve a trustee in all circumstances.

These standards parallel those applied in much of the banking community regarding the purchase of life insurance. In recent years, the 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 10-point prepurchase assessment analysis.[23] Although these guidelines were likely developed independently of the UPIA, the focus is similar. Where the OCC is concerned, the focus of these guidelines primarily affects the use of life insurance relative to the bank's operational needs. 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
- carrier selection

In the last several years, the OCC has further honed its guidelines relative to variable life insurance.[24] Where variable life insurance is concerned, the OCC restricts the use of variable life insurance in a bank setting except in very specific situations. The new guidelines do not remove any earlier guidelines; they merely add to the standards already established by this governing agency.

Clearly, the trend is toward setting standards relative to the monitoring of life insurance and assuring that there is both a prepurchase and ongoing review of the policies.

One final note regarding the standard of care: although the OCC standards were prospective in their application, the UPIA is not. Specific to this issue, the UPIA notes, "This [Act] applies to trusts existing on and created after its effective date."[25]

Although that section goes on to note that the act is only applicable to actions after the enactment date, circumstances are likely to place trustees on notice of any issues that they may have with existing life insurance.

How a Trustee Might Be Sued

It almost goes without saying that there is an increasing trend toward lawsuits in this country. While there is little by way of specific court cases involving the ongoing review, or lack of review, of TOLI, other cases show a trend toward lawsuits against trustees under circumstances related to their fiduciary duty and supervision of the trust assets. The cases below illustrate suits involving lack of dedication to the trust or disappointment over the death benefit received by the trustee.

In most cases, beneficiaries bring suit. The client who established the trust and is the insured typically does not have the legal standing to bring suit; he or she is deemed to have no interest in the trust after it is established. However, in a few extreme negligence cases, the trust's grantors were given the right to sue, or they attempted to sue, the trustees.

All cases turn on the facts and circumstances of each individual situation. As a result, many cases turned on the specific wording of the trust. Often that allowed

trustees sufficient leeway in their decisions and actions, so that few cases have resulted in decisions favoring beneficiaries claiming injury. Still, there is a clear trend toward suits. There is also a strong sense in the legal community that many of these are settled out of court, either because of the relationship of the parties or because a corporate trustee wanted to avoid adverse publicity.[26]

Following are some court cases in which trustees have recently seen lawsuits.

Negligence in Maintaining the Life Insurance Policy

In one case the beneficiaries sued a CPA acting as trustee for failing to pay premiums. In this case the CPA, due to problems related to the practice, missed premium payments. Despite this negligence, the case was settled on behalf of the trustee. The trust allowed for liability only in cases of gross negligence, which the beneficiaries were unable to prove.[27] In a second case, a corporate trustee accepted gifts over a period of years 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 than the insured grantor cared to cover by way of trust gifts. This second case shows the need to be sensitive to client/grantor gifting capacity. In this second case the grantors of the trust sued, but their case was dismissed because it was determined that they did not have standing to sue; only the trust beneficiaries were deemed appropriate parties to sue. It was also determined that the trust document allowed the trustee to not pay life insurance premiums, which is often the case with many irrevocable life insurance trusts, and a key consideration in this case. [28]

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.[29]

Poor Life Insurance Design or an Improper Policy

There are several cases in which the life insurance trust was set up anticipating a specific premium paying pattern, after which the policy cash values were expected to support the death benefit. In several cases trustees or advisers were sued when actual policy performance required additional premium payments (and additional gifts).[30] Portions of the article discuss the reasons why certain policy designs may have failed, and this is one key reason for trustees to periodically revisit their TOLI. In a similar design-related case, beneficiaries sued because they believed that the death benefit purchased was lower than might have been obtained from a different policy design at the same company. This latter case was settled out of court.[31]

Poor Selection of a Vendor

This ties in with the OCC standards of documenting, as part of the due diligence process, why a particular life carrier and agent was selected. In one trust-based case the trustees knowingly purchased life insurance from a felon whose life insurance license had been revoked.[32]

Areas Where Trustees Need to Review TOLI

Considering all of the areas where a trustee might be sued, or where the trustee must make decisions with respect to the UPIA, a trustee must be as diligent with the trust's **[AU: CORRECT?]** TOLI as with any other trust investment.

When life insurance is concerned, many items have changed in recent years that should cause trustees to reexamine their trust-owned policies. Consider what has happened with the economy and within the life insurance industry. These changes involve many items that may warrant trustees reviewing their existing life insurance:

- **Policies that are not performing as illustrated—** It was not unusual to have policies illustrated assuming very high dividend rates or UL **[AU: WHAT DOES "UL" STAND FOR?]** 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. In recent years market condi-

tions have seen reduced interest rates, potentially causing lower-than-expected UL crediting rates or participating life dividends. Similar market conditions in recent years have resulted in stock market returns that have been less than 10% on average. 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 warranted. This may be due to inflation, poor initial planning or simply evolving client needs.
- **Newer products that may be more cost efficient—** Improved life expectancy, better underwriting, and the streamlining of expenses among major insurers have driven much of this.[33]
- **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.[34]
- **New riders that may offer more appropriate features—**These allow a trustee more options in designing a policy that meets a client's needs, including 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 face 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 increased or extended gifts. For example, the death of a spouse effectively halves a client's annual exclusion gifting power, which can adversely affect his or her ability to continue funding the trust. 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 related to 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, 85% of existing trusts could obtain a 40% reduction in premium costs for the same amount of insurance or, conversely, obtain 40% more death benefit for the same premium cost.[35] The year 2000 study from which those values are derived is actually much more involved than that statistic might indicate.[36] However, it is clear from the surveys that many trusts could obtain significant cost savings.[37]

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 reexamine a particular asset in his or her portfolio.

Case Studies

Knowing the issues trustees face regarding TOLI, let's examine four cases where a policy review helped a trustee improve upon a client's existing life insurance in one or more ways—through either reduced cost, improved death benefit, improved guaranteed death benefits or some combination thereof.[38]

Example One

A 54-year-old had a $4,500,000 death benefit need. The current life insurance was made up of three life policies that cumulatively had a significant cash value of nearly $700,000. However, these three policies provided a death benefit that was short of the current death benefit need and cumulatively offered $3,850,000 of nonguaranteed death benefits. The combined premium cost was $63,900; however, on two of the policies the trustee determined that he or she could stop premium payments. On the third contract, the trustee needed to

maintain the premium of $9,700 for all years.

However, there were some issues with the current policies. For one of the contracts in which the premiums could stop, the in-force ledgers showed that the death benefit would dip slightly but increase in the later years. The trustee was unable to determine what caused the increase. Perhaps more importantly, none of the three existing contracts offered any guaranteed death benefits.

The trustee then examined a new life insurance policy. He was able to determine that with the current cash value, the trust could purchase a new policy that offered the necessary death benefit ($4,500,000), with secondary guarantees in every year and no illustrated premium payments.

One quick note about cash surrender value: in this case, the cash surrender value with the existing life insurance was very strong, and that supported the new, proposed life insurance policy. In fact, the existing life insurance cash values were—based on the in-force illustrations—scheduled to grow significantly. However, the trustee's needs were death benefits and cost savings. With the newly proposed insurance, the cash values were not as significant but still respectable. However, that was not important to the trustee. He was willing to give up the cash-value buildup in exchange for the increased death benefit (up approximately $700,000), secondary guarantees and reduced premium costs.

Example Two

In this example, the trustee maintained a life insurance policy on a married couple in which the spouses were ages 59 and 61. In this case the existing insurance—one policy—offered a $1,700,000 death benefit. The trustee was primarily concerned with maintaining this death benefit—both on a current and guaranteed basis—while reducing the trust's out-of-pocket costs.

The existing insurance offered both current and guaranteed death benefits in the early years, but the guaranteed death benefits dropped off significantly in the later years, when the couple was in their 90s. This is not uncommon in situations where participating whole life policies were originally illustrated with some blend of term insurance. Drops in actual dividends credited to a policy caused the performance of the life insurance policy to vary from the original illustration. As a result, dividends paid between the original illustration and the time of the policy review had not purchased sufficient paid-up additions to replace the ever increasing term costs under the blended policy. If in an in-force illustration future dividends were not able to support the purchase of sufficient paid-up additions, the guaranteed death benefit would decrease. In this case, the existing insurance was able to maintain the current death benefit—based on the in-force ledger—but at a significant cost. The annual premium on the existing policy was $19,000 each year. In the meantime, the guaranteed death benefit would drop in the later years.

The insureds were young and healthy enough that a new proposed policy would have reduced their cost significantly to $11,500 each year, a 39% annual drop. Additionally, they were able to maintain the desired $1,700,000 death benefit on both a current and guaranteed basis in each year examined. The downside was that the new proposed policy offered weaker cash surrender values. However, this was to be expected as a result of lower premiums and the higher costs associated with guarantees. Nevertheless, cash values were deemed to be less significant than the death benefits and cost savings.

Example Three

In this case, a trustee held a second-to-die policy that initially insured a married couple. At the time the policy was issued, the two insureds were ages 65 and 75. However, within the first decade one of the insureds, the husband, died.

Although second-to-die coverage is often considered to be the most cost-effective life insurance, in some cases changes in the life insurance policy and the life insurance industry might now allow a single life policy on the survivor to provide more appropriate coverage for the trust. What are these changes? First, improved life expectancy and more competitively priced products might allow insurance on the survivor to be more cost

effective. Additionally, with many older second-to-die policies, following a first death, an insurer may change the status of the older contract and treat it as a single life policy. As a result, they readjust their reserves and the cash value of the contract to reflect this change in status. This may offer the survivor, or in this case the trustee, a unique opportunity.

Here, the trustee was able to improve upon the trust-owned coverage with a simple review. In this case, the trustee wanted to maintain the existing $5,000,000 death benefit and improve the cost of the contract. The initial policy was designed with a mix of base coverage and an aggressive (50%) term blend. The original illustration assumed that the dividends would purchase enough paid-up additions each year that the term insurance would eventually be replaced, while the desired death benefit remained in the hands of the trust. However, because of the aggressive term blend, the policy was only able to provide a guaranteed death benefit of $2,500,000.

The trustee was able to purchase a new life insurance policy that offered both a current and guaranteed death benefit of $5,000,000 up to and through the survivor's age 100, a significant improvement over the original contract. Just as important, the trustee was also able to use the existing life insurance policy's cash surrender value to reduce the new policy's overall costs. Between inception and the survivor's age 99, the new policy required a lower premium cost of $1,300,000, compared to $2,300,000 under the existing life insurance contract, a cost savings of 43%.

Cautionary Notes

Just as a trustee should exercise care with existing life insurance, care should also be exercised during any review of TOLI. Keep in mind that a review is not a planned replacement. No insurance should be canceled or replaced until a trustee is certain and can document that a new policy offers an improvement to the trust and the beneficiaries.

When a new policy does offer an improvement, additional cautionary steps need to be considered. Along these lines trustees should be aware of surrender charges, new contestability periods, issues that might be involved with Section 1035 exchange as it relates to the insurance in question, and whether the insureds are sufficiently healthy to qualify for the proposed new policy at the new premium and with the design illustrated as part of the review process.

Although the examples here showed policies involving Section 1035 exchanges, it is not uncommon to see alternatives. A number of organizations currently promote the sale of existing life insurance on the secondary market. In certain cases such an approach might offer a trust and trustee advantages, but additional care and analysis must be undertaken. The scope of this article does not allow for a thorough discussion relative to the pros and cons of such an approach; however, a few items should be mentioned in terms of TOLI. When an existing policy is sold on the secondary market it may provide the trustee with a greater amount of funds than might have been received if the policy was surrendered for its cash value. Such an approach might make sense if the life insurance is no longer required. Again, the trustee must consider and clearly determine if the insurance is no longer required, must weigh the tax considerations, and may wish to receive some type of release from the trust beneficiaries before such a policy is sold if no new life insurance purchase is considered.

In certain cases additional planning might be suggested in conjunction with such a sale of the policy. For example, it is sometimes suggested that the trustee use the sale proceeds to purchase a single premium immediate annuity, with the annual after-tax annuity payments used for premiums on a new TOLI policy. This approach may be appropriate when

- the after-tax sale proceeds have a value greater than a pure policy surrender
- the annuity payments offer sufficient after-tax amounts to either cover the new policy's premiums or are sufficiently high enough to reduce a client's gifts into the trust
- the new policy offers an improvement over the older insurance

Such an approach may be appropriate in some circumstances; however, several items need to be considered. First, the insureds and the trustees must always keep in mind that clients have a limit on how much life insurance coverage might be available for them. This is a particular concern in large cases where reinsurance comes into the picture. When existing insurance coverage is sold and retained by third-party owners, the amount of insurance coverage remaining available for a client may be reduced. Clients and advisers should perform a thorough analysis of what coverage will be available for clients if their existing insurance is not cancelled.

Additionally, clients, trustees and tax advisers will also need to carefully weigh the consequences of selling a policy to a third party. This must be considered from both an income tax perspective[39] as well as from a financial perspective. Those amounts will need to be weighed against what life insurance coverage might be available if the existing insurance policies were exchanged—usually in one single Section 1035 exchange—into a new life insurance contract. The after-tax amounts from such a sale and annuity purchase must be sufficient to cover costs or meaningfully reduce current gifts made to a trust to cover life premiums. The return a trustee might see from a tax-free section 1035 exchange into a new policy would need to be weighed against the sale of a policy/purchase of an annuity approach.

In short, any TOLI transaction requires care and caution on the part of a trustee.

Conclusion

Clearly, trustees are exposed to many potential issues and suits regarding TOLI. Life advisers can help trustees by making them aware of these issues. With the help of life advisers, there are several steps trustees can take to assess their risks and correct potential issues. Among these are:

- Setting goals and standards regarding their TOLI. This includes examining existing life insurance policies and comparing alternatives—there are several tools available to help with this work—and examining client goals and beneficiary needs.
- Examining policy funding and determining if additional funding is necessary. This includes considering whether or not a client's gifting capacity is able to support future premium needs.
- Considering life insurance performance:
  - 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 subaccounts need to be reexamined based on evolving client needs and subaccount performance?

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

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(1) Some clients adopting irrevocable trusts might utilize advanced techniques, such as trust protectors, to oversee their trustees. However, these techniques vary widely and the vast majority of trusts are more standard arrangements.
(2) Whitelaw and Ries, "Managing Trust-Owned Life Insurance Revisited," *Trusts and Estates* (April 1999): 38, citing statistics on page 39.
(3) Harris and Prince, "The Problem with Trusts Owning Life Insurance," *Trusts and Estates* (May 2003): 62.
(4) Ibid., p. 63.
(5) Ibid.
(6) Ibid.
(7) Whitelaw and Ries, "Managing Trust-Owned Life Insurance Revisited." See also the survey published under the articles section of *http://www.trustbuilderservices.com/Publications/2000-04%20TOLI%20Survey%20and%20Comparative%20Analysis.htm.*

(8) For example, see Whitelaw and Ries.
(9) UPIA, drafted by the National Conference of Commissioners on Uniform State Laws, Annual Conference Chicago, IL, July 29-August 5, 1994.
(10) See OCC Bulletin 2000-23 (July 23, 2000), replacing and updating OCC Bulletin 96-51, September 20, 1996, which initially detailed the 10 points of due diligence as part of a life insurance pre-purchase analysis.
(11) See survey of states at *http://www.law.cornell.edu/uniform/vol7.html#pruinI.*
(12) UPIA, Section 1(b).
(13) UPIA, Section 6.
(14) UPIA, Section 2(a).
(15) UPIA, commentary concerning Duty of Care accompanying Section 2.
(16) UPIA, Section 4.
(17) UPIA, Section 2(b). The preface to the UPIA notes that the 1994 uniform act makes five fundamental alterations to the former criteria for prudent investing based on the "Restatement of Trusts 3d: Prudent Investor Rule." The first of these states, "The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term 'portfolio' embraces all the trust's assets." See also the commentary to UPIA Section 2(b).
(18) All are detailed in the UPIA, Section 2.
(19) Note that where life insurance is concerned extensive diversification is often difficult. The uniform act has broad language that takes unusual situations into consideration. UPIA, Section 2(b)(8) notes that trustees may take into account "an asset's special relationship…to the purposes of the trust." Section 3 deals solely with diversification. It notes that assets must be diversified unless the "trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." See the appendix that accompanies this article. In particular, it details additional changes the Commonwealth of Pennsylvania has made to the uniform act.
(20) See the commentary to UPIA Section 2(b), which includes 1) the Duty to Monitor: "'Managing' embraces monitoring…for oversight of the suitability of investments already made as well as the trustee's decision for new investments" and 2) the Portfolio Standard: "In the trust setting the term 'portfolio' embraces the entire trust estate."
(21) UPIA, Section 2(f).
(22) UPIA, Commentary to Section 2 regarding Professional Trustees.
(23) See OCC Bulletin 2000-23 (July 23, 2000), replacing and updating OCC Bulletin 96-51, September 20, 1996, which initially detailed the 10 points of due diligence as part of a life insurance prepurchase analysis. See also Office of Thrift Supervision, Regulatory Bulletin 32-16 (December 30, 1999).
(24) See OCC Bulletin 2000-23 (July 23, 2000). See also Interpretive Letters #850, February 1999 (written January 27, 1999) and #926, March 2002 (written September 7, 2001). 12 USC 24(7), 12 USC 92(A).
(25) UPIA, Section 11. State enactment may vary and you should check with the state law that governs the trust document.
(26) Donohue, "Unexpected Liability Awaits Many Trustees of Life Insurance Trusts," *Trusts and Estates* (April 1994): 43.
(27) *Pearson v. Barr,* 2002 WL 1970144 (Cal. Super Ct. 2002).
(28) *Sanders v. Citizens National Bank,* 585 S.2d 1064 (Fl Ct. App 1991).
(29) These cases are not necessarily related to life insurance but show the trend toward suing trustees over investment and management decisions. For example: *Seeman Life Insurance Trust v. Gumbiner,* 841 P.2d 403 (Colo. Ct. App. 1992), self-dealing; *Southwest Guaranty Trust Co. v. Providence Trust Co.,* 970 S.W.2d 777 (Tex. Ct. App., 1998), corporate trustee sued over an annuity purchase.
(30) These are often called "vanish" premium issues. In many cases the assumptions used in the original illustration failed to materialize. As a result additional premiums were required or a policy risked failure. See *Von Hoffmann v. Prudential Insurance Co.,* 202 F. Supp. 2d 252 (N.Y. Dist. Ct. 2002) and *Heslin vs. Metropolitan Life Insurance, Co.,* 733 N.Y.S. 2d 753 (N.Y. Sup. Ct. 2001). In the former case the insureds were held to have a cause of action; in the later case the insureds were held to not have a cause of action. Neither of these cases involved trust-owned insurance. Another key recent case is *Koehler v. Merrill Lynch, et al.,* 706 S.2d 1370 (Fl. Ct. App. 1998). Here, an existing trust's policy cash values were accessed to pay premiums on a new life insurance policy held by the trust. When the new policy premiums did not "vanish" as expected the grantor was informed that they needed to make additional premiums. No clear decision was reached by the court in this case; it was remanded to a lower court.
(31) This case was discussed in Donohue, "Unexpected Liability Awaits Many Trustees of Life Insurance Trusts." In this case the insured died shortly after the creation of the trust. The beneficiaries sued the trustee because they believed that for the same premium amount a greater death benefit could have been purchased. This case was settled out of court so no conclusion can be drawn as to whether or not the policy design appropriately or inappropriately looked at both the long- and short-term design decisions related to a policy.
(32) *Phillips v. Ostrer,* 481 S.2d 1241 (Fl. Ct. App. 1986). The court held that the trustees breached their fiduciary duty in their choice of policies and agent.
(33) As evidence of the improved life expectancies consider the following comparison between the 1980 CSO Standard Ordinary Mortality Table and the 2001 CSO Male Smoker/Non-Smoker Composite Mortality Table. Under the 1980 table, between two 45-year-olds the risk of one individual dying before age 65 was 35%. By contrast, that number had dropped to 21% under the 2001 table. Similarly, between two 55-year-olds the risk of one individual dying before age 65 was 27%. By con-

trast, that number had dropped to 12% under the 2001 table.
(34) Note: Many clients assume that secondary guarantees are an automatic death benefit guarantee. However, with many secondary guarantees, the guarantee is only available to the extent that it is backed by the life insurer or its successor. Care must also be taken to determine the specific requirements in maintaining this secondary guarantee and the life insurance company's financial strength.
(35) Mayer, "Fiduciary Duties for Trust Owned Life Insurance under UPIA," *Michigan Lawyers Weekly* (July 2, 2001). Article may be found at Mr. Mayer's Web site, *http://www.fiduciaryreview.com/Publications.htm.*
(36) For a complete assessment of the life insurance policies involved in this survey, see details presented in Whitelaw and Ries.
(37) Whitelaw and Ries.
(38) All case studies are based on true client examples. The cases, however, do not reflect the product of any specific company and the numbers reflect hypothetical examples. Your client's results will vary.
(39) The exact tax consequences of a sale of a policy on the secondary market has never been specifically addressed by the Internal Revenue Service or the U.S. Treasury. However, the common industry practice is to allow any gain on a life insurance policy (the cash surrender value in excess of the tax basis, typically the premiums paid) to be taxed as ordinary income. Any funds in excess of the cash surrender value received as part of the sale are treated as capital gain. Note that these income tax consequences are different than those that would be received under an advanced settlement in the event of a terminally ill insured. Chodes and Arenson, "Viatical Settlements as an Estate Planning Tool," *Personal Financial Planning* (July/August 1998): 23; Chodes, Tow and Hoopingarner, "Viatical Settlements and High Net Worth Transactions: New Uses for Affluent Policyholders," *Journal of Financial Service Professionals* (November 1998): 84; Eizen and Levy, "New and Novel Uses of Viatical Settlements in Insurance Planning," *Estate Planning* (December 1999): 481; Katt, "Assessing Clients' Life Settlement Offers," *Journal of Financial Planning* (July 2002). Note that the Katt article, in discussing income tax consequences, acknowledges the uncertainty of the income tax treatment and shows calculations on sale transactions as taxed in two ways: all gain over basis taxed as ordinary income and the ordinary income/capital gain approach.
(40) Legal Information Institute Uniform Laws Web site (*http://www.law.cornell.edu/uniform/vol7.html#pruin*). This site is also a good reference to locate uniform acts as adopted by specific states.
(41) California Probate Code Sections 16045-16054. Note that California Probate Code Section 4457 also enumerates and gives trustees broad powers to purchase, exchange, sell, rescind, pay premiums or elect to not pay premiums and exercise other general rights associated with life insurance.
(42) Massachusetts General Laws, Chapter 203C.
(43) Rhode Island General Laws, Title 18-15.
(44) 09 V.S.A., Chapter 147, Sections 4651-4662.
(45) Connecticut General Statutes, Title 45a Probate Courts and Procedures, Chapter 802c, Trusts, Title 45a-541(a)-(l).
(46) North Carolina General Statutes, Chapter 36A Article 15, §§ 36A 161-174.
(47) The statutes also added a short section clarifying that the uniform act, as adopted, would not interfere with the administration of charitable remainder trusts as controlled by other provisions of the state statutes. North Carolina General Statutes, Chapter 36A Article 15, § 36A 170.
(48) North Carolina General Statutes, Chapter 36A Article 7, §§ 36A-100.
(49) Pennsylvania Consolidated Statutes, Title 20, Chapter 72, §§ 7201-7214.
(50) Pennsylvania Consolidated Statutes, Title 20, Chapter 72, § 7208.
(51) Michigan Compiled Laws, Ch. 700, 386-1998-I-5.
(52) In addition to adopting the UPIA, the Michigan Compiled Laws also include other language holding a trustee to a prudent standard of care and trustees with special skills to higher standards of care. This language, adopted at the same time as the UPIA, is redundant and may simply be a carryover from earlier state law. It does not appear in any way to dilute the scope of the UPIA adopted by Michigan. MCL Ch. 700, 386-1998-VII-3, 700.7302.
(53) MCL Ch. 700, 386-1998-5, 700.1504.
(54) New York State Consolidated Laws, Estates, Powers and Trusts, Chapter 17-b, § 11-2.3. This section also holds professional trustees to a higher standard of those that hold themselves as possessing specialized skills.
(55) Florida Statutes, Title XXXIII, Chapter 518.11.
(56) Illinois Compiled Statutes, Trusts and Fiduciaries, Chapter 760 ILCS 5 *et al.*
(57) 760 ILCS 5/5.1.
(58) Alaska Statutes, Title 13, Chapter 36, §§13.36.225 *et al.*
(59) S.D. Codified Laws §§ 55-5-6 through 55-5-16. These provisions of the state code were adopted in 1995, following the enactment of the current UPIA, by S.L. 1995, Chapter 271. The law deviates from the UPIA with key wording such as: "Prudent investor rule. No specific investment or course of action is, taken alone, prudent or imprudent. The trustee may invest in every kind of property and type of investment, subject to this chapter. The trustee's investment decisions and actions shall be judged in terms of the trustee's reasonable business judgment regarding the anticipated effect on the trust portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance" (Section 55-5-7). Other language in this section allows a trustee to not diversify if the trustee reasonably believes it is in the best interest of the trust (Section 55-5-8), offers a discussion of circumstances that might influence investment decisions (Section 55-5-11) and offers a range of phases and terminology that is deemed to allow a trustee wide discretion when making investment decisions on behalf of a trust (Section 55-5-14).
(60) *http://www.law.cornell.edu/uniform/vol7.html#pruin.*

Appendix

Variations among States Adopting the UPIA

The UPIA is little more than a model act. This act was drafted and recommended for enactment by all the states by the National Conference of Commissioners on Uniform State Laws at their 1994 conference. This organization was formed in 1892 upon the recommendation of the American Bar Association for the purpose of promoting uniformity in state laws on all subjects where uniformity was deemed desirable and practicable.[40] However, states are not compelled to adopt uniform laws. Those states that do adopt the laws may vary from the uniform act. Therefore, it is critical that financial advisers become familiar with the laws of their respective states.

Where the UPIA is concerned there is a wide variety of methods by which the various states have adopted the provisions. This appendix will not survey every state that has adopted the UPIA; however, it will touch on many of the major states.

Many states have elected to adopt the act verbatim or with little change. This is the case with California,[41] Massachusetts,[42] and other New England states such as Rhode Island[43] and Vermont.[44] Other states have adopted the UPIA but folded the wording into their own, broader legislation. Connecticut[45] is a good example of this approach in which the state adopted the UPIA but included the provisions into a much larger set of provisions concerning trust administration.

In other cases, states have adopted the UPIA almost verbatim but elected to make selective changes. North Carolina[46] adopted the UPIA as part of its general statutes concerning trusts and trustees but made extensive changes to Section One of the model act to clarify its scope.[47] The North Carolina state code also has several provisions enumerating a trustee's ability to own and exercise rights in life insurance.[48]

Similarly, the Commonwealth of Pennsylvania adopted the uniform act, but then added detailed provisions in its own right.[49] For example, the basic uniform act requires trustees to diversify assets. This is not always easy to do where life insurance is concerned. The Pennsylvania code specifically adds a section concerning life insurance[50] that discusses this asset in much greater detail than the uniform act. In particular, this section notes that trustees can acquire or retain a life insurance contract but that they will *not* be responsible if they fail to 1) determine if it is a proper investment, 2) investigate the strength of the life insurance company, and 3) diversify the contract.

In a similar vein, Michigan has also adopted the UPIA with wording changes.[51] Virtually all of these changes are relatively minor, with the Michigan Compiled Laws encompassing the scope and extent of the UPIA.[52] However, Michigan made one significant change regarding diversification. The law, as it reads in Michigan, requires diversification unless the trustee determines that the purposes of the trust are better served without diversifying.[53] This diversification rule is not specific to life insurance and there are no other provisions that are as extreme as the Pennsylvania life insurance wording.

Other states offer very specific wording related to fiduciary investment standards but do not necessarily follow the UPIA. New York[54] and Florida[55] are both good examples of this. Illinois[56] also has its own very specific statutes on trust investments and prudent standards that do not follow the UPIA. In fact, where the UPIA allows trustees to delegate authority pursuant to certain guidelines, the Illinois statutes do not permit delegation[57] unless the trustee meets very specific due diligence standards.

What about those states that have repealed the Rule Against Perpetuities, or adopted other acts that allow some form of creditor protection to the trust grantors? Alaska[58] has adopted the UPIA standard and the model act's wording and incorporated it into its very extensive trust tax code. Although Alaska has unique attributes to its trust code, the UPIA standards of investment care apply. South Dakota adopted the UPIA with substantial modifications in 1995;[59] in fact, the modifications were so substantial that one Web site[60] dedicated to uniform laws does not document South Dakota as having adopted the UPIA. The Delaware Statutes, particularly Title XII dealing with Fiduciaries and Estates, appear to have adopted many uniform laws, but not the UPIA.

Texas is notable in that it is the one large state that has not appeared to have adopted this uniform act.