

## ADVANCED MARKET INSIGHTS

**TRUST-OWNED LIFE INSURANCE:  
MANAGING FIDUCIARY RISK**

“We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. But to say that a man is a fiduciary only begins [the] analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”<sup>1</sup>

—Hon. F. Frankfurter, SEC v Chenery (1943)

Fiduciary management of life insurance has never been easy. And as Justice Frankfurter noted, a fiduciary’s obligations and fulfillment of those obligations are not always clear cut. Life insurance policies are complex products requiring special knowledge. Fiduciary waivers and other state exculpatory statutes have softened the trustee’s fiduciary liability relating to the purchase and maintenance of life insurance. In addition, passively managed fixed interest life insurance products have been a product of choice for many settlors and trustees, given their perceived ease in management and, in some cases, underlying guarantees.

But there’s a catch: since the 1980s, the declining interest rate environment has caused many “passive” fixed rate life insurance policies to underperform and left consumers fewer alternatives to improve their performance without moving to a new product. Life insurance companies, constrained by low-yield investments, are faced with the decision to increase policy charges and lower crediting rates to their guarantees, further eroding policy performance.

Today, viewing life insurance as simply a passive asset can result in a conflict between the trustee’s investment duties, settlor’s objectives, and beneficiaries’ best interests. In response, life insurance carriers have created more options for fiduciaries managing life insurance policies. These options better align with traditional fiduciary standards, providing fiduciaries with broader investment options and control for the same, or even less premium, dollar.

Given these options, are waivers and exculpatory statutes still the best way to relieve fiduciaries of liability? Is low return, high-cost, passive insurance the appropriate approach? Or is working with a life insurance expert to find the best available product, including those with flexible investments and potential guarantees, a better approach?

<sup>1</sup> Justice Felix Frankfurter, (SEC v. Chenery Corp. 318 U.S. 80 (1943) at 85,86.)

## FIDUCIARY DUTIES AND LIFE INSURANCE

Generally, an irrevocable life insurance trust (ILIT) or any trust that owns life insurance as a trust asset, requires the trustee to manage the asset in a prudent manner unless the trust or other governing law modifies the trustee's investment duties.

In short, the duty of care required to a life insurance policy is exactly the same as for the management of any trust investment. The trustee's duties can include a duty to investigate and monitor a life insurance carrier's financial strength; a duty to select the appropriate life insurance policy to accomplish the settlor's intent; monitoring the policy's performance and condition and making appropriate adjustments; a duty to exercise policy options in a timely manner, and a duty to consider diversification within the policy's investment structure. Diversification can either mean holding policies from multiple carriers, or policies with various investment options and diversification among asset classes. A trustee can also reasonably be expected to regularly inquire about the insured's health.

### LOYALTY, CARE, AND IMPARTIALITY

Unless otherwise waived by the trust instrument, or by statute, a trustee owes a duty of loyalty to the trust beneficiary and must act solely in the beneficiary's best interest. The duty of loyalty requires acting without any conflict of interest. A trustee must generally act as a prudent investor of the trust assets and owes a duty of reasonable care to select trust investments that prudently balance risk and return. Finally, a trustee generally owes a duty of impartiality between present and future beneficiaries considering the needs of both in the trustee's administration of a trust.

### DIRECTED TRUSTS AND OTHER "REASONABLE" HELPERS

Together, the duties of loyalty, care, and impartiality, create a labyrinth of trust administration considerations. Without a "reasonableness standard," a trustee could be expected to be an expert in nearly all aspects of administration to fulfill their duty. However, modern trust law and practice have near fully incorporated an objective standard of care, establishing a reasonable or "prudent" person standard.

## THE PRUDENT PERSON STANDARD

A prudent trustee is one who invests trust assets as a "prudent person" would invest their own property, factoring in the beneficiaries' needs, the need to preserve the trust's corpus and provide regular and adequate income. The prudent person standard is now widely informed by the Uniform Prudent Investor Act (UPIA). The UPIA model rules, adopted in some form in most states, define a prudent investor standard, identifying the balance between risk and return as the fiduciary's primary consideration. The UPIA provides trustees with the ability to delegate their duties to other qualified advisors subject to certain safeguards; removes barriers around what types of investments are reasonable, so long as the trustee determines the investment plays an appropriate role in meeting the trusts objectives; and applies the prudent standard to all the trust assets.

## THE UPIA ON PRUDENCE

### UPIA SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES

- (a) 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.
- (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but **in the context of the trust portfolio as a whole as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.**
- (c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
  - (1) general economic conditions;
  - (2) the possible effect of inflation and deflation;
  - (3) **the expected tax consequences of investment decisions or strategies;**



- (4) the role that each investment or course of action plays within the overall trust portfolio . . . ;
  - (5) the expected total return from income and the appreciation of capital;
  - (6) other resources of the beneficiaries;
  - (7) needs for liquidity regularity of income, and preservation or appreciation of capital; and
  - (8) an assets special relationship of special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
- (d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.
  - (e) A trustee may invest in any kind of property or type of investment consistent with the standards of the act.
  - (f) 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 or expertise.

On its face, Section 2 of the UPIA establishes reasonable trustee guidelines: duties to the trust's purpose, and terms and the duty to manage a consolidated portfolio of assets. Section 3 of the UPIA incorporates investment guidelines from Modern Portfolio Theory which dictate that investments be managed to reduce risk. Generally, diversification is used to reduce risk—spreading uncompensated risk among the investments in the portfolio, including the use of mutual funds, insurance-dedicated funds, and exchange-traded funds.

Despite all the UPIA's guidance, the prudent investor standard is relational. The standard is measured by the degree of expertise (e.g., professional or unseasoned trustee). This means that the more informed and seasoned a trustee is, the standard by which they are measured is commensurately increased.

## LIFE INSURANCE CAN STILL BE A SIMPLE ASSET FOR A TRUSTEE TO MANAGE.

Life insurance was once considered a passive asset that was simple to manage. The trustee used trust funds to pay premiums on a policy likely selected by the settlor in anticipation that the policy would mature and pay a death benefit.

There is arguably little to no guidance on how a trustee's duty of loyalty applies to managing trust-owned life insurance policies, but the UPIA provides a framework for the duty of care both for amateur and professional trustees alike. This is particularly so when you consider the ability of a trustee to seek assistance from a life insurance professional or investment advisor with special skills or expertise.

## ARE TRUST WAIVERS AND EXCULPATORY CLAUSES EVEN NECESSARY?

Modern trust codes make managing trust-owned life insurance policies easier and encourage professional management by providing a grantor the ability to modify the trustee's responsibility to the beneficiaries as it relates to the life insurance policy as a trust asset. Additionally, a minority of states have passed a variety of exculpatory statutes relieving trustees of liability for losses to the trust incurred in managing life insurance policies owned by the trust.

But waiver language varies from trust to trust, and among drafting forms. Exculpatory statutes vary widely and are inconsistent in the minority of states that have enacted them. Some exculpatory statutes provide relief only on policies purchased on certain insureds. They may limit relief based upon how the policy is acquired and may even require the trustee to give notice to the settlor for the exculpatory statute to even apply.

**Importantly, exculpatory statutes may provide relief to the trustee if losses arise, but they do not necessarily waive the trustee's fiduciary duties. In other words, the clauses do not necessarily alter the standard of care—reasonable prudence. They only limit the liability of trustees who fail to act prudently.**

Grantor and statutory waivers, on the other hand, may provide an escape hatch for the fiduciary. Such waivers

may release the trustee from risk of loss in their duty to determine if the life insurance policy is or was a proper investment, whether a carrier was financially stable, and other points of oversight. Such waivers may seem reasonable. Often the settlor was actively involved in determining the life insurance carrier, product, premium payment pattern and beneficiary. The trustee may have had little or no involvement in the decision.

But the settlor's involvement does not, in fact, mean that the trustee should be passive simply because the settlor played or continues to play a role in the policy.

### **ANOTHER VIEWPOINT: VARIABLE UNIVERSAL LIFE PRODUCTS MAKE FIDUCIARY MANAGEMENT EASIER**

#### **Managing guaranteed general account life insurance policies: whole life and universal life with guarantees**

General account life insurance products such as whole life and universal life depend on the investment expertise of the life insurance carrier. Subsequently, the carrier invests primarily in high quality, low-risk assets such as investment-grade corporate and government bonds, commercial mortgages, and other secured assets. From a fiduciary perspective, this transfer of the investment duty from the fiduciary to the insurance carrier may lessen the fiduciary's strain. However, given the persistently low interest rate environment, and declining carrier crediting rates, these policies may be reduced to their own contractual guarantees and result in higher premium prices and/or cash value shortfalls. For life insurance companies that can support the guarantee without requiring additional premiums from the policy holder, the in-force block of policies may cause the carrier financial duress and may even result in the sale of the in-force policy block to a secondary buyer to reduce risk in the insurer's policy portfolio.

To sustain lifetime guarantees, whole life and guaranteed universal life (GUL) contracts require a trustee's discipline. Generally, the required premiums are substantially larger than required in an equity indexed or variable universal life (VUL) policy that has been managed with reasonable, or even conservative, return assumptions. It's worth inquiring whether this difference in premium results in fiduciary waste, allocating trust assets that could be otherwise deployed in the beneficiaries' best interest?

This confluence of factors may not bode well for the fiduciary managing general account life insurance products.

#### **A NOTE ON GUARANTEES**

**Guarantees are generally associated with whole life insurance products and pure guaranteed universal life insurance products that guarantee coverage for the entirety of the insured's life (generally age 120+). Additionally, in the modern life insurance marketplace nearly every type of product can include a secondary guarantee for a cost. This includes equity indexed and variable life products. Secondary guarantees provide guaranteed coverage based upon the premium payments made by the policyowner. The maximum duration of the guarantee may be for the life of the policy or until a maximum age (e.g., age 95 or age 105). The guarantee provides coverage to the specified age so long as there is a de minimis amount of cash value remaining in the contract's secondary guarantee account value at the insured's death. (e.g., \$1 of cash value).**

#### **MANAGING EQUITY INDEXED UNIVERSAL LIFE POLICIES**

Equity indexed universal life (IUL) policies occupy a niche inside of the life insurance portfolio space. Technically, it is a general account product and can have a guaranteed minimum crediting rate to the policy cash value. In addition to the general account fixed interest performance option, IUL products offer the trustee the option to hedge interest rate risk by investing in an indexed crediting account that uses structured notes to tie interest credits to an underlying index.

#### **At least up to a point . . .**

As part of the bargain of having upside potential and managing (not eliminating) downside risk, the life insurance company limits, or "caps" the maximum



return inside the index to hedge their own costs. As interest rates continue to drop however, so go the “caps”. For example, the IUL’s crediting rate may reflect the returns of the underlying index (e.g., S&P 500) over a given period of time. This is generally determined on a point-to-point basis, or the performance of the index over a 12-month period. For instance, a policy with a 0% floor and a 10% cap cannot credit more than 10% or less than 0% (notwithstanding internal policy charges).

Downward pressure on the interest rate cap causes a risk that the policy will not perform as intended, thus frustrating the settlor’s intent. While IUL provides greater opportunity to hedge interest rate risk in comparison to general account products, it still is subject to strain—with nowhere to escape to—other than surrendering the policy or exchanging it for a new policy. The option to buy a new policy assumes the insured is still healthy and insurable.

## MANAGING VUL POLICIES

VUL policies’ one substantial drawback compared to general account products is the potential for policy values invested in a variable subaccount to lose value. And at the same time, the variable subaccount provides the opportunity for growth to sustain long-term policy health and hedge falling interest rate risk.

Compared with non-VUL products, VUL can result in the same death benefit with greater premium savings and lower costs. This allows the fiduciary to avoid waste by carefully curating premium payments to meet only necessary costs and deploying capital for other purposes. The fiduciary may also make use of the tax deferral feature inside of the life insurance contract to deploy additional assets into the policy, avoid current taxation, and strengthen the overall policy’s performance (and increase the death benefit).

## EVALUATING VUL IN THE UPIA FRAMEWORK

Section 2 of the UPIA provides an ideal framework against which a fiduciary can benchmark a life insurance policy, and VUL fits the bill.

Many ILITs are created to hold only one asset—the life insurance policy. Life insurance held as an ILIT’s sole

asset has a special relationship to the grantor’s intent; to provide tax-deferred accumulation and income tax-free benefits paid at their death.<sup>2</sup>

The trustee, in most circumstances, can involve insurance and investment professionals with special skills and expertise to help manage the policy and fulfill their fiduciary duties at little or no cost to the trust.<sup>3</sup> Backed by specific expertise, the trustee can invest and manage the policy values prudently, and diversify the portfolio and reduce risk by selecting investments that meet the settlor’s objectives and the beneficiaries’ needs.<sup>4</sup>

VUL policies selected for strong cash value performance can provide the fiduciary comfort that there is access to capital for liquidity and income, if necessary, or provide comfort that the policy is supporting the ultimate preservation of capital through the policy death benefit.<sup>5</sup>

### VUL Subaccounts

VUL is known for its variable subaccount options and providing the fiduciary the opportunity to invest in variable insurance trusts, (VITs) offered by many of top investment firms. A VIT’s investment policy statement and advisory team are often nearly identical to similar mutual funds offered by the same investment house.

The investment options do not stop with VITs. VUL policies usually include in their offering the life insurance company’s general account option, and increasingly VUL policies are also offering equity indexed crediting accounts similar to those found in IUL products. This level of flexibility in investment choices inside of a life insurance policy can only happen within a VUL.

Additionally, VUL’s flexibility—whether in premium payment, death benefit or investment options—helps fiduciaries invest prudently and manage the life

<sup>2</sup> UPIA Section 2(c)(8)

<sup>4</sup> UPIA Section 2(a and b)

<sup>3</sup> UPIA Section 2(f)

<sup>5</sup> UPIA Section 2(c)(7)

insurance policy as a trust asset. The ability to select and re-balance investments across the risk spectrum allows the fiduciary to navigate the policy through both typical economic conditions and times of market turmoil. The investment policy statement of the trust may provide sufficient investment guidance to make decisions, or perhaps the policy is part of a larger pool of assets. In both cases VUL provides the investment options necessary to mirror the trust's investment policy or to diversify from other trust holdings.

## **VUL CAN PROVIDE SOLUTIONS, BUT ONLY THE FIDUCIARY CAN FULFILL THEIR DUTIES**

The trust codes, written terms, and other statutes may provide relief for a fiduciary overseeing a difficult and complex life insurance policy. What may be even more effective, however, is active policy management, which in concert with the specialized expertise of insurance and investment professionals and VUL's flexibility, can ensure you fulfill your fiduciary obligations.

### **SAMPLE TRUST EXCULPATORY LANGUAGE**

#### **Standard of Care with Respect to Acquisition and Retention of Life Insurance Policies**

**My Trustee does not have a duty to diversify with respect to policies, or to inquire into the suitability of an insurance policy or the financial condition of an insurer during the term of this trust or any trust created under this trust.**

**My Trustee may use all or any part of the trust principal and income to purchase and continue in force a policy, without any duty to diversify the investments of the trust in assets other than life insurance. My Trustee may purchase all insurance from one or more insurers, without a duty to diversify the types of policies or to purchase policies from more than one insurer.**

**My Trustee may not be held liable for purchasing or retaining a policy of life insurance as authorized in this Section, even if the investment in the policy does not satisfy applicable standards of prudence or diversification, or if the policy is inferior to another investment, including another life insurance policy that my Trustee could have acquired. My Trustee may not be held liable for any loss resulting from any failure of an insurer to pay claims under a policy or for the exercise or non-exercise of any benefit, option or privilege under the policy, including the right to borrow**

**or withdraw cash values in order to invest for a higher effective yield than under the policy.**

**My Trustee may, without incurring any liability to any person, purchase a policy upon the recommendation of an experienced insurance advisor or the Trust Protector, if one is then serving. My Trustee may not be held liable to any person for any loss suffered as a result of the financial condition, including insolvency, of any insurer.**

**My Trustee may invest in or retain indefinitely a policy that holds or acquires an interest in any entity or asset held by me, members of my family, or trusts created by any of us. My Trustee does not have a duty to monitor the investments or the investment performance of a policy owned by this trust.**

**My Trustee may not be held liable for a loss, decrease in value, or the economic consequences sustained as a result of my Trustee acquiring or retaining a policy, absent my Trustee's willful misconduct. The sole duty of my Trustee with respect to a policy will be to hold the policy and pay the premiums.**

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