How to Manage Your Fiduciary Liability as Trustee?

At Heckerling Institute (the premier estate planning symposium) and among many of the attorney's I have spoken with, agree that litigation against fiduciaries is one of the fastest growing areas of law. In this article we are going to focus on how to best manage your fiduciary responsibilities of an irrevocable insurance trust better known as an ILIT.

Let's first start with some perspective of the law. A "fiduciary relationship" is a broad term that covers any situation where there is a legal relationship created between parties, either by law or by contract. The ILIT document therefore puts this relationship in "motion" between the trustee and the beneficiaries. Clients who set these trusts up do not understand that the trustee's ultimate responsibility is to the beneficiaries and not the wishes of the Settler.

In most states the fiduciary standard governing the trustee's conduct has shifted from that of a "prudent man rule" to that of a "prudent investor". Yes, life insurance is considered an investment. It is a complex financial instrument that requires on-going management but there-in lays the problem; life insurance is probably the least managed asset on any of your client's balance sheets. There is $3 trillion dollars of cash value and $10 trillion dollars of death benefit inforce in the US but who is managing the actual property, the life insurance policy itself and its performance optimization?

Trustees are not only accountable for actions they take but also actions they do not take. While the "prudent man rule" emphasized preservation of trust principle, the "prudent investor rule" applies a more modern approach to the trust investment, in which the trustee's central concern is balancing an acceptable level of risk against increased returns, based on the overall purpose of the trust. This rule was adopted in order to respond to changing economic conditions, the introduction of new investment vehicles and strategies, and the development of modern portfolio theory.

The prudent investor standard is a "standard of conduct not of outcome or performance." The key to fulfilling your duty as trustee is to understand that prudence is a process not a result. The quality of the result will be directly correlated to the quality of the process. As trustee you must employ a process that documents that you have fulfilled your duties to the beneficiaries as outlined in the Uniform Prudent Investors Act (UPI Act).

Let's now turn our attention to the most important duties that must be shown to be the very fabric of your process as it relates to life insurance held in an ILIT. In determining whether the trustee has committed a breach of trust, the focus is placed on the trustee's performance and not whether the trust has suffered a loss. The issue with ILIT's is somewhat unique in that a "loss" results in the life insurance being reduced, needing more premium commitment or an actual lapse in death benefit.

As I mentioned above, prudence is a process. The principle of prudence consists of three elements; ***care, skill and caution.*** This is a basic standard of the UPI Act; the trustee must have a process that shows they acted prudently and exercised reasonable care, skill and caution. The requirement makes the trustee liable for loss that results form the failure to use care and skill of a man of ordinary prudence.

Let's help you better understand what this means by discussing each of these:

- The ***standard of care*** is the trustee's duty to examine and investigate before taking any action, being diligent and attentive to the matters of the trust. The trustee will be surcharged loses resulting from negligent inattentiveness or inaction. Care includes obtaining the necessary information, knowing what information is needed in order to properly manage the life insurance asset to insure the long term viability. This includes modeling performance, stress testing cost competiveness, review suitability, and outline assumptions and metrics by which you manage the property. This in contrast to what we usually experience; the insurance agent sells the insurance, Grantor sets up the trust, trustee signs the application but is not involved in any of the discussions, and the trustee is told to just pay the premiums when the gifts are made to the trust. The Crummy letters necessary to fulfill the requirement of making the gift one of a present interest is many times mishandled by the trustee.

- ***Skill*** refers to the trustee's ability to handle the trust duties as outlined within the UPI Act and the trust document. Most, if not all trustees, lack the life insurance expertise to fulfill this requirement. The UPI Act does allow the trustee to delegate this task in order to meet the skill criterion. Who should the trustee delegate this too? Most trustees are non-professional in that they do not have the financial background or proper understanding of their exact duties required of them. Do they even have the knowledge or expertise or access to whom it should be delegated?

- ***Caution*** refers to the trustee's duty to preserve the trust assets. This requires the proper analysis of the life insurance asset to insure the property does not "die" before the insured(s). Prudence would dictate that a process needs to be employed which can show that all the moving parts in this complex financial instrument are benchmarked and that insurance analytics employed to fulfill this task. Caution refers to understanding how the life insurance property works, what the moving parts are, how they interact and how changes in them and other assumptions impact the success of the investment. As it relates to life insurance, how will the policy be managed to optimize return, to make sure it remains inforce with the highest probability? Caution needs to be shown as prudently managing all the risks within the life insurance asset but what are the risk elements in life insurance?

There are a few more duties beyond this core standard of care, skill and caution that need to be noted as it relates to the management of the life insurance asset.

The duty of ***diversification*** is relatively difficult to apply to a life insurance asset. The intention of the Act is not to require that every life insurance acquisition needs to be diversified among different companies or of different types of insurance. The process of prudence would dictate that a thorough market analysis based on established metrics would be prudent or that a large acquisition be done with the top echelon of the insurance carriers defined by some metrics. A due diligence process is recommended to be documented.

The duty to ***monitor or manage*** the trust asset embraces the thought that the trustee has the continuing responsibility for oversight, namely the long term viability and stability as it relates to life insurance. Another duty closely aligned with the duty to monitor is the duty to investigate. This means that the trustee has the responsibility to examine information like to bear importantly on the value or success of the life insurance property.

A very important duty that seems to missed all to often especially as it relates to life insurance is that the trustee may only incur ***costs that are appropriate and reasonable*** (Section 7 of the UPI Act). This becomes very difficult to assess for life insurance without the proper tool. The costs we are referring are the internal costs associated with the mortality. The trustee, as part of a prudent process, must be able to how they have been benchmarked to make sure they are reasonable and appropriate.

There is a duty of ***loyalty*** to who the trustees actually work for, the beneficiaries. You must act with their best interest as the ultimate goal.

The UPI Act does allow for the trustee to ***delegate*** tasks that they lack the skill to accomplish. As part of that delegation the trustee needs to document how they chose the party and be able to monitor the delegate documenting the following:

- Selection
- Scope and terms
- Process of review

A third party fiduciary insurance advisory firm is the best to seek out.

Now that we have a better understand of the more important duties as it relates to managing a life insurance asset, let me now ask the following:

- How will you substantiate to your beneficiaries a standard of care in managing the life insurance property in your care?
- What process will you employ to demonstrate your duty to exercise reasonable care, skill and caution in managing the life insurance property?
- Who will you delegate this too? Who will you turn to for an objective opinion?
- What will happen if the life insurance asset “dies” before the Grantor?
- How will you fulfill your duty to monitor the suitability of such an asset of life insurance over the next 10, 20 or even 30 years?
- What process do you employ to fulfill your duty to investigate the components of life insurance that will likely bear importantly on the success of such an investment of capital?
- How will you go about optimizing return on the capital invested in the life insurance property?

In fulfilling these and other duties let me just say that ***prudence is a process not a result***.

Let me educate you in on a few statistics that will make your job even more interesting[1]:

- 95.4% of ILIT trustees do not have a Life Insurance Property Management Statement akin to an Investment Policy Statement
- 83.5% have no guidelines or process that is documented to protect there liability.
- 70%-90% have no assigned agent
- 71% have not done a policy review within the last 5 years

[1]Teitelbaum, "Trust-owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make" J. of Financial Services Professionals 38 (July 2005)

The Dilemma for Trustees: How will I fulfill my duties managing as a trust asset as life insurance?

It's getting more difficult for trustees to exercise prudent fiduciary responsibility in the life insurance arena. They must contend with developments affecting the policy's performance such as: a premium continuing beyond illustrative assumptions, new product developments, expense analysis, mortality changes and changes in the law pertaining to their duties and what is expected of them.

For many trustees, life insurance is a "black box" - something they do not understand. The trustee usually does not have the knowledge, experience, or skill set to do a proper analysis. Trustees' failure to adequately manage or administer life insurance can have a major, adverse impact on the death benefit they are suppose to be safe guarding for the beneficiaries.

As mentioned above, it has been shown that a glaring percentage of trustees do not have any stated guidelines, procedures, or processes in place to manage this valuable property. Those that do, I would contend, are frustrated with the lack of analytic tools that have some actuarial basis that can be utilized to document their attempted management of the life insurance property.

Therefore, it is critical to have a prudent process to safeguard not only the life insurance asset but to safeguard you liability as trustee. Trustees must show that acted prudently, the challenge is how!

Let me help shed some light on this daunting task. Here are steps that a trustee should implement:

1. Trustees need to understand and document their understanding of the purpose and goals of the trust
2. If life insurance has already been acquired, document the following:
    a. Purpose
    b. Goals
    c. How the amount was determined
    d. How often a review will be conducted
    e. Who will conduct the review, if a third party, document why they were chosen and services they are to provide
    f. What kind and type of insurance was purchased and why
    g. Why was a particular carrier selected, ask for the carrier due diligence
    h. Try to obtain the market analysis, if not available, then document the process by which the insurance contract was chosen
    i. Premium payment strategy (gifting constraints, etc..)

j. The statistical measure of life expectancy desired
k. Probability of life expectancy to be used
l. Policy performance assumptions

3. If life insurance is to be acquired, document the following:
   a. Due Diligence process – see below #5
   b. Document much of the same information as spelled out above in #2

4. When employing the policy management process that you have developed you will need to refer to the policy metrics by which the policy management is guided. Then develop any opportunities that can be actuarially determined in order to make sure you are optimizing return on capital. In building out different strategies the trustee will need to consider the following:
   a. Health
   b. Life Expectancy
   c. Stochastic simulation needed?
   d. Cost deviation analysis necessary?
   e. Suitability analysis needed?

5. As it relates to an acquisition, a due diligence process needs to be documented that will examine the following:
   a. Industry
   b. Carrier
   c. Market analysis
   d. Product analysis
   e. Which level of underwriting is necessary (5 levels of underwriting exist)
   f. Risk management issues

6. Policy operating manual, includes:
   a. Documentation of metrics
   b. Decision making process
   c. Management process going forward
   d. Life Insurance Property Management Statement (the trust's investment policy statement)
   e. Opportunity or market analysis
   f. Stochastic simulation results
   g. Life Expectancy information either personalized or non-personalized
   h. Cost deviation analysis

There was a recent case involving Key Bank as trustee. I will not get into the details but the judge said in the case they only reason he found in favor for the bank was that they had hired a third party to analyze and advise them.

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