THE UNIFORM PRUDENT INVESTOR ACT

The Uniform Prudent Investor Act (UPIA), promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1994 and adopted in whole or in part by all but nine states as of 2014, sets out default rules for how trustees should invest and manage trust assets. Prior to the UPIA, most states had laws governing trust investments; however, there was no uniformity among states. The UPIA sought to promote uniformity and as the comments say, to "update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as the 'modern portfolio theory'." Modern portfolio theory is a concept of diversification in investing, with the aim of selecting a collection of investment assets that has collectively lower risk than any individual asset. In adopting the portfolio approach, the UPIA states that the trustee's investment and management decisions regarding individual trust assets should not be evaluated in isolation but rather in the context of the trust portfolio as a whole, taking into consideration the overall investment strategy and risk and return objectives reasonably suited to the trust.

It should be noted that while the UPIA sets out to standardize the duties of trustees to manage trust assets, it is a default standard, so it will not always apply. Section 1 of the UPIA states that it "may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." Therefore, the terms of the trust are in control. The comment to section 1 also states that traditional

trust law allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Thus, a logical question is "To what extent should any or all of the remaining provisions of the UPIA be restricted or eliminated?" From the trustee's perspective for liability purposes, it can be argued that all of the provisions of the UPIA should be restricted or eliminated; however, from the beneficiary's perspective, it can be argued that none of the provisions should be restricted or eliminated because it is one of the main duties of the trustee to invest and manage assets for his/her benefit. The conflicts are not only between the trustee and beneficiary but also with the drafter and grantor. One issue facing planners and drafters of Irrevocable Life Insurance Trusts (ILIT) is to what extent, if any, will the grantor of the ILIT care about the duties UPIA sets out for trustees, and to what extent should the planner and drafter raise and address the issue with the grantor to reflect his or her informed consent?

Section 2 of the UPIA requires the trustee to invest as "a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust" while "exercise[ing] reasonable care, skill, and caution." Among the circumstances the trustee is to consider in investing and managing trust assets is "an asset's special relationship or special value to the purposes of the trust." Additionally, section 2 requires a trustee with "special skills or expertise" to use those special skills or expertise in managing the trust. The comments further explain that:

> The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs.

The issue section 2 of the UPIA illustrates, from the trustee's perspective, is to what extent, if any, the trustee (and especially the amateur trustee) should be relieved from the duty to manage the life insurance policies to be owned by an ILIT as a prudent investor? The trustee and the beneficiaries once again have competing interests in restricting or eliminating the trustee's section 2 duties under the trust document. However, the trustee and beneficiary are not the only ones with conflicting interests. From the planner and drafter's perspective, the issue is to what extent should relieving the trustee from the duty to manage the life insurance policies be discussed with the grantor. Thus, the

main issue that arises is, if the section 2 duties are eliminated under the trust document, who is left to manage the life insurance policies held by the trust? One suggestion is that the agent who sold the policy has an ongoing duty to the client/trustee to service the policy, but as a practical matter, many agents fall short in servicing policies over time. Most beneficiaries are not capable of managing the trust-owned policies (if they are even aware of their existence, since most grantors/parents do not fully disclose and discuss the assets of the trust), and the insured cannot safely participate in the management of a trust-owned policy because of the Internal Revenue Code (IRC) section 2042 incident of ownership concern. Therefore, unless the trustee has some knowledge about life insurance, there may be a need to delegate this duty, which is discussed in section 9 of UPIA below. Also, see Chapter 8, the Life Insurance Policy Management Statement, for a discussion regarding the basic minimum suggested requirements for a trustee.

Under section 3 of the UPIA, the trustee is required to diversify the investments of the trust unless "the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The comments to section 3 provide that, "prudent investing ordinarily requires diversification. Circumstances can, however, overcome the duty to diversify." Since the clear purpose of an ILIT, which is consistent with the settlor's intent in creating it, is to own one or more life insurance policies (and typically, no other assets) during the settlor's/insured's life, it would logically follow that this is a "special circumstance," which, in the words of the comment to section 3 would "overcome the duty to diversify." Notwithstanding the "special circumstances" argument, it appears there is no reason not to eliminate or to restrict the trustee's section 3 duty to diversify the assets of an ILIT during the insured's/settlor's lifetime but not thereafter. Interestingly, it seems that both the trustee and the beneficiaries have the same interests in the ILIT retaining the insurance policies, even as the trust's sole asset, during the lifetime of the insured(s). It should be noted that eliminating the duty to diversify an ILIT's assets during the insured's life should not be so broad as to prevent diversifying its insurance policies among carriers and policy types, where it is appropriate.

Section 9 of the UPIA allows the trustee to delegate investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." If the trustee decides to delegate investment and management functions, they must exercise reasonable care in selecting the agent, establish the scope and term of the delegations, and periodically review the agent's actions in order to monitor the agent's performance. For the

amateur trustee, delegation of the investment and management functions of an ILIT would seem perfectly appropriate, since most individual family member/trustees (and most nonprofessional trustees) do not understand the need for and are not equipped to manage the myriad forms of life insurance today. For this reason, there seems to be no reason for the drafter and planner to restrict or eliminate the power of the trustee to delegate the management of the life insurance policy to a suitable agent except perhaps for incurring additional fees. Chapter 9 raises the issue of who or what is a suitable agent—who is available, can it/should it be the agent who sold the policy, how will he/she be compensated? Is the grantor willing to make gifts to the trust to pay the agent's fee? These questions should be addressed in the Life Insurance Policy Management Statement (see Chapter 8). It should be noted the importance the court placed, in *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009), on the fact that the trustee delegated the review of the life insurance policy and replacement to an independent agent that had no financial interest in the outcome of the policy exchange it was reviewing.

EXHIBIT A

SELECTING A TRUSTEE

Personal or Institutional Trustee

The process of selecting a trustee is not usually an easy decision for the grantor(s). Selecting the wrong trustee can have devastating consequences for the beneficiaries as well as the financial purpose that the grantor intended. While a personal trustee may be a person whom the grantor already knows and trusts and personally knows the beneficiaries which allows them to make well-informed thoughtful decisions that reflect the grantor's goals, the drawbacks of a personal trustee are the limited duration of their ability to serve in the role, the possibility of bias towards certain beneficiaries, the need for successor trustee at their resignation, incapacity, or death; the lack of insurance coverage in case of liability as well as the possible lack of financial knowledge required to make sound decisions regarding trust assets and specifically their expertise and knowledge in managing life insurance policies. For these reasons, some grantors choose institutional trustees such as banks or trust companies who are supervised by state and or federal banking authorities and have a perpetual life.

While the institution may have a perpetual life, it does not mean that the original institution that the grantor wanted and intended will be the same entity in perpetuity. The modern trend of bank consolidation requires a replacement process that will allow the institutional trustee to be replaced if there is a change of control or sale. The additional advantages of the institutional trustee, besides perpetuity, include expertise and competence in trust administration; impartiality in dealing with beneficiaries; insurance liability coverage; and greater oversight by state and/or federal banking authorities to eliminate the probability of self-dealing, fraud, or embezzlement. The disadvantages of an institutional trustee include: greater administration costs, a lack of personal knowledge of beneficiaries and their needs, and a lack of continuity of the same trust officer since there is often turnover in these positions over time.

Questions to Ask a Professional Trustee to See if Qualified

1. What is your experience in administering trusts holding life insurance policies?
2. What are your procedures for managing policies?
3. What is your fee schedule?
4. Are there extra fees for "extra" services? What is considered "extra" services?
5. Is there a minimum account size?
6. Will there be an assigned trust officer instead of being routed to a national call center?
7. How many accounts is the trust officer assigned to administer? Is there a cap on the amount of accounts assigned to each trust officer?
8. Does your firm offer/sell insurance and investment services or have any affiliation with a company that does?
9. Is your firm currently subject to any regulatory penalties, discipline, or litigation?
10. Is your firm currently involved in any litigation with trust beneficiaries?

Questions to Ask Agent to See if Qualified

1. What are your credentials for being a life insurance professional?
2. Have you ever or are you currently subject to any disciplinary action, litigation, or consumer complaint?
3. What companies do you represent?
4. What amount of insurance are you advising the client purchase? How was that amount determined?
5. How long will the policy last?
6. What are the premiums? Are they guaranteed?
7. If the premiums are not guaranteed, how was the premium determined? What is the policy's rate of return and how does it impact the death benefit?
8. What are the guarantees associated with the policy?
9. What is the financial rating of the company?
10. If the insured does not qualify for the best underwriting, is there an opportunity to improve the rating in the future if the insured's health improves?
11. What riders are available on the policy? What are the costs for the riders?
12. What happens to the policy if premiums are not paid?
13. What is the premium payment window for paying premiums on guaranteed policies?
14. For term policies, what are the conversion terms/options?
15. How much compensation do you receive as a result of the purchase of the policy(ies)?