



WRMarketplace

An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Developments in Fiduciary Duties in Administering Irrevocable Life Insurance Trusts (“ILITs”)

MARKET TREND: Litigation continues to target ILIT trustees for fiduciary duty breaches providing important lessons.

SYNOPSIS: ILIT trustees are subject to certain fiduciary duties that are imposed by state statutes and common law. Trustees, particularly non-professionals who typically are unaware of their obligations, can easily run afoul of the rules, exposing the trustees to substantial liability. Advisors can bring significant value to the services they provide by helping trustees appreciate their fiduciary duties and responsibilities, and the procedures trustees can follow to reduce the chances of breaching such duties and defending themselves in the event their actions are later questioned.

TAKE AWAYS: Many ILIT trustees need to be more informed about the duties they owe beneficiaries and their exposure to liability for breaches. With the changing economic landscape, carriers have developed a variety of different product offerings, some of which offer various guarantees, while others are sensitive to interest rate and stock market fluctuations. Yet, even product guarantees can be altered by trustee action or inaction. Thus, ILIT trustees should have a clear understanding of the terms and benefits provided by the insurance product held by the trust. ILIT trustees also should carefully review the trust instrument to familiarize themselves with their duties and responsibilities and determine whether the document authorizes the trustee to take actions that would otherwise be prohibited. To mitigate any exposure, ILIT trustees should maintain records of their actions, including the trustees' deliberations, the basis/reasoning for taking such actions, information provided to the trustees and/or beneficiaries, and beneficiary consents or waivers.

PRIOR REPORTS: 12-28, 11-02.

MAJOR REFERENCES: [French v. Wachovia Bank, N.A., 2013 U.S. App. LEXIS 14399 \(7th Cir. 2013\)](#); [French v. Wachovia Bank, N.A., 800 F. Supp. 2d 975, 2011 U.S. Dist. LEXIS 72808 \(E.D. Wisconsin 2011\)](#).

While often underappreciated, the administration of an ILIT and the management of its life insurance portfolio can be thorny, especially as economic conditions change and life insurance products become more complex. To further complicate matters, ILIT trustees are subject to the same fiduciary duties imposed on other trustees. These duties, developed by case law and codified by state statutes, can be broadened or waived by the terms of the trust instrument.

Recognizing this, fewer financial institutions are willing to serve as ILIT fiduciaries – generally accepting such roles only as an accommodation for established customers or where the role is limited to that of a “directed” trustee with no responsibility for investment or asset management decisions. Consequently, clients are turning to friends and family, most of whom have minimal or no experience with trust administration or life insurance. These individuals generally are unaware of their fiduciary duties and the potential liability for breaching such duties and typically lack errors and omissions insurance coverage to protect them from missteps. A recent affirmation of a federal appeals court in *French v. Wachovia Bank, N.A.*¹ (“**French**”), however, emphasizes the need for anyone appointed as an ILIT trustee to understand and comply with fiduciary duties in the administration of an ILIT.

THE DUTY OF LOYALTY AND PROHIBITION AGAINST SELF-DEALING

In *French*, the ILIT trustee, after considerable analysis and discussion with the grantor and the grantor’s attorneys, exchanged the ILIT’s existing life insurance policies for new policies issued through an affiliate of the trustee. The new policies provided the same death benefit at lower premiums, but the exchange resulted in a sizable commission to the affiliate. The beneficiaries later brought suit against the trustee for making the exchange.

The beneficiaries alleged that the trustee breached its duty of loyalty by engaging in an act of self-dealing when it purchased the new policies from the trustee’s affiliate. One aspect of the duty of loyalty is the prohibition against self-dealing – when a trustee enters into a transaction with himself (as an individual), with one of his family members, or with an affiliate, agent or attorney of the trustee. Such acts of self-dealing can arise, for example, where the trustee loans money to or borrows from the trust, or when the trustee causes the ILIT to purchase assets from the trustee, personally, or from a family member or affiliate of the trustee.

Many transactions entered into by a trustee can expose the trustee to liability for breaching the duty of loyalty. The ILIT trustee can defend against this risk by taking the following steps:

- Appoint an independent or professional co-trustee for the ILIT.
 - A family member, friend or close advisor to the grantor will always struggle with loyalties that are divided between the beneficiaries and the grantor. An unrelated or professional co-trustee can establish independent administration and support an inexperienced trustee who may find it difficult to maintain separation from the grantor.
- When contemplating a transaction, obtain an independent analysis of the advantages and disadvantages of the proposed transaction.
- If a transaction is believed to be in the best interests of the ILIT beneficiaries, but could be considered self-dealing or some other breach of the duty of loyalty, fully disclose the proposed transaction, as well as any analysis obtained from independent parties and all

potential conflicts of interest, to the beneficiaries and obtain their informed consent before proceeding.

- In the alternative, consider seeking prior court approval of the transaction.
- Carefully review the provisions of the trust instrument to determine whether the particular transaction is authorized under the agreement.
 - In the planning stages for the creation of the ILIT, the grantor and his or her advisor should consider whether the trust instrument should authorize the trustee to engage in certain transactions, such as the ability to engage in transactions with related parties.
 - Even if authorized by the trust instrument, consider disclosure of the proposed transaction to the beneficiaries and obtaining their informed consent to help attain maximum protection.
- Keep clear written records of the trustee's deliberations and actions, the basis for taking such actions, information provided to the trustee and/or beneficiaries, and beneficiary consents or waivers.
 - These records would include any independent written analysis, as well as emails and notes of discussions.

THE DUTY OF PRUDENCE AND THE UNIFORM PRUDENT INVESTOR ACT

The beneficiaries in *French* also alleged that the new policies purchased by the trustee were a bad investment and that the trustee had breached its duty to invest prudently. Most states have codified the common law rule requiring the trustee to invest prudently by adopting a version of the Uniform Prudent Investor Act (“UPIA”), which requires a trustee to 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 fiduciary must exercise reasonable care, skill and caution.²

With ILITs, UPIA requires the ILIT trustee to proactively monitor and evaluate the insurance portfolio to determine whether the policies are appropriate for the purposes of the trust. Unless waived by the trust instrument, UPIA also requires the trustee to diversify trust assets.³ Accordingly, ILIT trustees cannot ensure full compliance with these duties by simply holding the policy and sending out required Crummey withdrawal notices.

Most clients and non-professional trustees, however, do not realize or understand that insurance policies must be actively managed like any other asset. This lack of understanding may be compounded by the fact that policy holders do not usually receive regular statements, like they do with typical investment accounts. Thus, advisors can add value to the services they provide by implementing a systematic, proactive program for reviewing the ILIT's insurance portfolio. The review could include an analysis of:

- The reason for holding the policies and whether the policies are projected to achieve that objective.
- The financial strength of the carrier and its ability to pay claims.

- The insured's current health and life expectancy.
- The reasonableness and competitiveness of the insurance portfolio's fees and expenses.
- The current in-force illustrations and projected performance of the insurance portfolio.
- Whether current premium levels are sufficient to maintain the policies (this may represent a key concern for policyholders).
- Whether the grantor has sufficient funds and the desire to maintain the policies. If not, are other sources of funding available and appropriate, or should the policies be sold?
- If the policy has a no-lapse rider that guarantees the death benefit, whether a system is in place to ensure premiums are paid on a timely basis.

The ILIT trustee should also consider the following additional measures to fulfill its obligations under UPIA and defend against the risk of exposure to liability for breach of trust:

- Review the terms of the ILIT to determine whether the duty to diversify is waived.
 - UPIA establishes a default rule that can be changed by the terms of the trust instrument. Carefully crafted ILITs generally authorize the trustee to hold life insurance policies even if the policies do not produce income, and waive the requirement of diversification during the grantor's lifetime.
- Obtain a third party/independent review of the trust's insurance portfolio.
- Document the periodic review of the ILIT's insurance portfolio and all decisions made as a result of the review.
 - The review and documentation should include a discussion of the basis for the trustee's decision to maintain the current policies or purchase other policies.
 - Copies of all documentation used in the review, including any analysis made by experts, in-force illustrations, notes from meetings, etc., should be maintained as part of the trust's records.

DUTY TO ACT IN GOOD FAITH

In *French*, the beneficiaries also claimed that the trustee acted in bad faith by purchasing the policies without the grantor's waiver to the transaction, even though the trustee had requested such a waiver.

An ILIT trustee has a duty to administer the trust in good faith and in accordance with its terms and purposes and the interests of the beneficiaries. This duty requires that the trustee act objectively (*i.e.*, what would a prudent person believe to be the proper action). If a prudent person would know that an action should not be taken, and the trustee takes the action anyway, then the trustee can face liability. Unlike other fiduciary duties, this duty generally cannot be waived by the trust instrument.

TAKE AWAYS

- ILIT trustees need to take a proactive role in managing the trust assets.
- ILIT trustees need to be informed about the duties they owe beneficiaries and their exposure to liability for breaching those duties.
- Among other duties, trustees owe the beneficiaries: (i) the duty of loyalty, which includes the prohibition of engaging in any act of self-dealing; (ii) the duty to invest prudently, which requires the trustee to monitor and manage the insurance portfolio; and (iii) the duty to act in good faith and in accordance with the terms and purpose of the trust and in the best interests of the beneficiaries.
- The ILIT trustee should carefully review the trust instrument to familiarize himself with his duties and responsibilities and determine whether the document authorizes the trustee to take actions that would otherwise be prohibited by a fiduciary duty.
- To mitigate any exposure to liability for breach of trust, ILIT trustees should periodically review the portfolio with outside experts and the insurance advisor and maintain records of the review and the trustees' actions, including the trustees' deliberations, the basis/reasoning for taking such actions, the information provided to the trustees and/or beneficiaries, and any beneficiary communications, consents, or waivers.
- ILIT trustees should work with insurance advisors who are willing to have a post-closing role of informing and managing the products.

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WRM 13-42 was written by Greenberg Traurig, LLP

Jonathan M. Forster

Martin Kalb

Richard A. Sirius

Steven B. Lapidus

Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012

¹ *French V. Wachovia Bank, N.A.*, 2013 U.S. App. LEXIS 14399 (7th Cir. 2013); *French v. Wachovia Bank, N.A.*, 800 F. Supp. 2d 975, 2011 U.S. Dist. LEXIS 72808 (E.D. Wisconsin 2011). The facts of this case are discussed in more detail in Bulletin No. 12-28, issued June 14, 2012.

² Uniform Prudent Investor Act § 2(a).

³ Uniform Prudent Investor Act § 3. A trustee shall 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.