The ILIT Liability Minefield: Trustees' and Counsels' Risks

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I. The Trend of Lawsuits Against ILIT Trustees

A. Irrevocable Life Insurance Trusts ("ILITs") provide an effective and efficient wealth preservation vehicle for settlers and a way to increase an insured's assets and liquidity. Life insurance, however, is a complex trust investment asset with unique characteristics that requires special attention.

B. There is an increasing trend toward lawsuits against trustees related to their fiduciary duties and supervision of trust assets.

1. However, there are only a few specific cases involving the ongoing review of trust-owned life insurance.

2. Typically, the ILIT trust beneficiaries bring the lawsuit.

a. The donor-insured generally does not have standing to bring the lawsuit.

b. The donor-insured generally has no interest in the trust after it is established.

c. Often the donor-insured is deceased when the lawsuit is brought.

3. These cases are very fact specific.

4. Many cases turn on the specific language in the trust instrument.

5. An unscientific sense is that many of these lawsuits settle out of court.

C. Potential Bases of Exposure

1. Negligence in Administering the ILIT. If *Crummey* notices are not administered properly, the IRS could challenge the use of the annual exclusion; contributions to the ILIT and death benefit may be subject to gift tax or estate tax respectively. In *Hattleburg v. Norwest Bank Wisconsin*, 2005 WL 1574958 (2005), a trustee was held liable for estate tax incurred by a trust where the trustee knew that there were no *Crummey* provisions and still encouraged the donor to make gifts to the trust.

2. Negligence in Maintaining the Life Insurance Policy.

   a. In *Pearson v. Barr*, 2002 WL 1970144 (Cal. Superior Court 2002), the beneficiaries sued a CPA acting as ILIT trustee for failing to pay premiums. Despite the CPA's negligence in failing to pay premiums due to problems related to his practice, the case was settled. The trust instrument allowed for liability only for gross negligence, which the beneficiaries were unable to prove.

   b. In *Sanders v. Citizens National Bank*, 585 S.2d 1064 (FL Ct. Appeals 1991), the corporate trustee accepted gifts over a period of years but failed to pay the premiums. The original policy failed and the trustee could only obtain a new policy that the insured was unwilling to cover through additional gifts to the trust. The co-donors of the ILIT sued but their case was dismissed because the court determined they lacked the standing to sue. A consideration in this case is that the trust instrument specifically allowed the trustee to not pay life insurance premiums

3. Inadequate Design or Premium Funding. A few cases have focused on an ILIT that anticipated a specific premium paying pattern after which the policy cash value was expected to support the death benefit. In these cases, the ILIT trustee or advisor was sued when actual policy performance required additional premium payments (and additional gifts to the ILIT). There have been a pair of "vanishing premium" life insurance cases that did not involve an ILIT.

   a. In *Von Hoffmann v. Prudential Insurance Co*., 202 F. Supp.sp2d 252 (N.Y. Dist. Ct. 2002), the insureds were held to have a cause of action against the insurance company.

   b. In *Heslin v. Metropolitan Life Insurance Co*., 733 N.Y.S. 2d 753 (N.Y. Sup. Ct. 2001), the insureds were held not to have a cause of action against the insurance company.

   c. The question remains as to what exposure the trustee might have in this case. In *Kohler v. Merrill Lynch, et al*., 706 S.2d 1370 (Fl. Ct. Appeals 1998), the cash value in an existing trust was accessed to pay premiums on a new policy purchased by the ILIT. When the new policy premiums did not "vanish" as expected, the donor-insured was told additional gifts were needed to enable the trustee to pay additional premiums. There was no clear court decision as the case was remanded to a lower court.

4. Carrier Insolvency.

   a. If the insurance company issuing the policy either was chosen at a time when its financial standing was questionable or if that financial standing changed while the Trust owned the policy, the Trustee would be exposed for not anticipating any financial losses flowing therefrom.

   b. Measuring carrier financial solvency is difficult due to the constant change in the economy, state regulatory and tax environment in which all carriers operate.

   c. The recent sub-prime mortgage debacle is an example of unforeseen change that has had some impact on some carriers.

5. Conflict of Interest. If the trustee shares in the insurance broker's commission, this could be grounds for a legal proceeding.

6. Bad Investment Decisions and Inadequate Management of the Insurance Portfolio.

   a. These cases often try to balance the trustee's decision making process against the beneficiary's disappointment

   b. The case of *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009) is among the first reported cases addressing the duties and liabilities of an ILIT trustee under the UPIA with respect to investment management responsibilities and monitoring of life insurance policies.

      i. The case seemingly suggests that an institutional trustee will not be held to a high standard of management care of investment due diligence as it relates to life insurance policies. In several different aspects of the case, the court found that "the process was not perfect."

      ii. One of the most important takeaways from the case is that the court confirmed that UPIA prohibits the use of hindsight in determining the appropriateness of investments and unforeseeable market forces.

iii. The corporate trustee here, Key Bank, considered only continuing the existing VUL life insurance policies and one other alternative, switching to paid-up no lapse guarantee policy but with a significantly reduced death benefit. The court was silent on the trustee's duty to assess underlying costs and performance assumptions that are standard practice for life insurance management by an ILIT trustee.

iv. While admitting that "of course it could have done more," the court found Key Bank's due diligence adequate.

v. What apparently saved the ILIT trustee here was that Key Bank engaged an outside professional (consultant) to review the existing VUL policies to help determine if those policies remained appropriate investments for the ILIT.

vi. It is uncertain whether other courts in other states will be similarly satisfied that the UPIA permits such a relatively low review by professional ILIT trustees.

vii. The concern in relying on this case is that Key Bank was found by the court to have performed the *minimum* acceptable management duties *in this case.*

II. New World of Life Insurance

A. What are the decisions a trustee and counsel are—or should be—making at the various stages of an ILIT as it relates to the underlying life insurance investment?

1. Creation of the trust
2. Acquisition of the policies
3. Ongoing maintenance of the trust and its investments
4. Termination decisions including whether to sell the policy to a third party.

B. The ILIT trustee must recognize and overcome outdated thinking concerning the life insurance portfolio.

1. Life insurance is far more than a custodial asset and is far more than a "buy and die" investment strategy.
2. In the past, ILIT trustees have made naïve assumptions which are no longer acceptable.

a. When it comes to acquiring the policy

   i. What is the trustee’s role and responsibility vis-à-vis policy acquisition decisions made by the trust creator?

   ii. It may or may not be appropriate for a trustee to select “name brand” carriers with significant assets and investment grade financial strength ratings. For instance, selecting a “name brand,” top-rated carrier is very desirable when selecting a Non-lapse Guaranteed (“NLG”) universal life policy but is likely less relevant when selecting a variable policy where it is the platform of mutual funds that is important.

b. When it comes to maintaining the trust, to what extent will the ILIT trustee permit the donor to continue to dictate how the trust and its assets should be managed? Clearly, the trustee is dependent upon the donor to the ILIT to make future contributions to enable the ILIT to pay future premiums.

c. When it comes to deciding whether to continue the trust and/or its investments there are at least four options for the trustee to consider. If he or she fails to continually consider all of these possible courses of action and fails to document the decision-making process, then he or she is exposed to liability.

   i. Hold until death with out-of-pocket or cash value payments, which can involve:

      I. doing nothing

      II. policy conversion

      III. paid up reduced face

      IV. extended term

      V. 1035 exchange

   ii. Lapse or surrender

   iii. Borrow cash to pay premiums

      I. from family members

      II. from beneficiaries (such as split dollar)

      III. from a bank or other commercial lender with outside collateral

      IV. from a specialized lender collateralized with death benefit

iv. Sell to a third party in a life settlement

III. What Fiduciaries Should Know and Ask About Life Insurance.

A. There are spiral considerations involved depending upon the type of product selected.

B. Different product types carry different types of risks.

1. Permanent life insurance policies (e.g., whole life and no lapse guarantee universal life) are not interchangeable. Their performance varies substantially one from the other as does the financial strength of the numerous carriers offering these products.

a. If a “non-guaranteed” product (e.g., whole life, universal life, variable life) is selected, the trustee has assumed investment risk of performance.

b. Where the type of product is no lapse guarantee universal life (e.g., NLG UL), the trustee’s primary responsibility as the policyholder is to ensure that premiums are paid on time and that the portfolio is diversified so that selected carriers have more than ample financial strength on a long-term basis.

c. Accepting sales and in-force illustrations can never be accepted on their face as credible and predictive.

C. Interest-driven policies (universal life and current assumption whole life) are one type of current assumption policy type, under which the carrier assumes investment responsibility.

1. Current assumption policies have two components:

a. Net amount at risk.

b. Cash value account.

2. The death benefit in an interest-driven policy is the cash value account plus the net amount at risk.

3. Payments into the policy (premiums) are not fixed or guaranteed.

a. Premiums accumulate at a currently declared interest rate set by the carrier, with a minimum rate specified in the policy.

b. For example, pre-2004 policies may carry a 4% minimum (guaranteed) interest rate while newer policies may carry only a 2-3% minimum (guaranteed) interest rate.

c. The cash value typically is assessed a surrender charge (i.e., a penalty) imposed on the policy if surrendered in the first 10-20 years.

d. In these types of policies, the insurance company has shifted premium adequacy/sufficiency risk to the policyholder (ILIT) and insured. The policyholder must pay enough into the policy so that at the prevailing interest rate set by the carrier on the policy, all future insurance charges (COI) and other policy expenses can be withdrawn when called for by the carrier.

e. The policyholder (ILIT) and insured must estimate the annual funding cost of such interest-driven policies. Unfortunately, premiums are almost always projected using fixed or constant interest rate assumptions, even though the carrier has reserved significant rights to change the interest rate assumptions and cost of insurance (COI) charges in the future.

f. Life insurance agents in the 1980s recommended converting whole life policies to universal life coverage by offering flexible premium policies. Due to the hyper-inflation of the 1980s, clients were told their policies could participate in the high interest rates then offered in the bond market. Some policyholders were told that future premiums could "vanish." Unfortunately, interest rates fell precipitously, policies seriously underperformed and projections that future premiums would disappear failed to materialize.

D. Investment-driven policies (variable fixed and variable universal life) carry additional risk and reward.

1. Like interest-driven policies, these are current assumption policies.

2. Unlike interest-driven policies, investment-driven policies shift to the policyholder and insured the investment opportunity by obligating them – not the carrier – to allocate premiums and account values into sub-accounts offered by the carriers that mirror a menu of investment choices offered by mutual funds.

a. If premiums are heavily invested in equities (i.e., the stock market) the net amount at risk can be very volatile. Underlying policy account balances can quickly collapse in a down market if a sufficient amount of reserves are not maintained for market underperformance.

b. Premiums accumulate in the account with whatever earnings (or losses) are generated from the policy sub-accounts. Unlike with an interest-driven policy, there is no minimum return guaranteed by the carrier in the policy.

c. Similar to interest-driven policies, the insurance carrier has shifted the premium adequacy/sufficiency risk to the policyholder (ILIT) and insured. The policyholder must pay enough into the policy so that with interest all future insurance charges and other policy expenses of the carrier can be met *and* payments into the policy are also sufficient to offset sustained negative returns and increasing net amounts at risk.

d. It is impossible to estimate likely annual funding for these policies.

e. These VUL policies were popular in the 1990s, as agents and carriers believed that their customers could depend on equity markets to provide reliable 10%-12% annual returns, but with insurance customers (policyholders and insureds) accepting greater investment risk. Then the economic recession of 2008-2009 hit and customers did not receive the projected 10%-12% returns on their invested premiums. In the 1998-2008 period the S&P actually had a negative return.

E. In response, the industry accepted all the investment risk and offered up thinly funded no lapse guarantee universal life (NLG UL) products.

1. NLG UL products feature relatively inexpensive permanent death benefit guarantees.

2. The trade-off is that NLG UL policies typically offer anemic cash value.

a. Until recently, these attractive IRRs extended well beyond life expectancy (to say age 110).

b. Due to balance sheet portfolio yields, the cost of credit and pressure from state insurance regulators to more adequately reserve capital for these policies, some carriers have cut back the period of their death benefit guarantee to 90 years. (Other carriers have suspended writing new NLG UL polices or have raised the cost).

IV. Trustee's Duties in General

A. The Reality of the Situation

a. Trustee compensation is often minimal. For most corporate trustees, serving as ILIT trustee is often done as "loss leader" or client accommodation, in expectation of future profitability from the account once cash is available for investments.

b. Some insureds expect to continue to actively manage and participate in the decision-making process for their own trust-owned life insurance, notwithstanding the trustee's responsibility to manage the policies in the best interest of the trust beneficiaries.

a. All too often the Settlor/insured acts as if it is "his" policy, ignoring the trust. When he or she wants changes, he or she tells the trustee what to do.

b. Example: The Settlor wishes to sell the policy in the ILIT on the secondary market (a life settlement); in point of fact, he began the conversation with "I want to sell my policy." He believes this is the best move in terms of the overall family finances/investments. What if the beneficiaries believe they are better off retaining the policy but the Trustee follows the direction of the Settlor?

c. Very often the trustee is not involved in the structuring of the initial portfolio or selection of life insurance policies to be held in trust. Typically, the insured and his or her agent, and perhaps in consultation with the insured's estate planning lawyer, discuss the initial portfolio of life insurance. Rarely does the ILIT trustee participate in such initial decision-making.

1. However, once the trustee accepts appointment and has control of the life insurance portfolio it is his or her duty to manage it. That might mean cashing in or selling the original policies along the way and replacing them with newer, better performing policies that diversify and minimize risk to the beneficiaries.

B. The Uniform Prudent Investor Act ("UPIA").

1. Section 4 of the UPIA, outlining duties at inception of a trusteeship, simply cross-references Section 2(a) of the UPIA: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the

trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."

a. The commentary to Section 4 of the UPIA states in part: "The criteria and circumstances identified in Section 2 of [UPIA] [Section 2 is the heart of the UPIA which contains the standard of prudent conduct] as bearing upon the prudence of decisions to invest and manage trust assets also pertains to the prudence of decisions to retain or dispose of inception assets under this Section."

b. Section 3(e)(5) of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) offers the following insight:

i. Section 3(e)(5) of UMPIFA states: "Within a reasonable time after receiving property, an institution shall make and implement decisions concerning the retention or disposition of the property, or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, distribution requirements and other circumstances of the institution and the requirements of this [act]."

ii. Much of the language of the Uniform Prudent Investor Act was copied into the text of UPMIFA.

iii. The commentary to Section 3 of UPMIFA notes, in part: "This subsection requires the institution make a decision, but does not require a particular outcome. The institution may consider a variety of factors in making its decision, and a decision to retain the property either for a period of time or indefinitely may be a prudent decision."

2. Under the UPIA, the (ILIT) trustee must "act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries." UPIA, Section 6.

3. Under the UPIA, the (ILIT) trustee must "consider the purposes, terms, distribution requirements and other circumstances of the trust." UPIA, Section 2(a).

4. Under the UPIA, the (ILIT) trustee has "continuing responsibility for oversight of the suitability of investments already made, as well as…decisions respecting new

investments." UPIA, commentary concerning Section 2, Duty of Care.

5. Can the draftsperson of a new ILIT avoid the higher standards of the UPIA?

   a. The donor-insured of an ILIT may not want the trustee to be held to a high fiduciary standard (i.e., the donor-insured does not want the ILIT trustee to worry about the Prudent Investor Rule in the UPIA).

   b. A donor-insured can include specific language in a new ILIT that pre-empts and overrides the UPIA.

      i. The ILIT's trustee's duties would be defined by the trust instrument, not the UPIA law of the governing state law.

      ii. It is rare to find such pre-emption language in existing ILITs.

   c. The donor-trustee can reduce or eliminate the ILIT trustee's duty to monitor and track policy performance.

   d. The donor-trustee can reduce or eliminate the ILIT trustee's duty to diversify policy selection by authorizing the trustee to retain indefinitely the original policies purchased by the trust.

   e. The donor-insured can reduce or eliminate the ILIT trustee's duty to search the marketplace to see if better-performing policies have become available.

6. Some states have enacted statutes that reduce or even eliminate a trustee's various duties specifically with respect to life insurance policies held in trust. In order to avail oneself of a particular state's statutes reducing or eliminating an ILIT trustee's responsibilities with respect to life insurance policies held in trust, there are some basic practical considerations for a donor-insured and the draftsperson of the ILIT.

   a. The ILIT trust instrument must recite that the trust is governed by the law of such state.

   b. There must be sufficient nexus between the ILIT and such state.

      i. The trustee (or a co-trustee) presumably would need to be a resident of such state.

ii. The donor-insured and some of the beneficiaries might also be residents of such state.

7. Several states have enacted statutes that relieve an ILIT trustee of liability in managing life insurance as an investment.

a. Among the states with some type of protective statute for the ILIT trustee are Delaware, Florida, North Dakota, Pennsylvania, South Carolina, West Virginia, and Wyoming. Alabama also has a limited statute.

i. The Delaware statute (Title 12 of Delaware Code, Section 3302) is a good example. Section 3302(d) carves out an exception to the general fiduciary standard expected of a fiduciary under Delaware law, relieving the trustee of an ILIT for liability under Delaware law for a loss resulting from the trustee's failure to:

I. Determine whether the insurance contract is or remains a suitable investment;

II. Investigate the financial strength or changes in the financial strength of the life insurance company;

III. Make a determination of whether to exercise any policy option under the contract;

IV. Make a determination whether to diversify such contracts in relation to one another or to other trust assets;

V. Inquire about changes in the health or financial condition of the insured or insureds.

VI. The trust instrument must specifically recite each of these provisions of Delaware law.

ii. Florida has recently adopted a statute (736.0902) that not only reduces an ILIT trustee's liability under the Prudent Investor Rule but also deals with the topic of insurable interest.

I. Florida's law may be more protective than Delaware. Like Delaware, Florida relieves the ILIT trustee from any duty to manage the life insurance policies as an investment.

II. The protection afforded an ILIT trustee under the Florida statute may be broader in scope and easier to access because it relieves the trustee from liability for any loss sustained with life insurance without specific reference to the duties removed.

III. Unlike the Delaware statute, the Florida statute removes any duty to investigate whether there is a sufficient insurable interest in the policy, so long as the trustee did not have knowledge of a lack of insurable interest or a stranger owned life insurance (STOLI) type arrangement. (An ILIT trustee, therefore, is safe as long as it is ignorant).

IV. A trust instrument can opt out of the new Florida statute that eliminates the ILIT liability.

V. Unless the trust instrument specifically opts in, beneficiaries can eliminate the new statute from applying by objecting upon request of notice.

8. How does a beneficiary motivate a trustee in these states?

a. In these states, a trustee is nothing more than a custodian.

b. Does this mean a judge will leave beneficiaries without recourse in the event that their inheritance is reduced or eliminated due to no management of the investment in the policy?

9. In those states that have adopted "directed trustee" statutes, such an arrangement would appear to offer a somewhat more balanced approach, at least in theory.

a. In a "directed trustee" arrangement, the trust advisor, protector or co-trustee would direct the trustee concerning the management of the life insurance and would be responsible for these activities.

b. As a practical matter, though, the “directed trustee” statute allows a bank or other professional possessing meaningful expertise or skills to avoid liability altogether, while a family member or friend of the insured named as trust advisor, with often limited knowledge about life insurance or estate planning, would bear full responsibility for the management of the investment in the policy. Somehow this does not seem equitable.

10. Increasingly, lawyers are drafting ILITs (and other types of trusts) that call for a “trust protector.” The trust agreement will typically set forth the dual roles of the trustee and the trust protector. While the trustee may be a trust company or other professional, the trust protector is often a person close to the family or a key financial advisor.

a. Depending on the powers granted in the trust agreement, the trust protector may be empowered to remove or replace an independent trustee, change the trust situs, veto distributions to beneficiaries and/or veto investment decisions (e.g., in an ILIT, the trust protector may have final say over product selection and restructuring of the life insurance portfolio). Along with these powers comes the potential for liability.

b. The liability of a trust protector has not been fully defined by state courts in the U.S. In a recent case for summary judgment, a state court of appeals indicated that resolution of this issue turns on whether the document (i.e., trust agreement) imposes fiduciary duties on the trust protector. The appeals court suggested that the document’s use of the term “fiduciary capacity” implied that the trust protector there owed “at least the basic duties of undivided loyalty and confidentiality…[and] the existence of at least some duty of care” to the beneficiaries. *McLean Revocable Trust v. Patrick Davis, P.C.*, 283 S.W.3d 786 (Mo. Ct. App. 2009).

V. Trustee’s Duties at Inception

A. The management of trust-owned life insurance is challenging for any trustee. Typically, a new ILIT initially holds few assets other than life insurance policies.

B. The initial assets of the typical ILIT generally represent a “concentrated” position in one investment class. Very often the life insurance investments are not diversified among a variety of different types of life insurance products.

C. The ILIT trustee must recognize that policy illustrations for non-guaranteed policies are *not* predictive. Except for NLG UL policy illustrations, illustrations on all non-guaranteed products are “projections” created by the agent with some involvement from the carrier to portray, generally, the “lowest possible” premium calculated with the most “hopeful” non-guaranteed results over many decades.

1. The most glaring defect in such simplistic projections is that the underlying earnings or interest rate is “fixed” over many years. This is unrealistic.

2. Many policy expense factors, including cost of insurance (COI), are projected into the future by the carrier using current assumptions of favorable claims experience by the carrier. The policy authorizes the insurance company to impose increased COI in the future if, for example, similar types of policies do not actually lapse as originally projected by the carrier’s actuaries.

3. The Society of Financial Service Professional’s illustration questionnaire clarified that “…illustrations [projections] have little value in predicting actual performance or in comparing products in companies. So the risk associated with the possible inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policyholder.” Illustration Questionnaire, Society of FSP, Newtown Square, PA.

4. The Society of Actuaries published an extensive examination of illustration practices associated with the purchase of life insurance and observed, “…(when) illustrations [projections] are used to show the client how the policy works, it is a valid purpose of policy illustrations. Illustrations [projections] which are typically used, however, to portray the numbers based on certain fixed assumptions - and/or are likely to be used to compare one policy to another – are an improper use of the policy illustration.” Final Report of the Task Force for Research on Life Insurance Sales, Illustrations under the Auspices of the Committee for Research on Social Concerns, Society of Actuaries, 1992.

5. Policy projections are better characterized as “illustration beauty contests.” This reflects the attractive impossibility versus the less attractive probability.

D. Rights and Expectations of Beneficiaries on Inception of Trust.

1. It is a well established principle of law that a beneficiary of a fully discretionary trust has only a speculative interest in trust property and personally has no enforceable rights against the trustee. He or she only has standing to sue for abuse of discretion if a trustee is dilatory or inefficiently administers the trust assets and such action or inaction proves detrimental to his or her beneficial interest.

2. But discretion does not imply the abandonment of prudence.

3. In many situations, a trustee defense based on the beneficiaries' investment directives (or donor investment directives or involvement), beneficiary acquiescence to poorly understood strategies, boilerplate trust language and self-serving exculpatory provisions may fail to avoid surcharge for a breach of fiduciary duty.

4. Unless the language in the trust instrument clearly shows the settlor's intent that the trustee can ignore principles of modern financial investing, a trustee should not retain property in the form received unless it is prudent to do so?

a. A power, such as discretion regarding investment decisions, tells a trustee that he or she has the ability to act or not act on any investment strategy.

b. A duty, however, imposes an obligation on the trustee.

c. In most jurisdictions, courts have ruled that discretionary powers, (including grants of "absolute discretion") must be exercised under the constraints imposed by the duty of prudence.

VI. Trustee's Ongoing Duties

A. What should the ILIT trustee do to monitor performance of the life insurance policies owned by the ILIT? The purpose for monitoring the policies is to determine if any policy is underperforming as well as to evaluate whether a new policy may provide greater benefit to the ILIT.

B. How might the ILIT trustee evaluate an ILIT's current policies and assess their performance?

1. Obtain and review (updated) in-force policy illustrations;

2. Compare the in-force illustration to the original illustration issued when the policy was purchased;

3. Compare the updated in-force illustration with prior years' in-force illustrations to determine performance trends;

4. Assess past policy performance and project likely future performance;

5. Review the current financial strength of the carriers whose policies are currently held in the ILIT and note any trends that may be a cause for concern;

6. Consider requesting an "informal" offer for one or more new policies (assuming the insured is cooperative and healthy);

   a. Before the insured is examined by a doctor, the insured's medical records can be submitted to the carriers.

   b. Experience has shown that "informal offers" provided by carriers generally provide a 95% indication of their eventual final underwriting offers.

   c. The insured's identity is disclosed but the HPAA prevents the carrier from disclosing the insured's medical information to other carriers.

   d. Most importantly, an "informal offer" avoids a premature rating by the carrier that could result in becoming part of the insured's permanent medical record, which can and will be shared with other carriers through the Medical Information Board (MIB). There is no reporting of "informal offers" to the MIB.

   e. Gathering various "informal offers" by surveying the entire marketplace often gives the insured and his or her advisors a good sense of the market and shows choice among carriers.

7. Compare the projected premiums, death benefit, cash value, death benefit guarantee and other relevant provisions of the current policies with any offers;

8. Assess the competitiveness of the current policy with potential new policies;

9. Decide whether to add, eliminate or exchange policies owned by the ILIT;

10. Keep a written record of all actions made in this review process;

11. Re-evaluate all trust-owned policies roughly every two to five years.

C. What are some of the external considerations that may impact the life insurance program?

1. Has the insured's health improved or declined since the policy was issued? Some carriers today have created super preferred categories (best underwriting) not available 10 or 20 years ago. All carriers monitor medical breakthroughs and advancements in medical treatment that generally result in greater life expectancy.

2. Diversification is vital to most insurance portfolios under the UPIA. An ILIT that owns only life insurance policies holds a concentrated asset that often carries higher risk.

   a. A trustee might diversify among a variety of different types of life insurance policies (i.e., whole life, variable, universal life, no lapse guarantee). This is a questionable strategy because certain types of policies may not be well-suited for the objectives of the particular ILIT.

   b. The trustee might diversify among a variety of different top-rated carriers, spreading risk in the event one carrier experiences financial difficulty in the future. Diversification and risk sharing is especially appropriate when purchasing no lapse guarantee policies providing a secondary guarantee of the death benefit (NLG UL policies), as well as in large coverage situations.

   c. A trustee who chooses not to diversify should address this issue in the IPS (discussed below at X.A). In many states that have adopted some form of the UPIA, a trustee need not diversify if there are special circumstances that might reduce the investment return. In these situations, the ILIT trustee should address the diversification issue in the IPS and state why he or she made the decision to spread (or not to spread) the coverage among a handful of carriers.

3. Does the split dollar plan or premium loan program comply with the final split dollar regulations?

   a. Has an "exit strategy" (e.g., estate freeze) such as a GRAT or sale to intentionally defective trust been implemented? If implemented, how is the underlying asset (investment) used to fund such "exit strategy" performing? What is the likelihood the "exit strategy" will ultimately succeed in transferring future appreciation to the ILIT to enable the trustee to pay future premiums and/or roll out of the split dollar plan or loan program?

b. When should a split dollar plan (which relies on the term value cost of life insurance protection, known as the reportable economic benefit amount) be converted to AFR loan regime reporting (relying on the aggregate annual interest due on prior premium advances structured as loans)?

c. If the split dollar loan program involves loans to an ILIT that only owns life insurance policies, are the loans to the ILIT "non-recourse" loans? If so, the contingent payment of interest rules in the final split dollar loan regulations apply to the loan, unless the parties to the loan (lender and borrower; insured and ILIT trustee in a private loan) each make a written representation to the IRS that a reasonable person would expect repayment in full of the entire loan, and the parties file the written representation with their tax returns for the relevant years. See Treas. Reg. Section 1.7872-15(d)(2)(ii).

4. The trustee should be aware of the life settlement value of the policies, as an alternative to surrendering the policies to the issuing carrier.

a. An increasingly robust and transparent life settlement market has developed.

b. If an older insured's health has deteriorated since a policy was issued, a life settlement funder may be prepared to pay far in excess of the cash surrender value to the policyholder to purchase such policy.

c. Presumably, an ILIT trustee is now responsible for considering a life settlement (sale of the policy in the secondary market) as an alternative to surrender of the policy. Failure to do so may result in fiduciary liability for the trustee.

d. There are some potential privacy and compliance issues, as well as life settlement laws in some states, that the ILIT trustee must consider.

5. Did the agent shop around for many different offers from virtually all of the top carriers? Some agents work for carriers supporting career agents who are precluded by contact from soliciting competitive offers outside their own company unless their own company fails to provide an offer. Will the agent disclose his or her commissions?

6. What impact will carrier demutualization have on the performance of the policy?

7. Has the policy inadvertently become a "modified endowment contract" (MEC) which will trigger potentially adverse income tax consequences to the policyholder under certain circumstances. An internal policy loan, premium finance, or converting the policy death benefit to paid-up status may each trigger MEC tax treatment.

8. If the ILIT is exempt from GST tax, how will premiums due in 2010 be paid by the ILIT in 2010? The donor-insured cannot allocate GST exemption to the ILIT with respect to any transfer made to the trust in 2010, absent reinstatement of the GST law by Congress.

9. If the ILIT is earmarked to be exempt from GST tax, how is the GST tax exemption allocated? Under the automatic allocation GST tax rules adopted by EGTRRA (in 2001), many ILITs are likely categorized as "GST trusts," even those for which no GST transfers to skip persons are contemplated. Treas. Reg. Section 26.2632-1(b)(2). GST exemption will be automatically allocated unless the "transferor" (insured) elects out on a timely filed gift tax return. (Note that the automatic allocation rules that applied to "indirect skip" transfers made under pre-2010 GST tax law would only return in 2011 if Congress overrules the "had never been enacted" rule of Section 901 of EGTRRA. Under Section 901 of EGTRRA, the various GST tax reforms enacted in 2001 do not apply to 2011 and beyond).

10. Have all *Crummey* notices been sent in a timely manner? The trustee should keep a control file that includes a copy of all *Crummey* notices as proof of notice for the beneficiaries.

VII. Professional Trustees: Held to a Higher Standard

A. Professional trustees are held to a higher standard of care than non-professionals (such as family, friends and business colleagues of the insured).

1. "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." UPIA, Section 2(f).

2. "Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals." UPIA, Commentary to Section 2 regarding Professional Trustees.

VIII. National Bank Acting as ILIT Trustee

A. In addition to adhering to the UPIA, national banks serving as ILIT trustee are subject to fairly stringent due diligence requirements imposed by the Office of the Comptroller of the Currency (OCC) regarding the purchase and monitoring of life insurance.

1. In 1996, the OCC imposed a 10 point pre-purchase assessment analysis. See OCC Bulletin in 2000-23, replacing and updating OCC Bulletin 96-51, which initially detailed the 10 points of due diligence as part of a life insurance pre-purchase analysis.

2. While these OCC guidelines were apparently developed independently of the UPIA and do not necessarily relate to trust-owned life insurance, they both demonstrate increasing standards of care.

B. The trend for national banks is toward setting standards in connection with monitoring life insurance and assuring that there is both a pre-purchase and ongoing review of policies.

C. National banks must demonstrate compliance with the OCC Reg 9 risk standards.

1. A national bank knows that a trust-owned life insurance policy is a concentrated investment requiring "specific facilities for investment management, which must include procedures for trust-owned life insurance that demonstrates compliance with OCC Regs Sections 9.5 and 9.6a."

2. If a bank accepts a trust-owned non-guaranteed policy (whole life, term, variable, variable universal life or universal life, but not no lapse guarantee), it must demonstrate the expertise to evaluate the risk of premium adequacy under OCC Reg. Section 9.6(b), otherwise it must recommend restructuring to a guaranteed death benefit policy.

3. If the bank's facilities are not adequate for today's best management practices expected of national banks and the trustee can no longer administer a non-guaranteed policy, the trustee must recommend restructuring or obtain the beneficiaries' approval to do nothing.

IX. Lawyer Liability For ILIT Management and Operations

A. At the inception of the engagement is it clear who the client is?

1. The attorney is typically engaged to:

a. advise the trust settlor-to-be as to the value and efficacy of the ILIT;

b. structure an appropriate trust given tax and personal/familial considerations;

c. draft the trust and ancillary documents (such as *pro forma Crummey* letters); and

d. advise and possibly oversee ongoing trust maintenance issues, including the *Crummey* letters, possibly investment and insurance premium issues and potentially trust distributions.

B. However, once the trust is established does the trustee become the client as well?

1. An unskilled trustee typically relies on the donor-insured's legal or tax professional concerning the administration of an ILIT.

a. Professionals serving as advisors to the donor-insured and friends or family who are unsophisticated ILIT trustees have the same basic fiduciary duties as a skilled trustee.

b. There is a general trend toward greater liability of the attorney, based on the attorney's continuing duty to the insured's ILIT trustee after the ILIT is established.

c. The enactment of the UPIA and the judicial relaxation of privity requirements, which allows third party lawsuits, support this trend. See e.g. *Estate of Schneider v. Finmann*, 2010 NY Slip Op 05281 (June 17, 2010).

d. The *Schneider* case is especially relevant in the trust-owned life insurance context, because the underlying malpractice claim against the decedent's estate planning lawyer revolved around whether the lawyer negligently advised the decedent to transfer (or failed to advise the decedent not to transfer) the policy into the decedent's individual name. In siding with other jurisdictions that now have a relaxed privity rule, the appeals court noted that "the estate essentially stands in the shoes of the decedent," and, therefore, "has the capacity to maintain the malpractice claim on the estate's behalf." In its decision, the court noted that strict privity remains a bar against estate planning malpractice claims brought by beneficiaries or other third-party individuals (absent fraud or special circumstances).

2. This duty may extend to the choice of particular life insurance products and the ongoing need to review and revise as facts change.

a. Counsel may have liability if the trustee acts on inaccurate legal advice about the life insurance, such as the choice of an under-capitalized carrier or poorly designed product in comparison to other options.

i. Rating agencies are unreliable and just using an agency rating may be prima facie negligence.

ii. Illustrations are not valid for due diligence.

b. The best option is to bring in consultants expert in the particular investment.

i. Document everything.

3. A conundrum: if the trustee is the client and the trustee's duty runs to the beneficiaries, and yet the settlor remains the client as well and in fact is paying all the legal fees, does the attorney owe a duty to the settlor, the trustee and, derivatively, the beneficiaries? What happens when what is best for the beneficiaries differs from what is best for the settlor?

X. How Trustees Can Protect Themselves.

A. Create an Investment Policy Statement (IPS). The Prudent Investor Rule of the UPIA imposes a duty on ILIT trustees to create a formal investment policy, known as an IPS.

1. The IPS is a written statement of the investment practices the trustee intends to use in managing the trust assets.

i. The IPS is not a legal agreement.

ii. The IPS is a statement by the trustee of how he or she expects to manage the trust assets in order to meet the trust's objectives.

iii. The IPS is a flexible statement that can be changed at any time by the trustee to improve the process and way in which the trust's assets will benefit the trust beneficiaries.

iv. There is no prescribed or specimen IPS that fits all situations.

a. If the ILIT is designed to invest exclusively in life insurance policies, the IPS should reflect this approach.

b. Creation of the IPS gives the trustee the opportunity to solicit insight from the trust's legal, accounting and other advisors.

v. Why is the IPS helpful?

a. The IPS guides the trustee in making investment decisions for the trust during administration of the trust.

b. If the procedures in the IPS are reasonable and have been followed, the ILIT is evidence of the trustee's compliance with the UIPIA, regardless of the trust's ultimate performance results. This may ultimately minimize the trustee's liability.

vi. What might be included in the IPS?

a. The type of policy to be purchased;

b. The ratings or other criteria required of the life insurance company issuing the policy to be included in the trust portfolio;

c. Risk tolerance level;

d. The premium schedule;

e. Current assets and investment choices;

f. Background information about the beneficiaries;

g. The purpose for the coverage and a statement of objectives;

h. Duties and responsibilities;

i. Contact information for all of the professional advisors;

j. Asset guideline.

vii. A copy of a couple of "sample" IPS statements are attached as Exhibit I to this outline.