February 2010

Duties of Trustees of Irrevocable Life Insurance Trusts (ILITs)

Many trustees of Irrevocable Life Insurance Trusts (ILITs) believe that their fiduciary duties are mainly limited to paying premiums on the trust-owned insurance policies and sending Crummey notices. In most states, however, the trustee of an ILIT has the same fiduciary responsibilities as the trustee of any other trust. A recent Indiana Court of Appeals case provides an insightful platform from which to discuss the investment and fiduciary responsibilities of a Trustee of an ILIT.

1. Background and Facts of the *Cochran* Case.

In *In re Stuart Cochran Irrevocable Trust*,[1] the beneficiaries of an ILIT alleged that Key Bank, the ILIT's trustee, violated the Indiana Uniform Prudent Investor Act (UPIA) and breached its fiduciary duties when it replaced two Variable Universal Life (VUL) policies with a combined death benefit of $8 million, with a single policy with a lump-sum death benefit of $2,536,000 guaranteed to age 100.

Key Bank, with the advice of the insured's insurance advisor, decided to purchase the replacement policy after hiring an independent outside insurance consultant to review the VUL policies. The insurance consultant's review indicated that it was likely that the two VUL policies would lapse prior to the insured reaching his life expectancy. At the time of the review, the insured was 52 years old and had a life expectancy of 36 years (age 88).

After reviewing the replacement policy suggested by the insured's advisor, the consultant recommended purchasing the fixed product, which could remain in force until age 100 without contributing additional premiums, so long as the insured was comfortable with the reduction in the death benefit. Based on the recommendations contained in the consultant's report, Key Bank retired the VUL policies and purchased the fixed product. Not long thereafter, the insured died unexpectedly at age 54.

2. *Cochran* Decision.

The appeals court in *Cochran* agreed with the trial court's finding that Key Bank did not breach its fiduciary duty nor did it act imprudently when it replaced the VUL policies with a policy with a smaller but guaranteed death benefit. Instrumental to this determination was the fact that Key Bank relied on the guidance of an "independent entity with no policy to sell or any other financial stake in the outcome" to review the policies. Moreover, despite the fact that the appeals court agreed with the trial court that the process was "less than perfect" and the trustee "could have done more" in terms of investigating more insurance alternatives, the court upheld the trial court's finding that the trustee's examination of "the viability of the existing polices and at least one other option" was adequate.

Although the beneficiaries argued that the court should consider the fact that the insured's death and recovery of the economy occurred shortly after the exchange of the policies in determining whether the trustee acted prudently, the court refused, noting that the UPIA required it to consider "the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."

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

- The trustee did not improperly delegate decision-making duties to the insured or his insurance advisor;
- The trustee provided sufficient information to the beneficiaries despite the fact that annual reports were sent to the non-custodial parent of the beneficiaries, documents were made available to the beneficiaries but copies were not sent to them, and the trustee did not obtain the consent of the beneficiaries before changing the insurance policies;
- The trustee did not breach its duty of loyalty by communicating with the insured; and
- The trustee's decision to change the insurance policies was not inconsistent with the grantor's intent.[2]

3. Fiduciary Duties of ILIT Trustee under UPIA.

Most states require a trustee to follow the guidelines set forth in the UPIA or similar statutes.

The UPIA[3] provides that 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." Among the various circumstances that a trustee should consider, those most important to an ILIT trustee include (1) the duty to monitor and (2) the duty to investigate.

The duty to monitor can be described as "the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments." The suitability of any trust-owned life insurance is a function of many factors, but should include consideration of:

- The financial strength and ability of the insurer to pay claims;
- The competiveness of the insurance expenses;
- The stability of the insurer's pricing representations;
- The accessibility of the cash values; and
- The reasonableness of performance expectations.[4]

The duty to investigate requires a Trustee to make reasonable efforts to verify facts relevant to the investment and management of trust assets. The UPIA also provides that a Trustee can delegate investment and management functions and will not be liable for the decisions or actions of the agent to whom the function was delegated when such delegation has been properly made.

4. Fiduciary Duties to Consider in Light of the UPIA and *Cochran*.

(1) A trustee should have sufficient expertise to be able to analyze and monitor the adequacy of the policies and investments owned by the trust or should delegate this duty to someone else if the trustee lacks this expertise.

A trustee has the responsibility to review a policy owned in a trust to determine if the policy is performing as expected and should engage an insurance specialist or consultant if the trustee does not have sufficient expertise to make such an assessment. In *Cochran*, the court found Key Bank's reliance on an "outside and independent consultant with no policy to sell or other financial stake" persuasive in its determination that there was no breach of fiduciary duty. Although it is not clear whether Key Bank hired the outside consultant because it lacked its own internal resources to analyze the policy or because it wanted to distance itself from the recommendations, having an outside consultant with no financial interest appeared to add legitimacy to the recommendations upon which Key Bank ultimately relied. One could question whether the outcome may have been different if Key Bank had relied solely upon the review and recommendations of the insured's insurance advisor who did have a financial stake.

A trustee should make sure that the Trust has sufficient funds in order to retain the expert internal or external advice that is needed to conduct policy review and monitor performance.

(2) A trustee should investigate multiple investment alternatives.

Although the Cochran court found Key Bank's consideration of just one other policy outside of retaining the existing VUL policies adequate, a more cautious trustee should consider multiple investment options with multiple insurers to demonstrate its due diligence in its duty to investigate.

(3) A trustee should be familiar with state statutes regarding limitation of liability.

The liability of a trustee under a state's prudent investor rules may be expanded, restricted or eliminated by the provisions of the trust document depending on state law. Although language limiting liability may exist in a trust, a trustee should be conscious of how the law of the state where the trust is domiciled affects this limitation of liability language.

(4) A trustee may find it prudent to investigate and obtain information about the health and likely life expectancy of the insured before making changes to the policy.

In Cochran, the court does not take issue with the fact that the insured died unexpectedly and acknowledged the fact that the UPIA prevented it from looking at the trustee's actions in hindsight. The court, however, may have viewed the trustee's decision-making in a different light had the trustee significantly reduced the death benefit despite the fact that the insured was in poor health. Consequently, a trustee may want to obtain information from the insured (to the extent of the insured's cooperation) before making significant changes to the death benefit.

(5) A trustee may want to obtain releases from beneficiaries prior to making substantial changes to a policy, including lowering the death benefit, or consider formal or informal accountings that will start running the applicable statute of limitations for challenges.

Despite the fact that the Cochran court determined that the beneficiaries had been kept sufficiently informed, a careful trustee should be attentive to the beneficiaries' family dynamics and current locations. In some circumstances, it may be prudent for a trustee to consider obtaining releases from beneficiaries prior to reducing death benefit or making other substantial changes to a policy.

(6) A trustee should remember that its duty of loyalty runs to the beneficiaries of the ILT and not the insured/grantor.

Although an ILIT trustee generally has to work with an insured in order to receive contributions necessary to support the insurance policies and will need the insured's cooperation at times in making investment decisions (e.g., when purchasing new insurance), a trustee should be careful to remember that its fiduciary duties run to the beneficiaries of the trust and not the insured.

1. 901 N.E.2d 1128 (Ind. Ct of Appeals, 2009).
2. LISI Estate Planning Newsletter #1486 (June 29, 2009) at http://www.leimbergservices.com/.
3. Uniform Prudent Investor Act drafted by the National Conference of Commissioners on Uniform States Laws, enacted July 29–August 5, 1994.
4. LISI Estate Planning Newsletter #1499 (August 5, 2009) at http://www.leimbergservices.com/.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It was not intended or written for use and cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

©2010 John Hancock. All rights reserved. MLINY01261012138