The Uniform Prudent Investor Act and Trust-Owned Life Insurance: The Impossible Dream or a Match Made in Heaven

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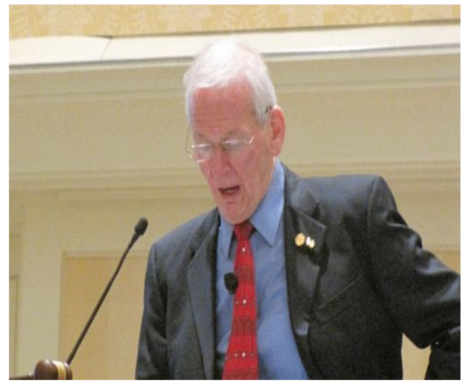
Gary L. Flotron, MBA, CLU®, ChFC®, AEP®

Gary L. Flotron is principal of G. L. Flotron & Associates, and specializes in the areas of trust-owned life insurance, estate and business planning, and, executive and employee benefit plans. He is also the Associate Director Financial Planning Programs and an Adjunct Faculty member at the College of Business Administration, University of Missouri - St. Louis, where he teaches courses in estate and trust planning, planning for business owners and professionals, employee benefits and life insurance. In addition, he is an Adjunct Professor with The American College of Bryn Mawr, Pennsylvania. An author and frequent national speaker, Gary has spoken to numerous professional associations and groups, including the Heckerling Institute On Estate Planning, the NAEPC Annual Conference, The Federal Tax Institute of New England, and, the FSP Video Training Conference.



Mr. Flotron has been an active member in various professional associations. He is Chair Emeritus and a Member of the Executive Committee for the Synergy Summit, an organization and think tank composed of representatives from ten major national legal and financial services professional organizations involved in estate planning. Previously he has served on the Executive Committee and is a Past Chair of the Professional Education and Development Committee for the Synergy Summit. He is a Past President of the National Association of Estate Planners & Councils (NAEPC) and The NAEPC Education Foundation, as well as past Chair of The NAEPC Education Foundation Committee and past Chair of the Accredited Estate Planner® (AEP®) Designation Committee for NAEPC. A past Member of the National Board of Directors of the Society of Financial Service Professionals (FSP), Mr. Flotron, in addition to having served on numerous National Committees and Task Forces, is the current Editor of the Estate Planning quarterly publication for FSP. He is also a member of the University of Missouri – St. Louis Planned Giving Advisory Committee.

A past President of the FSP Greater St. Louis Chapter, Gary is also a past President of the Estate Planning Council of St. Louis, and past President of the National Association of Insurance and Financial Advisors St. Louis Chapter. He is a past Member of the Board of Directors of the Foundation for Financial Service Professionals and a past Regional Chair for the National Council of The American College. Mr. Flotron has also served as a Member of the Chartered Financial Consultant (ChFC®) Curriculum Advisory Board for The American College.

An MBA graduate of the Washington University John M. Olin Graduate School of Business Administration, where he was inducted into Beta Gamma Sigma, the National Business Honors Fraternity; Flotron completed his undergraduate work in engineering management with a concentration in electrical engineering (B.S.E.Mgt.) at the University of Missouri at Rolla (now Missouri University of Science and Technology). He received the Chartered Life Underwriter (CLU®) designation in 1984 and the Chartered Financial Consultant (ChFC®) designation in 1985, both granted by The American College. In 1995 he was awarded the Accredited Estate Planner® (AEP®) designation by NAEPC. Gary is the 1996 recipient of the Stan Towerman Excellence in Professional Education Award from the FSP Greater St. Louis Chapter, and a 1994 recipient of the Paul F. Mills Scholarship from the Foundation for Financial Service Professionals. He was inducted into the National Association of Insurance and Financial Advisors St. Louis Chapter Hall of Fame in 2003. The University of Missouri – St. Louis named Mr. Flotron as the recipient of the 2014-2015 Chancellor's Excellence Award for a Part-time Faculty Member.

Gary has two sons, Paul and John, a daughter in law Anna who is married to John, and one grandson, Luke, and one granddaughter, Liliana. Flotron's hobbies include reading and learning, traveling, exercising, hiking, modern era architecture, photography, and walking/running his greyhound Jackson (at least in spirit and until he gets another greyhound). Gary's response when asked "what is something about you that is unique and most folks are unaware of?" is "that he had a dinner party in his home for a man that subsequently led a *coup d'état* and is now the President/Dictator of an African country."

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The Ticking Time Bomb of the Trust-Owned Life Insurance (TOLI) Insolvency Crisis

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The Ticking Time Bomb of the TOLI Insolvency Crisis

- The TOLI Center, LLC (TTC), a Fee-Based Policy Administration and Risk Management Services Firm Since 1992, Whose Clientele Includes Skilled and Unskilled Trustees, Attorneys, Affluent Family Groups and ILIT Beneficiaries, Has Maintained Portfolio Statistics (TOLI Specific Statistics Are Unavailable From Traditional Life Insurance Sources)
- According to the TTC Statistics As of December 2017, Approximately 36% of In-Force Universal and Variable Universal Life Products Are Carrier Illustrated to Lapse Prior to the Insured's Estimated Life Expectancy or Within Five Years of the Insured's Estimated Life Expectancy
- Further, According to TTC Approximately 15% of Whole Life and Guaranteed Universal Life Policies Have Compromised Guarantees
- Reliable Data About Life Insurance Polices Owed in ILITs Is Unavailable

The Ticking Time Bomb of the TOLI Insolvency Crisis (Continued)

- Since 1993, TOLI Risk Management Articles Have Suggested That Unskilled, (Brother-In-Law Like Accommodation) Trustees Administer Up to 90% of the In-Force Policies in ILITs
- If The TOLI Center Statistics, Whose Clientele Are Extremely Sophisticated, Mostly Skilled Professionals, Suggest a 36% Insolvency or Lapse Rate with TOLI Policies, What Is That Statistic For the Vast Majority of Unskilled, Accommodation Trustees? 60%? 70%? 90%?

The Uniform Prudent Investor Act (UPIA) and Trust-Owned Life Insurance (TOLI): Topics, Issues and Take Homes

- **Review of UPIA, UTC, Exculpation Statues Applicability to TOLI Plus Court Cases Involving UPIA and TOLI**
  - Review of UPIA (Uniform Prudent Investor Act) and Its Applicability of TOLI
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Review of UPIA, UTC, Exculpation Statues Applicability to TOLI Plus Court Cases Involving UPIA and TOLI

Review of UPIA and Its Applicability to TOLI

Review of UPIA and Its Applicability to TOLI Prudent Investor Rule

"All that is required of a trustee to invest is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence mange their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

[Harvard College v. Amory, 9 Pick (Mass.) 446 (1830)]

Review of UPIA and Its Applicability to TOLI
Objectives of UPIA*

1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets. [UPIA Section 2(b)
2) The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration. [UPIA Section 2(b)]
3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays as appropriate roll in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. [UPIA Section 2(e)]
4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. [UPIA Section 3]
5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. [UPIA Section 9]

* UPIA, Prefatory Note, Page1.

Review of UPIA and Its Applicability to TOLI
Comments to Objectives

- Applied Modern Portfolio Theory (MPT) and Portfolio Management Approach to Fiduciary Management of Trust Assets [UPIA Section 2(b)]
- The Term “Portfolio” Embraces All Trust Assets, i.e. Life Insurance [UPIA Section 2(b)]
- Eliminated Categoric Restrictions [UPIA Section 2(e)]
- Codified Diversification Requirement [UPIA Section 3]
- Permitted Delegation with Safeguards [UPIA Section 9]

Review of UPIA and Its Applicability to TOLI
UPIA Section 1. Prudent Investor Rule.

a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this Act.

b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

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Review of UPIA and Its Applicability to TOLI
Comments to UPIA Section 1 – Prudent Investor Rule

- Section 1 (a) Establishes UPIA as a Default Rule
- However Section 1 (b) Says the Default Rule may be " expanded, restricted, eliminated, or otherwise altered by the provisions of a trust"
- The Question Becomes To What Extent Should Any or All Provisions of UPIA Be Restricted or Eliminated for an ILIT?
  - Trustee's Point of View – All Provisions
  - Beneficiaries Point of View – None of the Provisions
  - To What Extent Does the Trust Settlor Even Care About this Issue

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Review of UPIA and Its Applicability to TOLI

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 and as 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:

Review of UPIA and Its Applicability to TOLI

UPIA Section 2(c) List of Circumstances that a Trustee Shall Consider in Investing and Managing Trust Assets.

1) General economic conditions;
2) The possible effect of inflation or 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, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
5) The expected total return form income and the appreciation of capital;
6) Other resources of the beneficiaries;
7) Needs for liquidity, regularity of income, and preservation of capital; and
8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Review of UPIA and Its Applicability to TOLI

UPIA Section 2. Standard of Care; Portfolio Strategy; Risk and Return Objectives.

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 this 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.

Review of UPIA and Its Applicability to TOLI

Comments to UPIA Section 2. – Standard of Care; Portfolio Strategy; Risk and Return Objectives.

- Objective Standard – Requires Trustees to Invest and Mange Trust Assets as "a prudent Investor would" – Standard is Relative
  - For Professional Trustees – Relative to Prudent Professionals
  - For Amateur Trustees – Relative to Prudent Amateurs
- "Investment and Management Decisions… Must Be Made As Part of an Overall Investment Strategy…"
  - Requires Written Plan to Document
- Duty to Monitor/Manage and To Investigate
  - To What Extent Should Amateur Trustees Be Relieved from Duty to Monitor/Manage and Investigate Life Insurance Policies
- Trustee Who Has Special Skills or Expertise Must Use Those Skills or Expertise
- Categoric Restrictions Eliminated
- It Seems Life Insurance is an Asset that Has "special relationship or special value,…, to the purposes of the trust…" in an ILIT – Section 2(c)8)
- Effects of Inflation On Certain Types of Life Insurance – Section 2(c)(2)

Review of UPIA and Its Applicability to TOLI
UPIA Section 3. Diversification

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.

Review of UPIA and Its Applicability to TOLI
Comments to UPIA Section 3. - Diversification

- Trustee is Required to Diversify the Investments of the Trust Unless "the trustee reasonably believes that, because of special circumstances, the purposes of the trust are better served without diversifying"
  - While Prudent Investing Ordinarily Requires Diversification, Circumstances Can "Overcome" the Duty to Diversify
  - Clear Purpose of ILIT Consistent with Settlor's Intent Is to Own One or More Life Insurance Policies During the Life of the Settlor/Insured, It Appears the this is a Special Circumstance
  - However, What About Diversification of Life Insurance Polices Among Different Policy Types and Different Carriers?
  - Not Withstanding the Prior Point, Is There Any Reason During the Grantor/Insured's Lifetime Not to Eliminate Or Restrict to Insurance Policies Only the Duty to Diversify

Review of UPIA and Its Applicability to TOLI
UPIA Section 4. Duties at Inception of Trusteeship

Within a reasonable time after accepting a trusteeship or receiving the trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this Act.

Review of UPIA and Its Applicability to TOLI
UPIA Section 5. Loyalty, and
UPIA Section 6. Impartiality

Section 5. Loyalty.

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Section 6. Impartiality.

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Review of UPIA and Its Applicability to TOLI
UPIA Section 7. Investment Costs. and
UPIA Section 8. Reviewing Compliance

Section 7. Investment Costs.

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

Section 8. Reviewing Compliance.

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Review of UPIA and Its Applicability to TOLI
Comments to UPIA Section 7. – Investment Costs

- Given the Lack of "True" Transparency with Life Insurance Is It Possible to Apply Section 7 Where the Trustee is Asked to Only Incur Costs that Are Appropriate and Reasonable?
- Other Than a Maximum Guaranteed Cost of Insurance and Expenses, Current Cost of Insurance and Expenses Can Change
- Life Insurance Policy May Need to Be Analyze As a Whole and Not By Its Individual Cost Components

Review of UPIA and Its Applicability to TOLI
UPIA Section 9. Delegation of Investment and Management Functions

a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill and caution in:
   1) Selecting an agent;
   2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
   3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Review of UPIA and Its Applicability to TOLI
Comments to UPIA Section 9. – Delegation of Investment and Management Functions

- Allows A Trustee to Delegate Investment and Management Functions that a Prudent Trustee Could Properly Delegate
  - Trustee Must Exercise Reasonable Care in Selecting an Agent, Establish the Scope of the Delegation and Periodically Review the Agent's Actions.
  - For the Amateur Trustee – As Well as Professional Trustees Who Lack Life Insurance Expertise – Delegation of the Investment and Management Function Would Seem Perfectly Appropriate
  - Question Becomes Who or What is a "Suitable Agent" and How They Will Be Compensated?
  - Note The Importance the Court In Cochran v. KeyBank (Discussed Later) Placed On the Independent Agent Chosen and the Fact that It Had No Financial Interest In the Outcome of The Policy Exchange
  - No Reason To Restrict or Eliminate the Power of the Trustee to Delegate the Management of the ILIT's Life Insurance to a Suitable Agent

Review of UPIA and Its Applicability to TOLI
UPIA Section 10. Language Invoking Standard of Act.

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this Act: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence excise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition or their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

Review of UPIA and Its Applicability to TOLI
UPIA Remaining Sections

Section 11. Application to Existing Trusts

This Act applies to trust existing on and created after its effective date. As applied to trusts existing on its effective date, the Act governs only decisions or actions occurring after that date.

Section 12. Uniformity of Applications and Construction

This Act shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this Act among the States enacting it.

Section 13. Short Title

This Act may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

Section 14. Severability

If any provision of this Act or its application to any person or circumstance is held invalid, the invalidity does not effect other provisions or applications of this Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are severable.

Section 15. Effective Date

This Act takes effect………….

Section 16. Repeals

The following acts and parts of acts are repealed: [None listed.]

Review of UTC Provisions Affecting UPIA and ILITs

Review of UTC Provisions Affecting UPIA and TOLI UTC Section 105. Default and Mandatory Rules.

a) Except as otherwise provided in the terms of the trust, this [Code] governs the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary.
b) The terms of the trust prevail over any provision of this [Code] except:
   1) the requirement for creating a trust;
   2) the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries;

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 105(b). Default and Mandatory Rules. (Continued)

3) the requirements that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;
4) the power of the court to modify or terminate a trust under Sections 410 through 416;
5) the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust as provided in [Article] 5;
6) the power of the court under Section 702 to require, dispense with, or modify or terminate a bond;
7) the power of the court under Section 708(b) to adjust a trustee's compensation specified in the terms of the trust which is unreasonably low or high;

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 105(b). Default and Mandatory Rules. (Continued)

8) [the duty the duty under Section 813(b)(2) and (3) to notify qualified beneficiaries of an irrevocable trust who have attained 25 years of age of the existence of the trust, of the identity of the trustee, and of their rights to request trustee's reports;]
9) [the duty under Section 813(a) to respond to the request of a [qualified] beneficiary on an irrevocable trust for trustee's reports and other information reasonably related to the administration of a trust;]
10) the effect of an exculpatory terms under Section 1008;

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 105(b). Default and Mandatory Rules. (Continued)

11) the rights under Sections 1010 through 1013 of a person other than a trustee or beneficiary
12) periods of limitation for commencing a judicial proceeding; [and]
13) the power of the court to take such action and exercise such jurisdiction as may be necessary in the interest of justice [;and
14) the subject-matter jurisdiction of the court and venue for commencing a proceeding as provided in Sections 203 and 204].

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 801. Duty To Administer Trust.

Upon acceptance of a trusteeship, the trustee shall administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries, and in accordance with this [Code].

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 813. Duty To Inform and Report.

a) A trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall promptly respond to a beneficiary's request for information related to the administration of the trust.
b) A trustee:
   1) upon request of a beneficiary, shall promptly furnish to the beneficiary a copy or the trust instrument.;
   2) within 60 days after accepting a trusteeship, shall notify the qualified beneficiaries of the acceptance and of the trustee's name, address, and telephone number;

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Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 813. Duty To Inform and Report. (Continued)

3) within 60 days after the date the trustee acquires knowledge of the creation of an irrevocable trust, or the date the trustee acquires knowledge that a formerly revocable trust has become irrevocable, whether by the death of the settlor or otherwise, shall notify the qualified beneficiaries of the trust's existence, of the identity of the settlor or settlors, of the right to request a copy of the trust instrument, and of the right to trustee's report as provided in subsection (c); and
4) shall notify the qualified beneficiaries in advance of any change in the method or rate of the trustee's compensation.

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Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 813. Duty To Inform and Report. (Continued)

c) A trustee shall send to the distributes or permissible distributes of trust income or principal, and to other qualified or nonqualified beneficiaries who request it, at least annually and at the termination of the trust, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets and, if feasible, their respective market values. Upon a vacancy in a trusteeship, unless a cotrustee remains in office, a report must be sent to the qualified beneficiaries by the former trustee. A personal representative, [conservator], or [guardian] may send the qualified beneficiaries a report on behalf of a deceased or incapacitated trustee.

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 813. Duty To Inform and Report. (Continued)

d) A beneficiary may waive the right to a trustee's report or other information otherwise required to be furnished under this section. A beneficiary, with respect to future reports and other information, may withdraw a waiver previously given.
e) Subsections (b)(2) and (3) do not apply to a trustee who accepts a trusteeship before [the effective date of this [Code]], to an irrevocable trust created before [the effective date of this [Code]], or a revocable trust that becomes irrevocable before [the effective date of this [Code]].

Review of UTC Provisions Affecting UPIA and TOLI
UTC Section 1008. Exculpation of Trustee.

a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it:
   1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or
   2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.

b) An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.

State Statutes Exculpatating Trustees of ILITs

State Statutes Exculpatating Trustees of ILITs
General Comments

- 14 States – Alabama, Arizona, Delaware, Florida, Maryland, North Carolina, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia, Wyoming – Have Enacted Statues that Exculpate Trustees Holding Life Insurance
- Statutes Either Limit the Liability for Management of Life Insurance Polices or Waive the Duty of Diversification within ILITs, or Both.
- May Be Limited to Life Insurance Only On the Grantor, the Grantor or the Grantor's Spouse As Joint Insureds, or Both Polices on the Grantor or the Grantor's Spouse.
- Implication is that Statutes Only Apply to Unfunded ILITs.
- Query: What About Funded ILITs?

State Statutes Exculpatating Trustees of ILITs
South Dakota Statute 55-5-17
Non-application of Prudent Investor Rule

- South Dakota Has Enacted a Statute That Virtually Eliminates Trustee Liability with Respect to Managing, Monitoring and Investing In Life Insurance Policies.

State Statutes Exculpatating Trustees of ILITs
South Dakota Statute 5-5-17
Non-application of Prudent Investor Rule (Continued)

55-5-17. Duties of trustee to life insurance—Notice to Settlor.

(a) Unless otherwise required by the terms of the trust instrument or court order, no trustee of a trust, with respect to acquiring, retaining, or disposing of a contract of insurance or holding one or more insurance contracts upon the life of the settlor, or the lives of the settlor and settlor's spouse, has the following duties:

(1) To determine whether any such contract is or remains a proper investment;

(2) To investigate the financial strength or changes in the financial strength of the life insurance company;

(3) To make a determination of whether to exercise any policy options available under such contact;

(4) To make a determination of whether to diversify any such contract relative to one another or to other assets, if any, administered by the trustee;

(5) To inquire about changes in the health or financial condition of the insured or insured's relative to any such contract;

(6) To vote, or give proxies to vote, on corporate matters.

State Statutes Exculpatating Trustees of ILITs
South Dakota Statute 55-5-17
Non-application of Prudent Investor Rule (Continued)

A trustee of a revocable or an irrevocable trust, or of either a directed trust pursuant to chapter 55-1B or a delegated trust pursuant to § 55-5-16, is not liable to the beneficiaries of the trust or to any other party for any lost arising from the absence of those duties upon the trustee.

(b) The trustee of a trust described under subsection (a) of this section which was established prior to the effective date of this section, shall notify the settlor in writing that, unless the settlor provides written notice to the contrary to the trustee within sixty days of the trustee's notice, the provisions of subsection (a) of this section shall apply to the trust. Subsection (a) of this section does not apply if, within sixty days of the trustee's notice, the settlor notifies the trustee that subsection (a) does not apply.

State Statutes Exculpatating Trustees of ILITs Exculpatating State Statutes Will Not Apply to Regulated Trust Departments

- OCC (Office of the Controller of the Currency) Regulates National Banks
- Most State Bank Regulators and Savings and Thrifts Regulators All Follow OCC Guidelines and Procedures
- The OCC August 2012 Handbook Requires Regulated Trustees to Actively Manage Policies in Their ILITs Regardless of State Laws Eliminating that Duty and Presumably Similar Exculpatory Trust Provisions
- Handbook Also Seems to Require Pre-Acquisition Policy Reviews
  - Would a Bank Trustee Refuse to Accept a Policy Applied For and Paid for By the Trust Grantor/Insured?
- OCC's Guidelines for Managing Policies Held in Trust by Regulated Trustees Are Also Helpful for Amateur Trustees

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Four Court Cases Involving UPIA and TOLI

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Four Court Cases Involving UPIA and TOLI

- Cochran v. KeyBank [*In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128(Indiana Court of Appeals, March 2, 2009)]
- Paradee v. Paradee [W. Charles Paradee, III v. Eleanor Clement Paradee et al., No. CA No. 4988-VCL (In the Court of Chancery of the State of Delaware, October 5, 2010)]
- French v. Wachovia Bank [*French v. Wachovia Bank, N.A.*, 2011 U.S. Dist. LEXIS 72808 (E.D. Wisconsin 2011),2013 U.S. App. LEXIS 14399]
- Rafert v. Meyer [Rafert v. Meyer, N.W.2d, 290 Neb. 219, 2015 WL 832590 (Nebraska Supreme Court February 27, 2015. No. S-14-003.)]

Four Court Cases Involving UPIA and TOLI
Cochran v. KeyBank Case
Take-Aways for the Amateur Trustee

- While the Process Was "Not Perfect" There Was a Documented Process
- Reliance On the Advice of a Delegated Agent Which Had No Financial Incentive to Approve the Exchange
- KeyBank Examined Both the Existing and the Proposed Policy Before the Exchange
- For Amateur Trustees, This Suggests:
  - Having a Documented Process for Reviewing Policies Periodically
  - Delegating to an Appropriate Agent the Responsibility for Policy Management and Review of Policy Exchanges
  - Documenting the Comparison Between an Existing and Any Potential Replacement Policy

Four Court Cases Involving UPIA and TOLI
Rafert v. Meyer Case
Take Aways From The Case

- In States That Have Adopted the Uniform Trust Code And Have Not Adopted Exculpation Statues For Unfunded ILITs, the Terms Of the Trust Cannot Prevail, Restrict Or Eliminate the Duty Of the Trustee To Act In Good Faith And In Accordance With the Terms and Purposes Of the Trust And the Interest Of the Beneficiaries
- This, Undoubtedly, Includes the Duty To Monitor And Manage the Assets Of the Trust And To Keep Qualified Beneficiaries Of the Trust Reasonably Informed About the Administration Of the Trust And Of the Material Facts Necessary For Them To Protect Their Interests

Four Court Cases Involving UPIA and TOLI
Rafert v. Meyer Case
Take Aways From The Case (Continued)

- Additionally, It Confirms That An Exculpatory Term Drafted Or Caused To Be Drafted By the Trustee Is Invalid Unless the Trustee Proves That the Exculpatory Term Is Fair Under the Circumstances And That Its Existence And Contents Were Adequately Communicated To the Settlor
- In Other Words, An Attorney Needs to Communicate And Explain the Terms Of the Trust To the Settlor And The Responsibility Of All Parties With Regard To Trust Assets; For ILITs, Who Is Responsible For Monitoring And Managing the Insurance Policies; Particularly Non-Guaranteed Policies

Four Court Cases Involving UPIA and TOLI
Rafert v. Meyer Case
Take Aways From The Case (Continued)

- Trust Provisions Relieving Trustees Of Liability For Breach Of Trust Are Not Adequate Protection For Negligent Acts Committed In Bad Faith Or With Reckless Indifference To the Purposes Of the Trust Or the Interest Of the Beneficiaries

Risks of Life Insurance Policies

Risk of Life Insurance Policies - Part 1

Risk of Life Insurance Policies – Part 1
Risk In Life Insurance

- But Isn't Talking About Risk in Life Insurance Rather Ironic Since Life Insurance is a Risk Transfer Device?
- Risk Shift Started in the Great Divide of 1979
- Prior to 1979 Products Were All Guaranteed Products with the Risk of Sufficiency and Sustainability Retained and Maintained by the Insurance Carrier
- With the Introduction in 1979 of Indeterminate, "Flexible" Premium Non-Guaranteed Products the Risk of Sufficiency and Sustainability was Transferred from the Insurance Carrier to the Policy Owner
- This Risk Shift Has Mostly Either Been Completely Misunderstood or Thoroughly Ignored

Risk of Life Insurance Policies – Part 1
What is Risk and What Are TOLI Expectations?

- Risk is a Variation from Expectations
- What are Expectations with Respect to TOLI?
  - Carrier Remains Solvent and Financially Viable
  - Life Insurance Product Performs According to the Policy Illustration
    - Premium is Sufficient
    - Policy will Sustain Itself
  - Life Insurance Product Remains Suitable
  - For Some, Purchasing Power Remains Constant

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics

- Life Insurance Pricing and Assumptions
  - Cost of Insurance (COI)
    - Mortality
  - Expenses
    - Administration
    - Start-Up
      - Underwriting
      - Commissions
  - Investment Returns
    - Interest Credited
    - Earnings of Separate Accounts
  - Persistence (Lapse Rate)
  - Lack of Transparency
  - Integrated – View as Whole, Not Separately

Risk of Life Insurance Policies Part 1
Some Life Insurance Basics

- All Life Insurance Is Based on **ASSUMPTIONS**
- In Some Product Types the Methods of Calculating the Results of the Current Assumptions Is Guaranteed, But Not the Results
  - I.E. – **Performance Risk Transferred to Policy Owner**
- In Some Other Product Types the Results of the Assumptions Is Guaranteed
  - I.E. – **Performance Risk Retained by Insurance Carrier**

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics

- Product Types
  - Fixed Premium "Guaranteed" Products
    - Term
    - Whole Life
    - No Lapse Guarantee Universal Life
  - Indeterminate "Flexible" Premium Products
    - Universal Life
    - Variable Universal Life
    - Indexed Universal Life
  - Blended Part "Guaranteed" Products
    - Base Whole Life with Combination Paid-Up Additions and Decreasing Term Dividend Option and/or Paid-Up Additions Rider

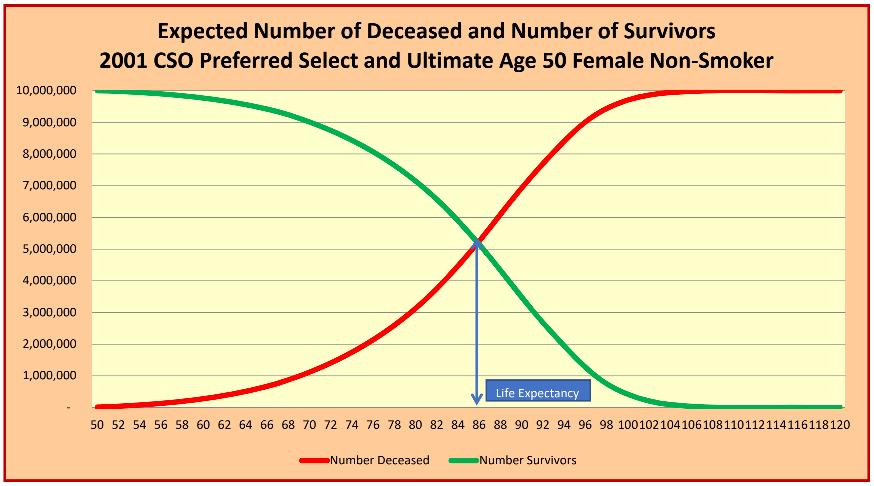
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics

- Product Types
  - Fixed Premium "Guaranteed" Products
    - **PERF0RMANCE RISK RETAINED BY CARRIER**
  - Indeterminate "Flexible" Premium Products
    - **PERFORMANCE RISK TRANSFERRED TO POLICYOWNER**
  - Blended Part "Guaranteed" Products
    - **SOME PERFORMANCE RISK RETAINED BY CARRIER (THE "GUARANTEED" PART) AND SOME PERFORMACE RISK TRANSFERRED TO POLICYOWNER**

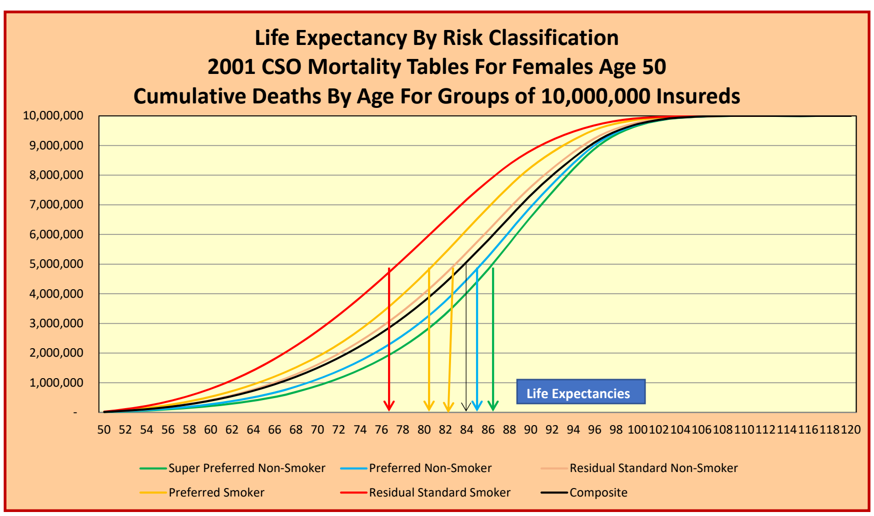
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mortality Tables

- Actuaries Construct Mortality Tables Based on the Ages of Death of Various Members of Population Groups
- Tables May be for Aggregate Groups, or Groups With Specific Characteristics and Criteria
- From Either the Aggregate Population or Specific Characteristic Groups Chosen, the Probability of Death at Any Age is Derived
- Probability of Death Increases with Age, Although There Have Been "Blips' at Young Ages and Some Smoothing is Involved
- Every Mortality Table Constructed Has a Maximum Age in Which Death is Assumed to be Certain (100% Probability)
  - For Official Tables Constructed Prior to 2001 the Maximum Age was 100
  - For Official Tables Constructed in 2001 and 2017 the Maximum Age is 120
  - Will the Next Generation of Mortality Tables Have a Maximum Age of 150?

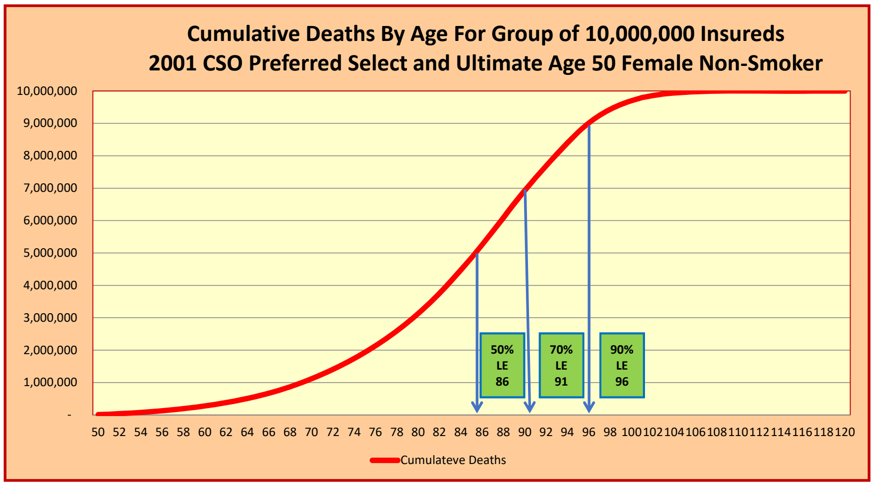
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mortality Tables and Life Expectancy



Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics



Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Life Expectancy - Percentile



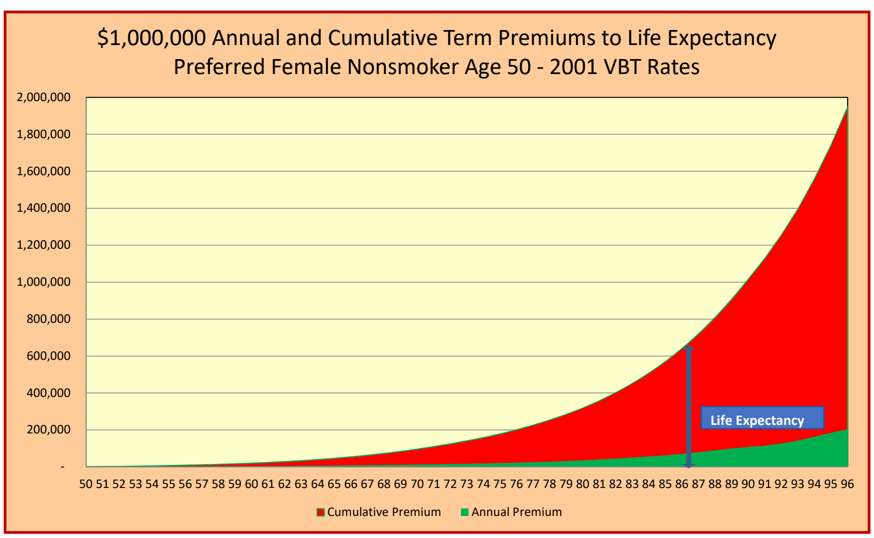
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Life Expectancy

- Life Expectancy Is Always Measured From A Starting Age and Is Dependent on That Starting Age
  - Generally Life Expectancy Increases With Starting Age
- Life Expectancy Is Generally Measured With Respect to Specific Groups With Common Characteristics or Risks
  - I.E., Preferred Risk Females Age 50 Nonsmokers, Standard Risk Males Age 25 Smokers
- Life Expectancy Can Also Be Measured With Respect to Large Aggregate Groups
  - I.E., All Males Age 45
- Life Expectancy Represents the Medium Age or Mid-Point Where Half of A Group Are Deceased and Half Have Survived; It, Therefore, Represents the 50% Percentile Mark
- There Also May Be A Shift In Life Expectancy Due to Changes in Health, Occupation and/or Avocation

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of the Cost of "Pure" Term Insurance

- Term Insurance is Best for "Temporary" Needs for Life Insurance
- What Constitutes a "Temporary" Need Time Period is Debatable
  - Clearly 10 Years Or Less
  - Possibility As Many As 30 Years
  - But Clearly Less Than Life Expectancy
- Essentially the Annual Cost of Term Insurance Is Based On the Probability of Death for Each Year
  - It Is "Pay As You Go" Life Insurance
  - Obviously Cost Increases Each Year and Over Time Escalates Exponentially
  - Reasonable Cost at "Younger" Ages, Unaffordable Cost at "Older" Ages
  - Cost, However, May Be Levelized Over 5, 10, 15, 20 or 30Years, Or, To Age 55,60,65, 70 or 75

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of the Cost of "Pure" Term Insurance



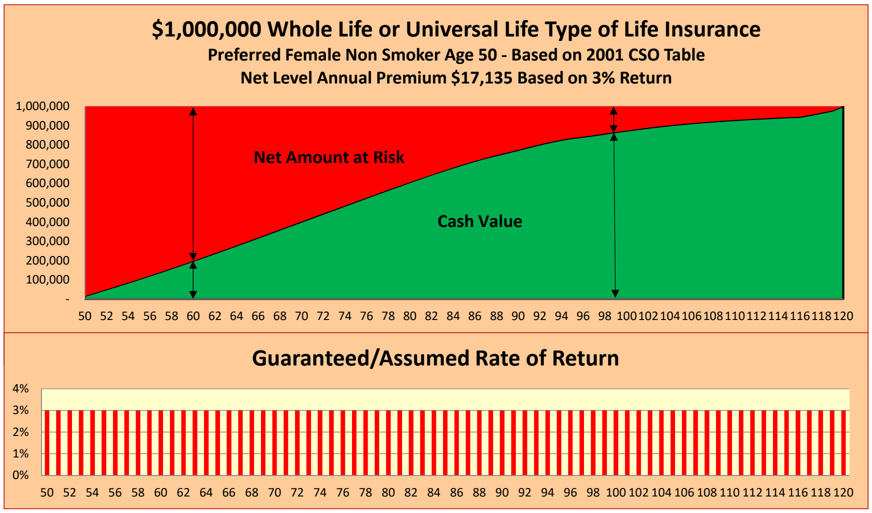
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of the Cost of "Pure" Term Insurance (Continued)

- Total Cumulative Annual Term Premium Costs For $1,000,000 of Coverage For A 50 Year Old Female Preferred Non-Smoker Using Rates Based On the 2001 Valuation Basic Table (VBT) Non Interest Adjusted
  – To Life Expectancy of 86 Years is $640,900
  – To Life Expectancy Plus 10 Years, Or Age 96 is $1,948,420
  – To Age 100 is $2,879,620
  – Beyond Age 100 – You Don't Want to Hear It
- For Life Insurance Needs Close To Life Expectancy and Beyond Clearly Term Insurance Is Not the Answer and Does Not Work

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of "Permanent" Types of Insurance

- Recognizing the Problems With Term Insurance, Actuaries Came Up With "Permanent" Insurance For Long-term Needs
- Goal Was to Make Permanent Insurance Affordable For the Insured's "Whole" Life By Levelizing Annual Premium Cost
- Simplified Explanation of Levelizing Computation Process:
  – Compute Net Present Value of All Annual Mortality (Term) Costs to Maximum Age of Mortality Table To Create A "Net Single Premium"
  – Take Net Single Premium and Amortized - Level It Out - Over Premium Paying Period, Which Is Generally to End of Mortality Table, To Create Net Level Annual Premium
  – Add Policy Expenses Levelized By The Same Above Process To Create Gross Level Annual Premium
  – All of Above Done With A Constant Assumed Rate Of Interest

Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of "Permanent" Types of Insurance



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Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of "Permanent" Types of Insurance (Continued)

- With Level Premium Concept In Early Years The Premium Is Greater Than the Actual Cost of Insurance Protection and In Later Years the Cost of Insurance Is Greater Than the Premium
- The Excess Premium Is Put Into a Reserve Which Creates the Cash Value of the Policy
- In Fact, Anytime Premium is Levelized A Reserve, Or Cash Value, Is Created
- Cash Value Becomes Part of Death Benefit
- Over Time Cash Value Grows To Equal the Total Death Benefit Amount At The Maximum Age of the Mortality Table Used for the Policy

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Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of "Permanent" Types of Insurance (Continued)

- At the Same Time, Over Time, the "Pure Insurance Protection" Over and Above the Cash Value, Called "Net Amount At Risk" Decreases
- It Is this Relationship that Makes Permanent Life Insurance Affordable
- Thus, At Any Particular Point In Time The Total Death Benefit Is Equal to the Sum of The Cash Value Plus The Net Amount at Risk
- This Relationship, Like All Insurance, Is Based On Assumptions and Is A Very Delegate Balance

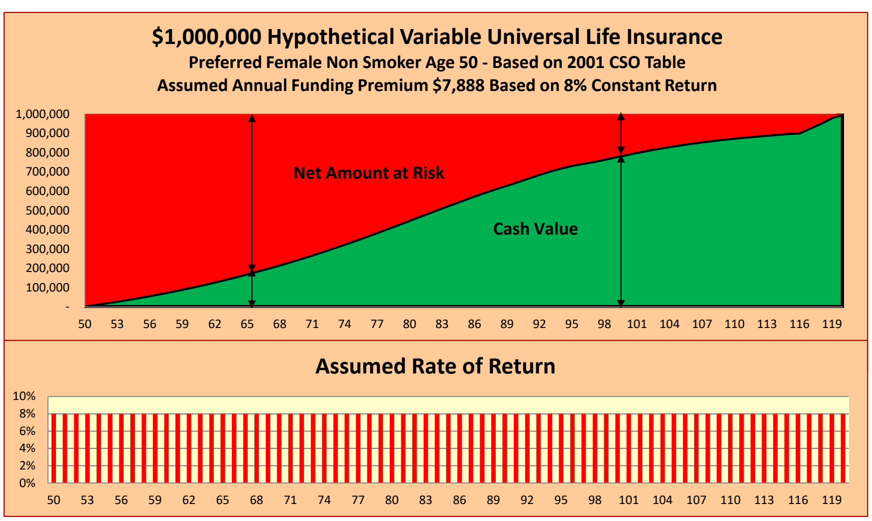
Risk of Life Insurance Policies – Part 1
Some Life Insurance Basics
Mathematics of "Permanent" Types of Insurance (Continued)

- If the Life Insurance Product Is a Guaranteed Product, Or All the Assumptions – The Policy Earnings, Cost of Insurance, Policy Expenses and Premiums – In a Non-Guaranteed Product Remain Constant, Than the Previous Graph Is an Accurate Representation of the Life Insurance Policy
- Note That the Graph Represents a Picture of a Constant Assumption Policy Illustration
- However, What If in Non-Guaranteed Products the Assumptions Are Not Constant, But Volatile – Particularly Policy Earnings?

Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)

- Following Graph Represents a $1,000,000 Hypothetical Variable Universal Life Policy for a Preferred Female Non-Smoker Age 50 With the Planned Assumed Funding Premium of $7,888, Based on the 2001 CSO Mortality Table with Select and Ultimate Rates, No Expense Loading, and an Assumed <u>Constant</u> Rate of Return of 8%
- Note Comparison of Premiums Derived at 8% and the Premium Derived of $17,135 for Whole Life or Universal Life Using Same Assumptions As in Previous Graphs But with Assumed <u>Constant</u> Rate of Return of 3%

Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance



Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

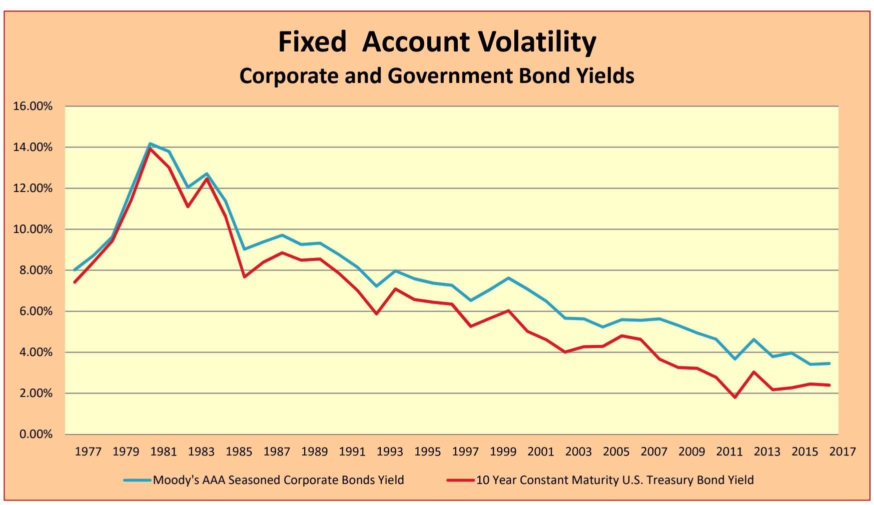
Mathematics of "Permanent" Types of Insurance (Continued)

- But for Variable Universal Life Policies (And Other Non-Guaranteed Products) Returns Are <u>Not Constant</u> Every Year But Changing and <u>Volatile</u>
- Thus, the Constant Average Return Life Insurance Policy Illustration <u>Does Not</u> Reflect Reality
- Keeping All Other Assumptions Constant But the Assumed Rate of Return, Let's Look at the Effect of Volatile Rates of Return

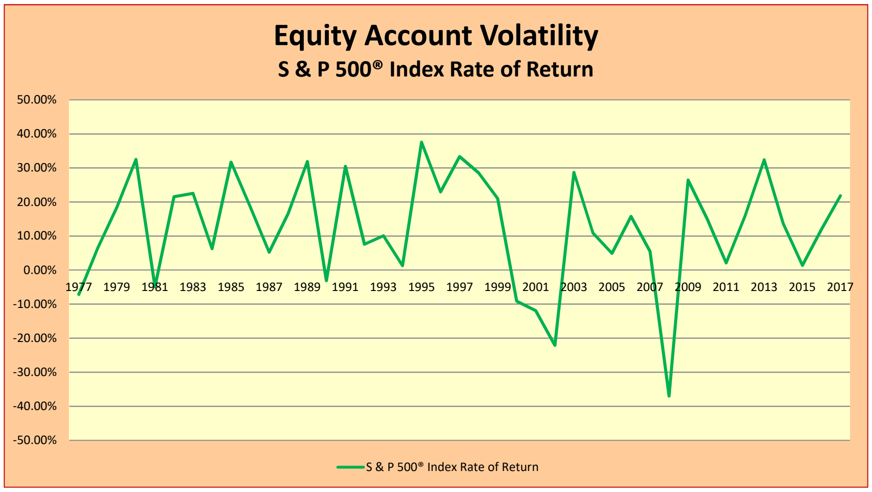
Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of "Permanent" Types of Insurance (Continued)



Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)



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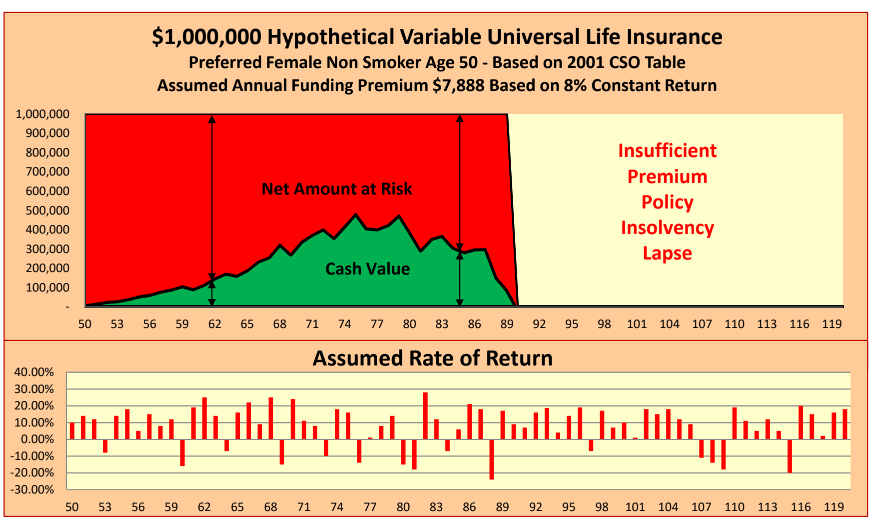
Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)



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Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)

- The Preceding Graph Has an Overall Average Rate of Return of Just Short of 9%, And an Average Rate of Return of 8%-9% For Each 10 Year Period
- However, Note that the Assumed Funding Premium of $7,888, Based On a Constant Rate of Return of 8%, Is Inadequate To Sustain the Policy Pass Age 90 Given This Pattern of Assumed Rates of Return, The Insufficient Premium Causes Policy Insolvency and Lapse

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Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)

- What Causes This Policy Insolvency and Lapse?
- The Answer Is In the Very Delicate Relationship Between the Net Amount at Risk and Cash Value
- When Planned Assumed Funding Premiums Are Calculated With an Assumed Constant Rate of Return To Endow at Contract Maturity, Generally At or Near the End of the Mortality Table, As Long As Actual Rates of Return Remain At or Above the Assumed Rate of Return, Assuming No Change in Premiums, Cost of Insurance, Or Expenses, the Policy Will Endow or Mature

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Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)

- However, If the Rate of Return Falls Below the Assumed Constant Rate of Return the Very Delicate Balance Between the Net Amount at Risk and Cash Value Is In Danger, and the Whole Thing Can Go Eschew Causing the Policy to Become Insolvent, Or Lapse, Unless Sufficient Additional Premiums Are Added
- Lower Rates of Return Than the Assumed Constant Rate of Return Causes a Decrease In Cash Value And an Increase In Net Amount at Risk

Risk of Life Insurance Policies – Part 1
Constant Assumption vs. Reality
Mathematics of "Permanent" Types of Insurance (Continued)

- This Results In an Increase In Cost of Insurance (COI) Because COI Is Determined By the Net Amount at Risk Multiplied By Mortality Rates For the Insured's Attained Age In Any Particular Policy Year (Note Mortality Rates Increase Constantly Each Year and Exponentially At Older Ages)
- Cost of Insurance Is Deducted From the Cash Value, Now At an Increased Amount, Further Reducing the Cash Value

Risk of Life Insurance Policies – Part 1

Constant Assumption vs. Reality

Mathematics of "Permanent" Types of Insurance (Continued)

- With Volatile Rates of Return, And No Increase In The Funding Premium, The Result Can Be a "Death Spiral" Causing the Policy To Become Insolvent and Lapse
- The Policy Can Die Long Before the Insured
- The Following Three Graphs Illustrate the Interaction Between Rates of Return, Net Amount at Risk, Cost of Insurance and Mortality Rates

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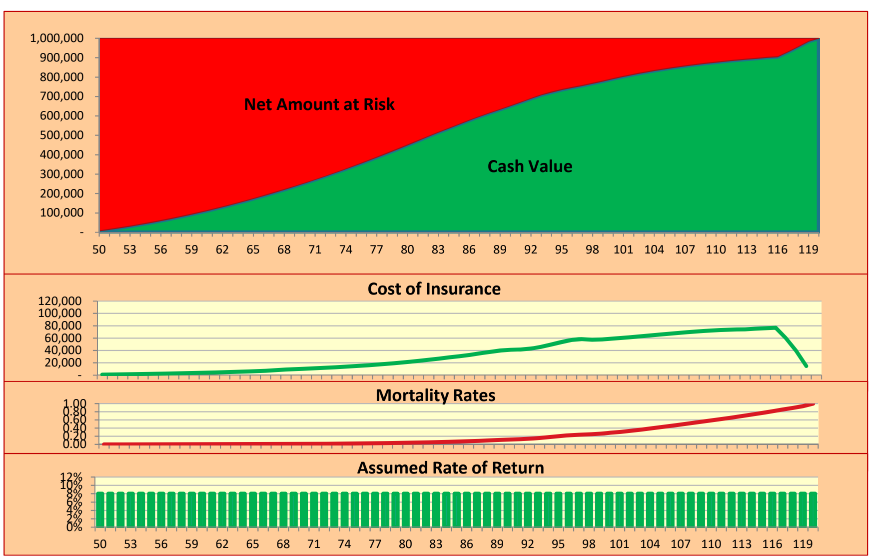
Risk of Life Insurance Policies – Part 1

Effect of Rate of Return on Net Amount at Risk and Cost of Insurance

Variable Universal Life Policy - Constant 8% Rate of Return



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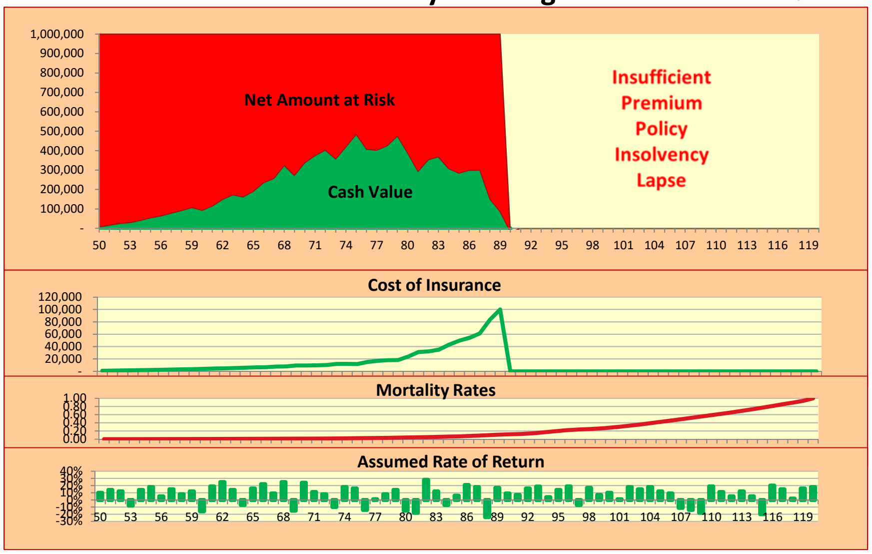
Risk of Life Insurance Policies – Part 1

Effect of Rate of Return on Net Amount at Risk and Cost of Insurance

Variable Universal Life Policy - Average Rate of Return 8%



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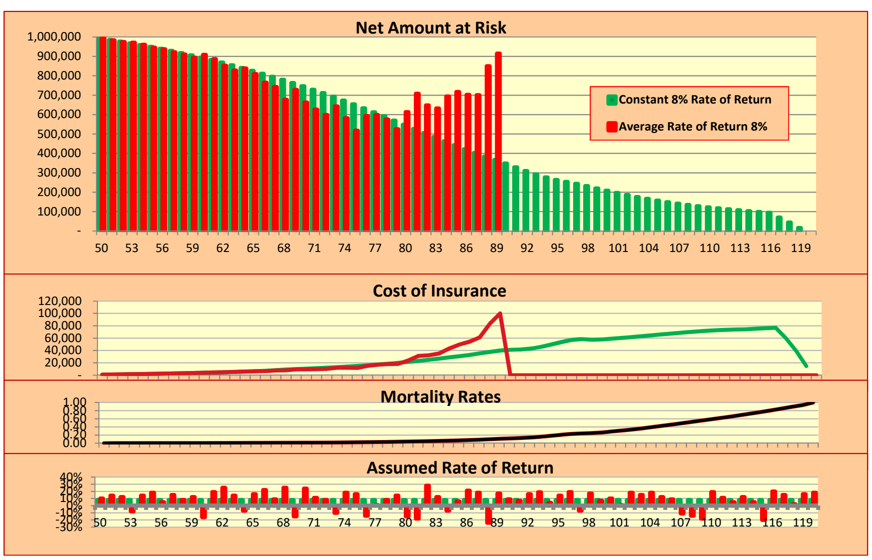
Risk of Life Insurance Policies – Part 1

Effect of Rate of Return on Net Amount at Risk and Cost of Insurance

Variable Universal Life Policy – Constant vs. Average Rate of Return of 8%



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Risk of Life Insurance Policies – Part 1

Effect of Earnings on Net Amount at Risk and Cost of Insurance
Mathematics of "Permanent" Types of Insurance (Continued)

- With the First Graph, Assuming Constant Earnings of 8%, The Policy Matures At Age 120
- Note With Constant 8% Earnings, While Mortality Rates Increase Over the Period Shown, the Net Amount at Risk Deceases
- The Second Graph Illustrates An Average Earnings of Just Short of 9% But With Volatility for Each Year The Policy Is Insolvent and Lapses At Age 90
- While Mortality Rates are the Same as in The First Graph, Note the Cumulative Effect of Volatility in Rates of Return on the Net Amount at Risk and Cost of Insurance

Risk of Life Insurance Policies – Part 1

Effect of Earnings on Net Amount at Risk and Cost of Insurance
Mathematics of "Permanent" Types of Insurance (Continued)

- The Third Graft is a Composite of the Two Proceeding Graphs Dramatically Illustrating the Effect of Constant Rates of Return vs. Average Rates of Return
- Cost of Insurance Is Equal to the Net Amount at Risk Multiplied By the Mortality Rate for Each Year
- Note That While Mortality Rates Remain the Same In Both Graphs, The Application of Those Rates to the Increased Net Amount At Risk In the Second Graph Causes a Substantial Increase In the Cost of Insurance Which Eats Up the Cash Value Causing the Policy to Lapse
- Later In This Presentation We Will Examine How To Address The Volatility Issue And Properly Evaluate Non-Guaranteed Flexible Premium Life Insurance Products, And Derive A Premium That, While Certainly Not Guaranteed, Can Accurately Reflect The Effect of Volatility In Rates of Return, With Statistical Probabilities of Confidence

Risk of Life Insurance Policies - Part 2

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Risk of Life Insurance Policies – Part 2
Carrier Insolvency

- Rating Services
  - A. M. Best
  - Fitch
  - Moody's
  - Standard & Poor's
- Comdex
  - Recommend at least 85, Preferably 90 or Better
- State Guarantee Funds
  - Limited to $300,000 to $500,000 Face Amount Depending Upon State

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Risk of Life Insurance Policies – Part 2
Risk by Product Types

- Risks Vary by Product Types
  - Affected by What's Guaranteed and Not Guaranteed
  - Affected by Non-Guaranteed Policy Performance
    - Earnings or Interest Crediting Rates
    - Cost of Insurance
    - Expenses
    - Lapses
  - Affected by Policy Funding Adequacy
    - Universal Life
    - Variable Universal Life
    - Indexed Universal Life
  - Affected by Dividend Performance on Blended Base Whole Life with Combination of Paid-Up Additions and Decreasing Term Dividend Option and/or Paid-Up Additions Rider
  - What About Purchasing Power Risk?
    - Depends On Policy Type and Funding Adequacy

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Risk of Life Insurance Policies – Part 2
Purchasing Power Risk
Effect of 2.5% Inflation on $1,000,000 Life Insurance Policy

Issue Age Female	Life Expectancy @ Issue Age	Value of $1,000,000 @ Life Expectancy	Needed Now for $1M Purchasing Power @ L.E.
45	90	$329,174	$3,037,903
55	91	$411,094	$2,432,535
65	91	$526,235	$1,900,293
75	92	$657,195	$1,521,618

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Risk of Life Insurance Policies – Part 2
Purchasing Power Risk
Effect of 2.5% Inflation on $1,000,000 Life Insurance Policy

Issue Age Male	Life Expectancy @ Issue Age	Value of $1,000,000 @ Life Expectancy	Needed Now for $1M Purchasing Power @ L.E.
45	88	$345,839	$3,037,903
55	88	$442,703	$2,258,851
65	89	$552,875	$1,808,726
75	91	$673,625	$1,484,506

Risk of Life Insurance Policies – Part 2
Purchasing Power Risk
Effect of 2.5% Inflation on $1,000,000 Life Insurance Policy

Issue Age Joint Female/Male	Life Expectancy @ Issue Age	Value of $1,000,000 @ Life Expectancy	Needed Now for $1M Purchasing Power @ L.E.
45/45	95	$290,942	$3,437,109
55/55	95	$372,431	$2,685,064
65/65	95	$476,743	$2,097,568
75/75	96	$595,386	$1,679,582

Risk of Life Insurance Policies – Part 2
Risks by Product Types – Term Insurance

What's Guaranteed	What's Not Guaranteed - Risks
• Premium for a Period • Death Benefit • Renewability for a Period • Conversion for a Period	• Current Rates at End of Term Period • Insurability at End of Maximum Term of Term Insurance • Purchasing Power of Death Benefit

Risk of Life Insurance Policies – Part 2
Risks by Product Types – Par Whole Life

What's Guaranteed	What's Not Guaranteed - Risks
• Premium • Premium Paying Period • Cash Values (Minimum Guarantee) • Death Benefit • Policy Sustainability • Premium Sufficiency	• Dividends • Purchasing Power Depending on Dividend Amount and Option, Some Purchasing Power Protection can be afforded with Paid-Up Additional Insurance Dividend Option

Risk of Life Insurance Policies – Part 2
Risks by Product Types – Universal Life

What's Guaranteed	What's Not Guaranteed - Risks
• First Year Death Benefit and Minimum Required Amount of Premium • Minimum Interest Crediting Rate • Maximum Cost of Insurance • Maximum Policy Expenses	• Premium Sufficiency • Policy Sustainability • Current Interest Crediting Rates • Current Costs of Insurance • Current Policy Expenses • Purchasing Power – Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

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Risk of Life Insurance Policies – Part 2
Risks by Product Types – Variable Universal Life

What's Guaranteed	What's Not Guaranteed - Risks
• First Year Death Benefit and Minimum Required Amount of Premium • Maximum Cost of Insurance • Maximum Policy Expenses	• Premium Sufficiency • Policy Sustainability • Earnings • Current Costs of Insurance • Current Policy Expenses • Purchasing Power – Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

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Risk of Life Insurance Policies – Part 2

Risks by Product Types – No-Lapse Guarantee Universal Life

What's Guaranteed	What's Not Guaranteed - Risks
• Premium amount if Paid Timely and Other Conditions • Death Benefit Subject to Premium Conditions Above • Policy Sustainability Subject to Premium Conditions Above • Premium Sufficiency Subject to Premium Conditions Above	• Policy Owner Fails to Comply with the Conditions of the Guarantee, Especially Not Making Premium Payments on Time • Carrier Solvency • State Guarantee Fund Coverage – A.G. 38 • Purchasing Power

Risk of Life Insurance Policies – Part 2
Risks by Product Types – Indexed Universal Life

What's Guaranteed	What's Not Guaranteed - Risks

• First Year Death Benefit and Minimum Required Amount of Premium
• Crediting Rate Formula
  – Based on Some Index Such as S&P 500® **Without** Dividend Component, with non-guaranteed Participation Rate and Caps; and Minimum Interest Crediting Rate (Typically 100 Basis Points or More Below UL Min. Rate but can be Zero)
• Maximum Cost of Insurance
• Maximum Policy Expenses
	• Premium Sufficiency
	• Policy Sustainability
	• Adequacy of Earnings
	• Participation Rate
	• Maximum Caps on Increase in Index
	• Current Costs of Insurance
	• Current Policy Expenses
	• Purchasing Power
	  – Depends on Factors Such As Level or Increasing Death Benefit Option, Policy Performance, Funding Adequacy and Section 7702 Corridor

Risk of Life Insurance Policies – Part 2

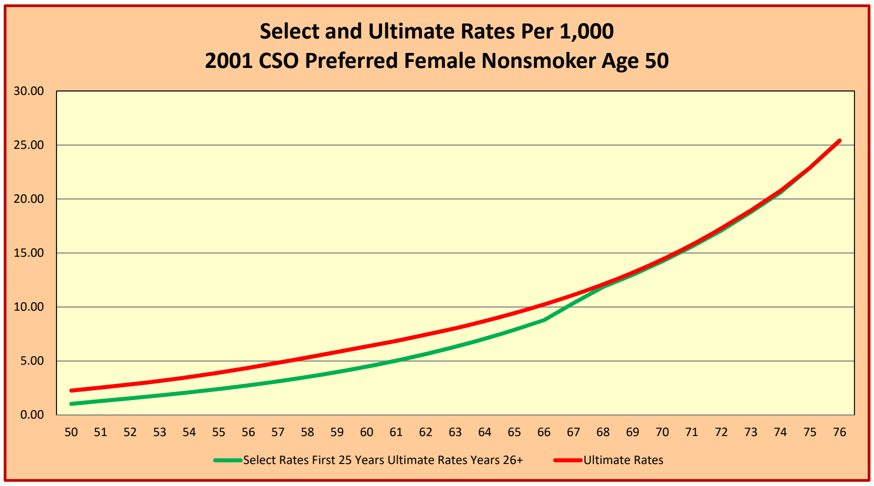
Risks by Product Types – Blended Base Whole Life with Combination Paid-Up Additions and Decreasing Term Dividend Option and/or Paid-Up Additions Rider

What's Guaranteed	What's Not Guaranteed - Risks
• Base Whole Life Premium • Base Whole Life Premium Paying Period • Base Whole Life Cash Values (Minimum Guarantee) • Base Whole Life Death Benefit • Base Whole Life Policy Sustainability • Base Whole Life Premium Sufficiency • Paid-Up Additions Rider – The Right to Purchase on a Continuous Ongoing Basis at a Fixed Dollar Premium Amount, Single Premium Paid-Up Whole Life Insurance at the Insured's Attained Age for Each Policy Year • Paid-Up Additions Rider Face Amount Purchased at Each Year's Attained Age • Paid-Up Additions Rider Cash Values (Minimum Guarantee) • Paid-Up Additions Rider Death Benefit, Policy Sustainability and Sufficiency	• Dividends for Both Base Policy and Paid-Up Additions Rider • Inadequate Dividends Failure to Cover Term Cost Requiring Term Premium Contributions, Which Probably Could Increase in Subsequent Years • Purchasing Power Depends on Dividend Amount , Some Purchasing Power Protection Can be Afforded with the Paid-Up Additional Insurance Dividend Option After Paid-Up Additional Insurance Face Amount Additions Are Equal to the Initial Decreasing Term Face Amount

Risk of Life Insurance Policies – Part 2
Product Suitability

- Need for Life Insurance
  - Increase
  - Decrease
  - No Longer Needed
    - Consider Life Settlement
- Product Type Appropriateness
  - Risk Tolerance
  - Lowest Premiums vs. Growth in Death Benefit and Cash Values
- Premium Paying Capacity
- Policy Replacement
  - Insurability or Change in Insurability
  - Select and Ultimate Mortality Costs vs. New Acquisition Costs Such as Commissions
  - Society of Financial Service Professionals Replacement Questionnaire
  - Life Settlements

Risk of Life Insurance Policies – Part 2
Select and Ultimate Rate Comparison



Risk of Life Insurance Policies – Part 2
Diversification

- Life Insurance is a Concentrated Asset
- Life Insurance Diversification
  - By Multiple Policy Carriers, and
  - Multiple Policy Types Based on "Asset Allocation" by
    - Risk Tolerance
    - Preference for Lowest Premiums vs. Growth in Death Benefit and Cash Values
  - Trade Off Between Benefits of Diversification vs. Lower Cost Based on Premium Banding and Multiple Policy Fees
  - Depends on Total Face Amount of Life Insurance

Managing and Evaluating Life Insurance

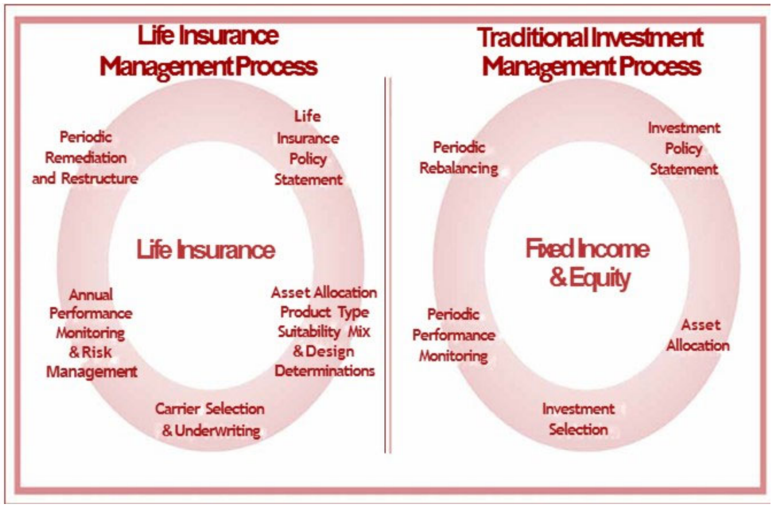
Life Insurance Has to be Risk Managed

Life Insurance Has to be Risk Managed
But Who Does the Managing for TOLI Policies?

- The Trustee?
  – Professional Trustee
  – Amateur Trustee, i.e. The Brother-in-Law Trustee
- The Grantor?
- The Life Insurance Professional?
- The Beneficiaries?
- What About Delegation and to Whom?

Process of Managing Life Insurance Policies

Process of Managing Life Insurance Policies
Life Insurance and Traditional Investment Management Process



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Process of Managing Life Insurance Policies
TOLI Investment Policy Statement (TIPS)

- Formalizes the Trust's Objectives and Grantor's Expectations
- Identifies the ILIT Parties and Sets Out the Duties of Each Party
- Specifies Risk Tolerance Pursuant to Trust Objectives
- Provides for the Delegation of Life Insurance Expertise and Policy Evaluation Duties
- Summarizes the Risk Management Criteria to be Annually Evaluated and the Procedure to Monitor and/or Restructure Under-Performing or Unsuitable Policies
- Confirms the Annual Beneficiary Reporting, Accounting and Communication Schedule Functions

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Process of Managing Life Insurance Policies

TOLI Administration and Risk Management Duties May Be Delegated

- If ILIT Trustee Lacks Life Insurance Expertise and Policy Evaluation Ability, and/or Administration Capacity These Functions May and Should Be Delegated to Independent Qualified Parties
- Delegation Must Follow a Prudent Process Which Should Include Requests for Proposals (RFP) and the Procedures and Process Should Be Written in the TOLI Investment Policy Statement (TIPS)

Spectrum of TOLI Delegation	
❖Investment Policy Statement Review ❖Carrier/Product Suitability Analysis ❖Fact-Based Policy Risk Assessment ❖Life Expectancy and Duration Analysis ❖Policy Underwriting Oversight ❖Policy Acceptance Oversight ❖Portfolio "Watch List" Procedures ❖Policy Remediation Consulting ❖Policy "Rescue" Option Analysis ❖Requests for Proposal Oversight ❖Professional Adviser Communications	❖ILIT Client Administration ❖Policy Performance Evaluation ❖Portfolio Risk Management Reporting ❖Policy Performance Management Reports ❖Actuarial-Certified Policy Evaluation o Premium Adequacy o Lapse Evaluation o Policy Cost Evaluation ❖Monte Carlo Simulation Analysis ❖Remediation Option Evaluation ❖Grantor/Beneficiary Communications

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Process of Managing Life Insurance Policies

Best vs. Predatory Practices

For Professional and Amateur Trustees

- Process the Same for Both Amateur and Professional Trustees.
- Amateurs Can Use Best Practices of Professional Trustees.
- Best Practices - Policy acceptance, management, and restructure decisions based upon the ILIT Agreement, TOLI Investment Policy Statement and TOLI-specific expertise.
- Predatory Practices - The conscious and willful inattention to, avoidance of and disregard for the ILIT Agreement, known ILIT trustee duties and known life insurance guidance. (Ignorance and lack of awareness are not defensible excuses.)

Spectrum of TOLI Risk Management Options			
	Predatory	Questionable	Best
Trustee	No Duties	Limited Duties	Active Oversight
IPS	No	No	Yes
Life Insurance Expertise	Unknown	Grantor Friend	Delegation per IPS
Policy Monitoring	No	Illustrations	Dispute Defensible per IPS
Annual Communication	No	Periodic	Yes per IPS
Restructure Evaluation	Unknown	Unknown	Yes per IPS

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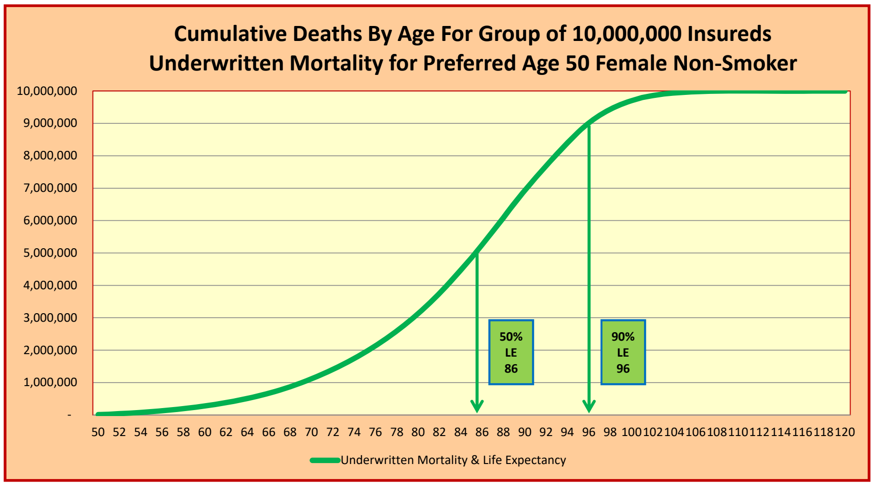
Process of Managing Life Insurance Policies

Duration Analysis Planning

Underwritten Mortality & Life Expectancy Percentiles



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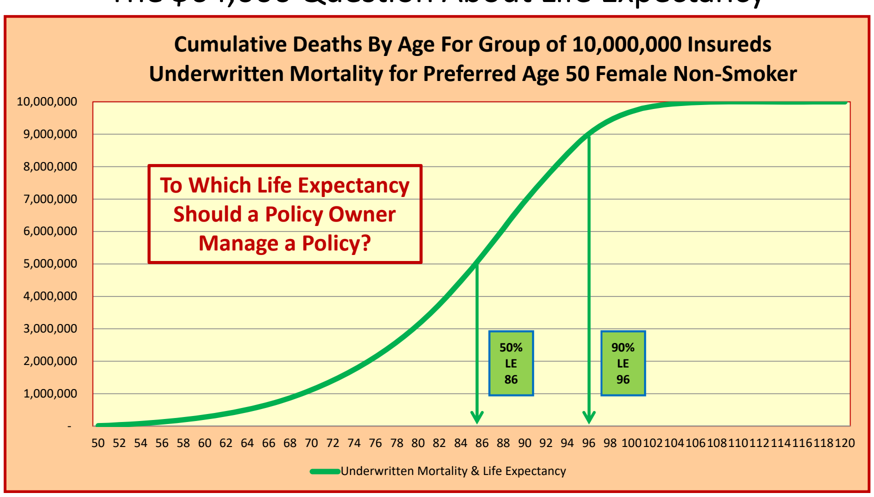
Process of Managing Life Insurance Policies

Duration Analysis Planning

The $64,000 Question About Life Expectancy



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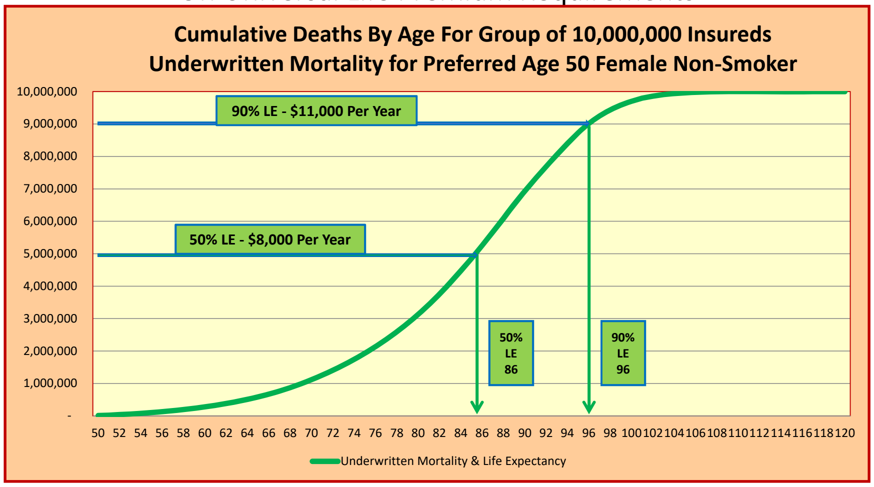
Process of Managing Life Insurance Policies

Duration Analysis Planning

Effect of Life Expectancy Objective On Universal Life Premium Requirements



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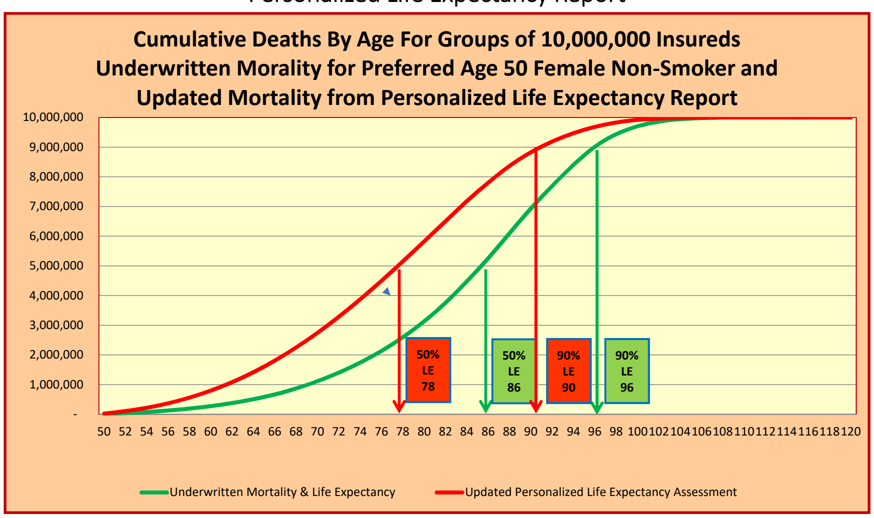
Process of Managing Life Insurance Policies

Duration Analysis Planning

Shifting Mortality and Life Expectancy From Updated Personalized Life Expectancy Report



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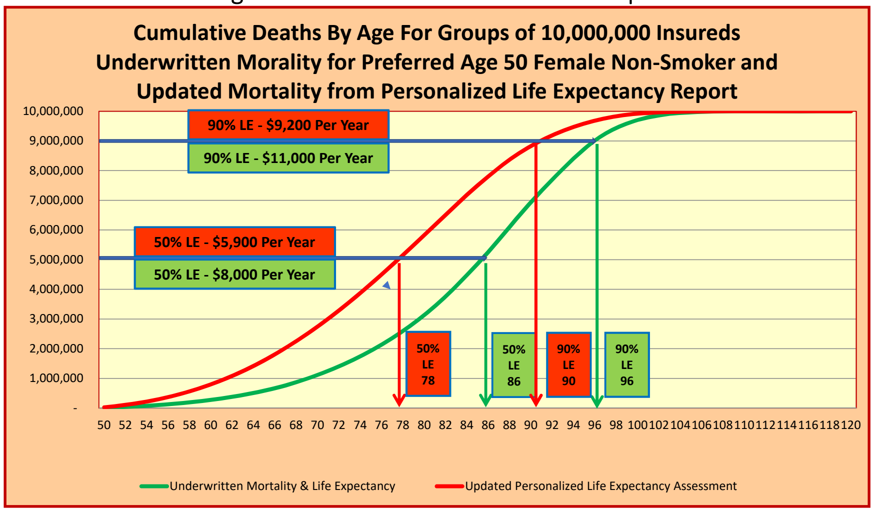
Process of Managing Life Insurance Policies

Duration Analysis Planning

Effect of Updated Personalized Life Expectancy Report
On Management of Universal Life Premium Requirements



Creditable Evaluation of Life Insurance

Creditable Evaluation of Life Insurance

- Policy Illustration Comparisons: 1992 Society of Actuaries Task Force on Policy Illustrations Report
  - "…[when] illustrations are used to show the client how the policy works; [it is] a valid purpose of policy illustrations. Illustrations 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 a policy illustration."
  - "…How credible are any non-guaranteed numbers projected twenty years in the future, even if constructed with integrity? How does the consumer evaluate the credibility of two illustrations if they are from different companies? Or even if they are from the same company if different products with different guarantees are being considered? *Most illustration problems arise because the illustrations create the illusion that the insurance company knows what will happen in the future and that this knowledge has been used to create the illustration." (Emphasis added.)*

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Creditable Evaluation of Life Insurance

- **FINRA Rule 2210 - IM-2210-2. Communications with the Public About Variable Life Insurance:**
  - IM 2210-2 (b)(5)(A)(i) "Hypothetical illustrations using assumed rates of return may be used to demonstrate the way a variable life insurance policy operates. The illustrations show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. **These illustrations <u>may not</u> be used to project or predict investment results as such forecasts are strictly prohibited by the Rules**. …."
  - IM 2210-2 (b)(5)(C)"… it is inappropriate to compare a variable life insurance policy with another product based on hypothetical performance as this type of presentation goes beyond the singular purpose of illustrating how the performance of the underlying investment accounts could affect the policy cash value and death benefit….."

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Creditable Evaluation of Life Insurance

- Would a loan officer accept an unaudited financial statement from the bookkeeper of a company being considered as a loan candidate? Would the loan officers not want a financial statement audited and certified by a CPA? Than why would a trust officer not want an evaluation of a life insurance policy that is not certified by an actuary using actuarially-based principles?

Creditable Evaluation of Life Insurance

What is Not an Acceptable Evaluation Method?

- Using Policy Illustrations to Project and/or Predict Non-Guaranteed Policy Vales
- Using Policy Illustrations to Compare One Policy to Another (Even of the Same Type of Policy)
- Policy Audit Reports (They are all Based on Comparing Policy Illustrations)
- Premium Optimization Reports (Again, Based on Comparing Policy Illustrations
- Any System that Uses Non-Guaranteed Constant Earnings or Interest Crediting Rates to Predict Values or Compare Policies
- All of the Above are not "Dispute Defensible"

Creditable Evaluation of Life Insurance

What is Required for Acceptable Evaluation of Non-Guaranteed Life Insurance Products?

- Evaluation Must Be Unbiased, Credible, Impartial and Fact-Based
- Uses Objective Data
- Uses Actuarial Evaluation Using Generally Accepted Actuarial Methods (Note Parallel to Generally Accepted Accounting Principles)
- Use of Quantitative, Measurable Benchmark Comparisons and Policy Standards
- Is This Possible With Non-Guaranteed Life Insurance?

Creditable Evaluation of Life Insurance

What is Acceptable Evaluation of Non-Guaranteed Life Insurance Products?

- Actuarially Certified Policy Standards and Benchmarking Model to Access Cost of Insurance and Policy Expenses
- Accounting for Volatility in Earnings, Crediting Rates and Interest
- Applying Monte Carlo Methodology and Stochastic Analysis Techniques
  – Used In Trust Investment Portfolio Analysis For Many Years
  – Applied to Cash Value Reserve Accounts (General Asset Account, Separate Sub Accounts, or Point to Point Indexes) Backing Up Cash Value of Non-Guaranteed Policy, Which Are Like Portfolios
  – Assesses Probability of Successful Outcome As Defined by Policy Owner/Trustee

Creditable Evaluation of Life Insurance

What is Acceptable Evaluation of Non-Guaranteed Life Insurance Products? (Continued)

- Actuarially Certified Evaluation Includes
  - Accessing the Probability that Carrier's Illustrated Scheduled Premiums Are Adequate to Successfully Sustain the Policy to Contract Maturity, Or At the Very Least, to the Insured's Life Expectancy
  - Evaluation of the Most Likely Five Year Range of Policy Lapse Given Current Scheduled Premiums, As Well As Earliest Possible Lapse
  - Evaluation of the Competitiveness of Policy Pricing of Cost of Insurance and Policy Expenses Relative to the Benchmark Policy Standards
  - Correcting Premium to Sustain Policy to Desired Age Or Contract Maturity Given Policy Owner/Trustee's Risk Tolerance
- Proper Policy Monitoring Requires Annual Actuarial Certified Evaluation
- Is Available, Affordable, And, Is "Dispute Defensible"

Creditable Evaluation of Life Insurance

Example of Actuarial Evaluation of In-Force Policy

Insured Information	
Name:	Ms. Toli Ilit
Current Age:	62
Gender:	Female
Risk Classification:	Preferred Non-Smoker
Life Expectancy (Calculated):	91

Creditable Evaluation of Life Insurance

Example of Actuarial Evaluation of In-Force Policy (Continued)

In-Force Policy Information	
Carrier:	GLF Insurance Company
Year of Policy Issue	2007
Issue Age:	50
Face Amount:	$1,000,000
Policy Type:	Variable Universal Life
Asset Allocations (Equity/Bond):	80%/20%
In-Force Policy Account/Cash Value:	$114,280 (Originally Projected $118,465)

Creditable Evaluation of Life Insurance

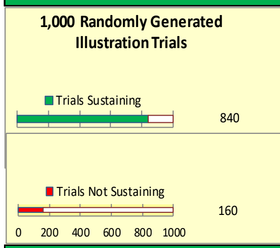
Example of Actuarial Evaluation of In-Force Policy (Continued)

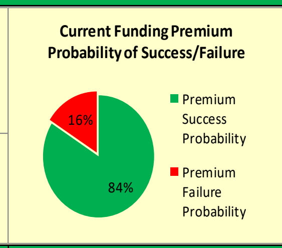
In-Force Policy Illustration Data & Risk Tolerance	
Current Annual Funding Premium:	$7,888
Premium Paying Years:	58
Illustration Interest/Crediting Rate:	8.00%
Ilustrated Lapse Age:	97
Premium Adequacy To Sustain Policy Risk Tolerance (Confidence Level):	90%

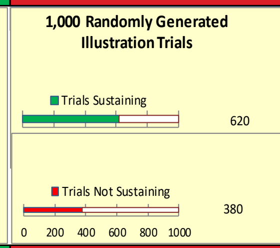
Creditable Evaluation of Life Insurance

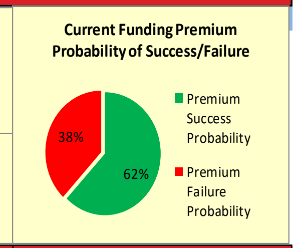
Example of Actuarial Evaluation of In-Force Policy (Continued)
Probability of Current Funding Premium Sustaining Policy To:

Life Expectancy		Age 100	









Current Funding Premium:	$7,888	Correcting Funding Premium @ 90% Confidence Level:	$9,089	Current Funding Premium:	$7,888	Correcting Funding Premium @ 90% Confidence Level:	$13,008
Life Expectancy Age:	91			Life Expectancy Age:	91		
Earliest Lapse:	82	Correcting Funding Premium Increase/(Decrease) Over Current Funding Premium:	15%	Earliest Lapse:	82	Correcting Funding Premium Increase/(Decrease) Over Current Funding Premium:	65%
Highest 5 Year Period of Concentrated Lapses:	89-93			Highest 5 Year Period of Concentrated Lapses:	88-92		
Calculated Average Return:	9.32%	Pricing Deviation Actuarial Policy Standards Database Relative to Illustrated Policy	-4%	Calculated Average Return:	9.34%	Pricing Deviation Actuarial Policy Standards Database Relative to Illustrated Policy	-4%

Creditable Evaluation of Life Insurance

Credit For Software Creation and Development

- The Actuarially Certified Benchmarking and Policy Standards Software, Which Applies Statistical Stochastic Analysis (Monte Carlo Simulation) to Universal Life Polices (Including Variable and Equity Index), Was Invented and Developed By Richard M. Weber, MBA, CLU®, AEP® (Distinguished) and Christopher Hause, FSA, MAAA, CLU® of Ethical Edge Consulting, LLC and Hause Actuarial Solutions, LLC

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Creditable Evaluation of Life Insurance

"Dispute Defensible" Policy Evaluation Summary

- Illustrations for non-guaranteed products disclaim predictive value and, at best, offer a static picture of policy performance whereas actual future values depend on continually changing future conditions. ILIT fiduciaries that rely upon illustration-based analysis and related 'subjective' risk assessments paper their file with documents that demonstrate imprudence.
- Fact-based evaluation using generally accepted actuarial methods, impartial analysis, and objective data to assess the probability that an illustration's scheduled premiums will successfully sustain the policy to contract maturity or insured life expectancy, as a minimum.
- A benchmark model tests the reasonableness of an illustration's projected values given (1) interest rate conditions prevalent on the test date, and (2) lapse, mortality and expense assumptions approximating industry norms and appropriate for the policy type.
- The goal is to help determine the relative credibility of an illustration as opposed to predicting the actual performance of a specific policy.

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Creditable Evaluation of Life Insurance

Results of Actuarially Certified Benchmark Policy Standards Evaluation Utilizing Monte Carlo Simulation for Non-Guaranteed Life Insurance

- Provides Unbiased, Credible, Impartial and Fact-Based Analysis
- Provides Quantitative, Measureable Actuarially Certified Benchmark and Policy Standards for Comparisons for Cost of Insurance and Policy Expenses
- Most Importantly, Monte Carlo Simulation Accounts for Volatility in Earnings for Sub Accounts, Crediting Rates and Interest
- Accesses Probability of Carrier Illustrated Scheduled Premiums Adequacy to Sustain Policy to Chosen Duration Based On Risk Tolerance of Policy Owner.
- Is Available, Affordable, and, is "Dispute Defensible"

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The Uniform Prudent Investor Act and Trust-Owned Life Insurance Summary

- **Review of UPIA, UTC, Exculpation Statues Applicability to TOLI Plus Court Cases Involving UPIA and TOLI**
  - The Provisions of UPIA Fully Apply to TOLI Unless the Trust Instrument Alters, Restricts or Eliminated Any or All Provisions of UPIA
  - With States that Have Adopted the UTC Certain Fiduciary Duties Cannot Be Eliminated or Modified By the Trust Instrument
  - With Regulated Trustees State Statutes Exculpatating Trustees of ILITs, and Presumably Similar Exculpatory Trust Instrument Provisions, Do Not Apply
  - The Cochran vs. KeyBank Case Teaches Us the Importance of Having a Documented Process and Delegation to An Independent Party

The Uniform Prudent Investor Act and Trust-Owned Life Insurance Summary (Continued)

- **Risks of Life Insurance Policies**
  - Despite Being a Risk Transfer Device, Life Insurance, Like All Financial Products, Has Risks
  - Life Insurance Pricing Elements Are Integrated and Must Be Viewed As A Whole and Not Separately
  - For Non-Guaranteed Elements of Life Insurance Policies, We Cannot Reply Upon Constant Assumption Policy Illustrations In Predicting Results or To Compare One Policy to Another
  - Risk Varies By Product Type
  - In Addition to Risk By Product Type, There is Also Carrier Insolvency Risk, Purchasing Power Risk, Product Suitability Risk and Diversification Risk

The Uniform Prudent Investor Act and Trust-Owned Life Insurance Summary (Continued)

- **Managing and Evaluating Life Insurance**
  - Life Insurance Has to be Risk Managed
  - The Process of Managing Life Insurance Policies Is Analogous To the Investment Portfolio Management Process
  - Like An Investment Policy Statement (IPS) for Investment Portfolios, UPIA Requires A Similar Written Plan for TOLI Sometimes Called a Life Insurance Policy Management Statement or TOLI IPS (TIPS)
  - The Creditable Evaluation of Life Insurance Requires Actuarial Evaluation Utilizing Actuarially Certified Policy Benchmark Standards and May Utilized Monte Carlo Simulation
  - The Process of Managing TOLI and Creditably Evaluating TOLI Polices May Be – And Should Be If ILIT Trustee Lacks Life Insurance Expertise – Delegated To A Qualified Independent Life Insurance Consultant

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Questions???

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Thank You for Your Attention!

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APPENDIX E*

EXCERPT FROM THE OFFICE OF THE COMPTROLLER'S HANDBOOK

Bank fiduciaries are responsible for protecting and managing the life insurance policy for the benefit of the beneficiaries for the life of the grantor. A bank fiduciary must understand each life insurance policy that the trust accepts or purchases, or the bank fiduciary must employ an advisor who is qualified, independent, objective, and not affiliated with an insurance company to prudently manage these assets. In addition, the bank fiduciary must periodically review the financial condition and rating of the insurance company. The majority of these policies are deposited into the trust by the grantor. Many states have recently passed legislation to limit the liability of bank fiduciaries, in certain situations, by rescinding requirements under state law to perform due diligence on insurance companies as a directed bank fiduciary. The OCC, however, continues to require bank fiduciaries to follow 12 CFR 9.6(c) and 12 CFR 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion. This review should evaluate the financial health of the issuing insurance company as well as whether the policy is performing as illustrated or whether replacement should be considered.

Bank fiduciaries need to have well-developed risk management practices to evaluate and administer accounts with insurance policy holdings. A bank fiduciary with discretion over the account must complete formal pre-acceptance, initial post-acceptance and annual reviews of the insurance policy. Independent of these reviews, a fiduciary bank must have risk management systems and reviews that address the following.

- Sufficiency of premiums: The bank fiduciary must determine whether current premiums are sufficient to maintain the policy to maturity or to meet the insured's life expectancy.

- Suitability of the insurance policy: Consider replacing an insurance policy if the bank fiduciary identifies concerns with the condition of the insurance provider or if that provider does not meet the needs of the grantor or beneficiaries. Also assess any tax changes that could affect the suitability of the policy.

* Emphasis added.

- Carrier selection: The bank fiduciary needs to evaluate the carrier's financial condition. To the extent insurance carrier ratings are available, they generally lag corporate and market events, and should be used principally as indicators of a firm's creditworthiness.

- Appropriateness of investment strategy: The bank fiduciary must evaluate the appropriateness of investments of any segregated account to support the cash value.

For policies with flexible premiums and nonguaranteed benefits, the trustee should obtain the original policy illustration, which shows planned premium strategies. This policy illustration is subject to a high degree of fluctuation. Periodically, the trustee should obtain an in-force illustration. This provides a measure of performance of a life insurance policy against what was initially illustrated. By obtaining an in-force illustration, the trustee can monitor the effectiveness of the policy to date and project how the policy may perform in the future and plan for any potential shortfall in premiums. This process assists the trustee in monitoring the economics of the policy.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2428

Date: 21-Jun-16
From: Steve Leimberg's Estate Planning Newsletter
Subject: Gary Flotron & Randy Whitelaw: A Comprehensive Perspective on Four UPIA-TOLI Cases, Plus One That Includes the UTC, and Their Astounding Implications for ILIT Trustees, Part 1 of 2

May marked the eighth anniversary of the trial court decision while March marked the seventh anniversary of the appellate court decision of the first case dealing with the Uniform Prudent Investor Act (UPIA) and trust-owned life insurance (TOLI) – namely the Cochran v. KeyBank, N.A., which is more formally known as In re Stuart Cochran Irrevocable Trust. Since that time we have had three more cases involving UPIA and TOLI, with one of those cases also incorporating the Uniform Trust Code (UTC) – namely Paradee v. Paradee, French v. Wachovia Bank, and Rafert v. Meyer. Each of these cases has provided guidance to trustees – both professional and amateur – and astonishing implications as to what constitutes prudent trustee behavior. Of course, there will, undoubtedly, be more cases in the future which will provide us with further refinements in the drafting, duties of trustees, administration and operation of ILITs and TOLI.

Now, **Gary Flotron** and **Randy Whitelaw** present a comprehensive review of these four cases and interpret the lessons learned from each case and their consequences as to prudent behavior to be adopted by trustees. Part 1 will describe and analyze in detail the Cochran v. KeyBank case in which co-author **Randy Whitelaw** was the lead expert witness for the plaintiffs. Part 2 will describe and analyze the subsequent three UPIA-TOLI cases, including in detail the last case of Rafert v. Meyer which also applies the UTC in addition to UPIA to TOLI.

Gary L. Flotron, MBA, CLU®, ChFC®, AEP® is the **Associate Director** for **Financial Planning Programs** and an **Adjunct Faculty** member at the **College of Business Administration of the University of Missouri – St. Louis**, where he teaches courses in estate and trust planning, employee benefits, and life insurance. Mr. Flotron was the 2014-2015 recipient of the Chancellor's Award for Excellence to a Part-Time Faculty Member, a

University wide award given annually to one awardee for outstanding teaching, service and contributions to areas of specialization. He is also the consulting principal of G. L. Flotron & Associates and specializes in the areas of trust-owned life insurance, estate and business planning, and executive and employee benefit plans. Gary is a Past President of the National Association of Estate Planners & Councils, Chair Emeritus of the Synergy Summit, and a Past Member of the National Board of Directors of the Society of Financial Service Professionals (FSP), where he also serves as editor of the FSP Estate Planning publication.

E. Randolph "Randy" Whitelaw, AEP® (Distinguished) is the **Managing Director of Trust Asset Consultants, LLC (TAC)**, a fee-based life insurance counseling firm, and **Co-Managing Director** of **The TOLI Center, LLC (TTC)**, a fee-based life insurance policy administration and risk management firm. TAC provides counseling and expert witness litigation support to individual and business policy owners, professional advisers, affluent family groups, and trustees, skilled and unskilled, of irrevocable life insurance trusts seeking both life insurance and fiduciary practices counseling. TTC provides policy owners, fiduciaries, professional advisors, affluent families and businesses with a service-based life insurance plan administration and policy risk management platform. He lectures nationwide on life insurance planning, suitability and dispute defensible risk management, and regularly authors in-depth peer-reviewed articles on the same topics. He is also the co-author with Henry Montag of the soon to be published book by the American Bar Association titled **The Life Insurance Policy Crisis - The Advisors and Trustees Guide to Managing Risk and Avoiding a Client Crisis**. Mr. Whitelaw was the lead expert witness for the plaintiffs in the Cochran discussed in this article. In 2013, he was inducted into the NAEPC Estate Planning Hall of Fame® and awarded the Accredited Estate Planner® (Distinguished) designation.

Now, here is Part 1 or their commentary:

EXECUTIVE SUMMARY:

David Burdette published an article in the **American Bankers Association**

Trusts & Investments magazine in 2002 titled "Pay Attention to TOLI."[1] While the admonition in Mr. Burdette's article was primarily addressed to corporate trustees, the warning is just as appropriate to the approximately over 90% of trustees who are the amateur trustee that have been solicited – and some even drafted - by the trust creators and grantors to serve as an accommodation and favor to the trust settlors of their newly created irrevocable life insurance trusts (ILITs). Very few of these trustees have been instructed or trained in the duties of a trustee, let alone have any expertise in the life insurance policies that they now have a duty to manage and monitor whether they realize it or not.

Since Mr. Burdette's article, there are now four cases that have gone to trial – and there are reportedly numerous cases that have been settled out of court before going to trial – where the beneficiaries of the ILITs have sued the trustee for breach of fiduciary duties as trustees. All of these cases involve the application of the Uniform Prudent Investor Act (UPIA) – and one also involves the application of the Uniform Trust Code (UTC) – to trust-owned life insurance (TOLI). Two of these cases involved skilled corporate trustees, one involved of what appears to be a series of unskilled accommodation trustees, and, the last and most recent case, involved the attorney who drafted the ILIT serving as trustee. In the two cases involving the corporate trustees the court found for those corporate trustees. In the other two cases the court found for the beneficiary plaintiffs.

All four of the cases have lessons and practical guidance for both the professional, corporate trustee and the amateur, accommodation trustee. This newsletter will do a comprehensive review and analysis of each of the four cases as to the case facts, issues, court opinions, analysis and decisions, and what are the implications and lessons that can be gleamed from the cases for the trustee, both professional and amateur. Of course, while each of these cases give us some guidance, there still remain questions that need to be answered. Additionally, there is no guarantee that future courts may not come to different conclusions - particularly with respect to the Cochran v. KeyBank case, which was the first case concerning UPIA and TOLI, with which we will begin this discussion.

Cochran v. KeyBank[2] - The First of the Four UPIA-TOLI Cases

The very first and, indeed, watershed court case applying the Uniform Prudent Investor Act (UPIA) to trust-owned life insurance (TOLI) was the Indiana case of Cochran v. KeyBank. In this case, KeyBank was the successor trustee that approved the recommendation made by Cochran's insurance advisor[3] to replace two variable universal life policies providing $8 million of death benefit - that hypothetical inforce policy illustrations projected to lapse long before the insured's life expectancy – with a guaranteed universal life insurance policy providing $2,536,000 of death benefit after underwriting considerations.

In the evaluation process for this transaction, KeyBank employed an independent insurance consultant who was not licensed to sell variable insurance products[4] and had limited inforce VUL policy risk management evaluation capabilities. This limited scope fact was disclosed in the reports that eventually advocated the proposed replacement.

Cochran died unexpectedly of a heart attack at the age of 53, shortly after the replacement. Cochran's two daughters, the beneficiaries of the ILIT, sued KeyBank for breach of fiduciary duties. From the point of view of choosing the appropriate and applicable portions of Indiana law – namely the precedent Indiana court cases and the Indiana version of UPIA – the trial and appellate courts properly affirmed the importance of delegation to an outside independent, third-party entity, having a documented process, adherence to the intentions of the trust grantor, trustee discretion, and, beneficiary communications. On the other hand, from the point of view of determining the facts relative to the properly chosen applicable law the Cochran trial court[5] determined a questionably low[6] set of standards for prudence and for compliance with the chosen applicable laws.

The court ignored the limited scope policy evaluation report[7] and its questionable process, and stated the issue in the case as: "Was it prudent for the trustee to move trust assets from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit?" Noting that "the process was certainly less than perfect," especially considering the available policy evaluation analytics for variable universal life policies and market outlook available from Key Bank's Chief Investment Officer, there was a documented process. Both the trial court and the appeals court found in favor of KeyBank based on their reliance on guidance from "an outside, independent entity with no policy to sell or any other financial stake in the outcome."

FACTS:

On December 28, 1987, Stuart Cochran created an irrevocable life insurance trust (ILIT) naming his two daughters, Chanell and Micaela, who were two and four years old at that time, respectively, as beneficiaries of the trust. A parallel trust was also created at that time by Mr. Cochran's wife, Mary Kay Cochran, who in 1989 filed for divorce and was awarded full custody of the children, and is now known as Mary Kay Vance. The trust was funded with life insurance policies and insurance advisor Art Roberson assisted in the transaction. Elkhart National Bank was named as the initial trustee of the trust and, subsequently, Pinnacle Bank was named as successor trustee and served as the trustee until 1999.

On December 11, 1998, Steven Krieger, Senior Vice President of Pinnacle Bank, advised Cochran that Pinnacle Bank was no longer willing to serve as trustee due to Cochran's insistence on having third parties involved in the trustee's decision making process. Mr. Krieger specifically noted the continued involvement of Cochran, his sister and insurance advisor Art Roberson. Krieger subsequently called Vance on January 22, 1999 to inform her of the intended immediate resignation of Pinnacle Bank as trustee and advised her that pursuant to the provisions of the trust that in the event of the resignation of a trustee, Vance had the power to appoint a successor trustee.

Immediately prior to January 1999, Roberson initiated his own review of the existing policies in the trust and in January 1999 Roberson contacted Vance by telephone and suggested that Vance authorize the replacement of the three life insurance policies and one annuity then held in the trust with two new life insurance policies: a Manulife Variable Universal Life Policy and an American General Variable Universal Life Policy. As a consequence of her discussion with Roberson, Vance retained an attorney, Kenneth Sheetz, to represent her in dealing with the issues surrounding the selection of a successor trustee and trust investment strategies. Vance's parallel trust at this time was being administered by KeyBank, N.A. and Vance and Sheetz met with Mike Nicolini, a representative of KeyBank, to discuss moving the successor trusteeship for Stuart Cochran's trust to KeyBank.

The trial court's "Findings of Fact, Conclusions of Law and Order" addressed in great detail the issue of the exact arrangements and nature of the trustee agreement entered into by KeyBank and the duties KeyBank had assumed as trustee. However, the appellate court never addressed or even mentioned these issues. One can only conclude that both the appellant-petitioners and appellee-respondent were satisfied with the trial court's findings and decision on these matters, or, at least, did not question the trial court's decision on these particular issues. Essentially the second paragraph of the "Acceptance of Trust" document given to Vance and her attorney Sheetz by Nicolini - along with the "Resignation of Successor Trustee" and "Appointment of Successor Trustee" documents, all of which were approved by Sheetz with two minor corrections – limited substantially KeyBank's duties with respect to the management, periodic reviews and monitoring of performance of the life insurance policies. This paragraph stated:

> The Trustee shall not be required to perform any periodic reviews with respect to the policy or policies held in trust. No review of the insurance carrier, the performance of the policy or policies, their appropriateness or amount, or any other aspect of them, shall be required. The Trustee's only duties with respect to the insurance shall be to hold the policy(ies) and pay the premiums (if any). It is recognized that this limits the duties of the Trustee and it is acknowledged that the Trustee has discounted it [sic] fees to reflect these limited duties.

However, the trust agreement itself conferred broad powers and responsibilities with respect to investments and management of assets. "In the administration of the trusts, the Trustee shall have the following powers and discretion, in addition to those now or hereafter conferred upon trustees generally," and including "all of the rights of the owner of such [life insurance] policies . . . and generally including all of the incidents of ownership of such [life insurance] policies." The court noted "[a]ny document which purports to modify or limit the duties of the trustee in any substantive way would, of necessity constitute a modification of the trust. The Beneficiaries assert that the Acceptance of Trust document signed by KeyBank was such a document, and that KeyBank was attempting to modify its duties without modifying the terms of the trust document." The Cochran Trust was an irrevocable trust which could not be modified without court approval and KeyBank did not apply for court approval to modify or amend its duties under the trust. Nor did KeyBank apply for court approval to accept only a portion of the duties to the trust.

Furthermore, the trust agreement provided that no person other than the trustee shall have or exercise the power to control the investments of the trust either by directing investments or vetoing proposed investments, or to require or exchange any property of the trusts by substituting other property of equivalent value. The trial court specifically referred to the common usage in the banking industry of the terms "directed account" and "full responsibility account" and noted the testimony of one KeyBank senior vice president that the determination as to whether a trust is a full responsibility account or a directed account is determined by looking at the trust agreement. This KeyBank senior vice president along with one other KeyBank official testified that the Cochran Trust was coded in KeyBank's computer database as a full responsibility account.

The court found that Vance made the decision to select KeyBank as the successor trustee, and that Cochran did not have any involvement or input in Vance's decision, and that on February 3, 1999, KeyBank was appointed as successor trustee by Vance. On that same date, KeyBank accepted appointment as successor trustee and on February 4, 1999, Pinnacle Bank resigned as successor trustee.

At the time KeyBank assumed the duties of successor trustee the trust's assets consisted of three life insurance policies and one annuity with a collective net death benefit of $4,735,539. As already noted, Roberson had recommended an exchange of policies replacing the four existing policies with the two variable universal life (VUL) policies with a new total death benefit of $8 million. The trial court noted that "[a]ccording to insurance experts, unlike a whole life policy, a VUL policy requires a more active management and monitoring." When KeyBank assumed its duties, the underwriting for the exchange of policies had been approved and Stuart Cochran had already submitted to the physical exams. In February and March of 1999 KeyBank approved the transaction and the exchange of policies was executed.[8]

Neither the trial court nor the appellate court described or discussed the asset allocations for the separate mutual fund-like accounts for the VUL policies. We, therefore, do not know what percentage of the VUL cash value accounts were invested in equities as opposed to fixed income like accounts. However, it was noted that following the terrorist attacks on New York and Washington on September 11, 2001 the stock market took a dramatic decline and that that decline had an adverse effect on the value "of the mutual fund investments contained in the VUL policies held by the Trust." In fact, in 2001 the policies lost money, which meant that the cost of insurance and the carrier's administrative charges were greater than the income generated by the investments, and, in 2002, the losses were even greater. It was reported that for the American General VUL policy that "[t]he net investment loss for the period 1/1/2001 to 3/31/2001 was $12,189.39," and, for the ManuLife VUL policy "[t]he net investment loss for the policy year ending on January 4, 2003 was $36,672.43." Why the court opinions only mentioned the losses for these specific time periods, which were inconsistent and different for each of the two policies, is unknown.

In the spring of 2003, KeyBank retained Oswald & Company (Oswald), an independent outside insurance consultant, to audit the existing VUL policies with American General and Manulife, which were held by the trust. At that time Stuart was 52 years of age and the VUL policies had a combined death benefit of $8,007,709.

Oswald's review of the American General VUL policy found in pertinent part that "[w]e feel the financial strength ratings for the carrier are excellent. . . . Based on a hypothetical gross interest rate of 8% and current cost of insurance, the policy is shown to remain in force through Stuart's age 71. Based on a hypothetical gross interest rate of 0% and the guaranteed cost of insurance the policy is shown to remain in force to Stuart's age 58." Oswald's recommendation was the following: "The policy is rated as a Category Three (3) policy (on a scale from one to five, with one being the best). This is due to the fund performance of the policy and the fact that additional future premiums many be required. The policy should be audited every two to three years or more often if the underlying fund performance remains lower than projected, the carrier's financial strength ratings decline or there are policy loans or withdrawals taken."

Oswald's review of the Manulife VUL policy was very similar, with finding that "[w]e feel the financial strength ratings for the carrier are very good to excellent. . . . Based on a hypothetical gross interest rate of 8% with current cost of insurance, the policy is shown to remain in force through policy year 22 [Stuart's age 70]. Based on the guaranteed cost of insurance and a hypothetical gross interest rate of 0%, the policy is shown to remain in force through policy year 12 [Stuart's age 60]." Other than not containing the sentence "[t]his is due to the fund performance of the policy and the fact that additional future premiums many be required," Oswald's recommendation for the Manulife VUL policy was identical to the recommendation for the American General VUL policy.

The trial court noted "[t]he Oswald review indicated that it was likely that the two existing policies would lapse before Cochran reached his life expectancy of 88 years." Additionally, because Stuart's "financial fortune had also taken a negative turn by this point in time, he had no financial wherewithal to supplement the trust with additional resources or through the purchase of additional policies of life insurance."

As Oswald conducted its review of the VUL policies, Roberson completed his own review of alternative policies and, eventually, proposed to KeyBank that a John Hancock policy be purchased to replace the two existing VUL policies. However, while the proposed policy was guaranteed to age 100, the total death benefit would be reduced to $2,787,624.

KeyBank requested Oswald to review the proposed John Hancock policy. Representatives of those companies [the phrase "those companies" was used in the appellate court opinion and was referring to KeyBank and Oswald] exchanged some emails, in which an Oswald employee noted that the John Hancock policy "drastically reduces" the expected death benefit, and asking KeyBank, "[i]s this . . . . what [your] client wants to do?" The KeyBank representative [unspecified who was the representative] replied in the affirmative, stating that "[i]t is [Stuart's] intention to reduce his life insurance coverage to the amount seen on the John Hancock illustrations." Oswald found after reviewing the proposed John Hancock policy and comparing it to the two existing VUL policies as follows:

> We feel the financial strength ratings for John Hancock are very good. . . The proposed John Hancock illustration shows no further premiums and projects coverage at current mortality and interest rates, to remain inforce [sic] to Stuart's age 100. At guaranteed morality and interest rates the policy is projected to remain inforce [sic] to age 100.
>
> <u>Pros of exchanging to John Hancock Policy:</u>
>
> · Since proposed John Hancock is a non-[VUL] policy, there will [be] less fluctuation in the cash values.
>
> · The proposed John Hancock policy offers guaranteed coverage to age 100 of $2,787,624.
>
> · No ongoing premiums are required to maintain the proposed policy coverage of $2,787,624.
>
> <u>Cons of exchanging to John Hancock Policy:</u>

· There will be a new contestability period and suicide period in the new policy.

· There will be new expense charges, including commissions . . .

· There will be a surrender charge incurred of . . . $107,764.

RECOMMENDATION

> If the client feels comfortable with the points referenced in this report and feels comfortable with the proposed John Hancock policy and the concomitant results associated with this transaction, then purchase is recommended.
>
> Our recommendation is contingent upon underwriting. Should his underwriting come back other than Super Preferred Nontobacco, as illustrated, then we will need to review the resultant changes.
>
> If purchased, the John Hancock policy will be rated as a Category One (1) policy (on a scale of one to five, with one being the best). No further audits are necessary unless this carrier's ratings decline.

In an email, an Oswald employee summarized its conclusion:

> We're sure the guarantees in this John Hancock product have a lot of appeal to [Stuart] given the fact of his substantial investment losses in the current [VUL] policies.
>
> Given the facts that he is moving to a fixed product with the death benefit guaranteed to age 100 and $0 future outlay, our recommendation would be to move forward with the proposed John Hancock coverage if the client is comfortable with the reduction in death benefit.

After reviewing Oswald's analysis of the respective policies and considering the recommendations contained in the reports, in June 2003, KeyBank decided to effectuate a Section 1035 exchange replacing the American General VUL policy and the Manulife VUL policy with the John Hancock policy that would insure Cochran until age 100. After Stuart completed a medical exam, the John Hancock underwriters rated him as a preferred risk rather than as a super preferred risk. The result on the change in risk classification was to reduce the guaranteed death benefit to $2,536,000 from the $2,787,624 originally proposed death benefit. The Oswald employee who had performed the analysis testified that this change in the death benefit would not have altered Oswald's ultimate recommendation.

It should be noted that in the trial court's "Findings of Fact," item number 37, the trial court stated that "[w]hile no evidence was introduced showing that KeyBank sent regular financial statements to the Beneficiaries or to their mother, Vance, it was uncontroverted that KeyBank transmitted an account statement to Chanell [Stuart Cochran's oldest daughter who recently turned age 18 and requested documents from KeyBank] for the period April 1, 2003 – June 30, 2003." The information received by Chanell would have been after the replacement of the two VUL policies with the John Hancock policy.

In January, 2004, while shoveling snow at his home, Stuart Cochran died unexpectantly at the age of 53. The trust received the sum of $2,536,000 in life insurance proceeds, tax free, and these proceeds were distributed to the beneficiaries of the trust – Cochran's daughters.

In April of 2004 the beneficiaries of the trust began legal proceedings against KeyBank, eventually claiming, among other things, that KeyBank breached its fiduciary duties as trustee of the trust. A bench trial was held on August 28-30, 2007. On May 29, 2008 the trial court entered findings of facts and conclusions of law, ruling in favor of KeyBank. The beneficiaries appealed the trial court decision but the Court of Appeals of Indiana affirmed the trial court decision.

Trial Court's Conclusions of Law and Analysis

The trial court first cited the appropriate Indiana court cases and statutes to be applied to the case. These included from the Indiana Code the definitions of a trust, settlor, minor and trustee. The court noted from the case of Goodwine v. Goodwine, 819 N.E.2d 824, 829 (Ind. App. 2004 [citing In re Hanson Revocable Trust, 779 N.E.2d 1218, 1221 (Ind. App. 2002), trans denied] that "[i]n construing a trust instrument, the primary objective is to ascertain and carry out the settlor's intent." The court noted the Indiana Trust Code specifically provides that the rules of law contained there shall be "interpreted and applied to the terms of the trust so as to implement the intent of the settlor and the purposes of the trust." Ind. Code § 30-4-1-3. Citing from the Goodwin case noted above which was citing Stowers v. Norwest Bank Indiana, N.A., 624 N.E.2d 485, 489 (Ind. App. 1993), "i[n] determining the intent of the settlor, the courts look first to the language used in the trust document. If the terms of the trust document are not ambiguous, a court may examine only the four corners of the instrument to determine the settlor's intent. If the settlor's intent is clear from the plain language of the instrument and not against public policy, the court must give effect to that intent." Quoting from Indiana Code § 30-4-1-3, the court noted that in fact, where the rules of law and the terms of the trust conflict, the terms of the trust shall control "unless the rules of law clearly prohibit or restrict the article which the terms of the trust purport to authorize."

Noting from Indiana Code § 30-4-3-11 "that a trustee who commits a breach of trust may be held liable to the beneficiary of the trust," and, "that in considering the action of an [sic] trustee, Indiana law provides it is the duty of a trustee to comply with the Indiana Prudent Investor Rule," the court cited the following sections of the Indiana Prudent Investor Rule, which are essentially the same as the Uniform Prudent Investor Act (UPIA) Sections 1, 2, 8 and 9:

> Indiana Code Section 30-4-3.5-1 (UPA Section 1).
>
> > (a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this chapter.
> >
> > (b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the

trust.

Indiana Code Section 30-4-3.5-2 (UPA Section 2).

(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 investments and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as 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 those of the following that are relevant to the trust or its beneficiaries:

(1) General economic conditions.

(2) The possible effect of inflation or 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, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property.

(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.

(8) An asset's special relationship or special value, if any, to the purposes of the trust or one (1) 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 this chapter.

(f) A trustee who has special skills or expertise, or is named in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use the special skills or expertise.

Indiana Code Section 30-4-3.5-8 (UPA Section 8).

> Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Indiana Code Section 30-4-3.5-9 (UPA Section 9).

> A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill and caution in:
>
> (1) Selecting an agent.
>
> (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and.
>
> (3) Reviewing the agent's actions periodically in order to monitor the agent's performance and compliance with the terms of the delegation.

In again citing Goodwine, 819 N.E.2d at 831, the court stated the Indiana Prudent Investor Act has been interpreted by the Court of Appeals to act as a limitation on the actions of a trustee, and not as a "set of rules giving him permission to act in ways in which he otherwise could not."

The trial court first addressed the issue of KeyBank's limiting the duties of the trustee by the Acceptance of Trust document, contrary to the duties imposed on the trustee by the trust agreement itself. Indiana Code Section 30-4-3-26 provides that an irrevocable trust may be modified only upon court approval. While neither Vance nor the beneficiaries objected to the Acceptance of Trust document, and, under certain circumstances, silence may be considered as acceptance or ratification, the court declared that the Acceptance of Trust document represented an attempted modification of the trust agreement, and such modification may be made only with court approval pursuant to Indiana Code Section 30-4-3-26 as noted above. In addition, Indiana Code Section 30-4-3-5 provides that if the duty of the trustee in the exercise of any power conflicts with the trustee's individual interest, the power may be exercised only with notice to interested persons and authorization of the court.

However, the court noted, under Indiana law, a duty may be imposed on one who undertakes to act even though the person may not otherwise have a duty to act. By undertaking the evaluation of the policies as part of its duties and making the decision to execute the exchange of policies in June of 2003, KeyBank assumed the obligation to act in a prudent manner. So, the court concluded, that, "KeyBank undertook to act and therefore had a duty to act prudently, without regard to any limitations upon its duty that the second paragraph of the Acceptance [of Trust] Document purports to impose."

The court cited that both the Restatement (Third) of Trust § 227(c)(2) and the Indiana Prudent Investor Rule provisions for delegation and noted, additionally, that "due to lack of regular financial reports and as a consequence of the process of selecting KeyBank as the successor trustee, KeyBank placed itself in the position of undertaking responsibility to make prudent decisions for the investment of the corpus of the trust."

The court narrowed down what it considered to be the key issue and essence of the case as follows:

> The ultimate question facing this Court, however, is whether the actions of the Trustee, KeyBank, were consistent with the Settlor's intent as expressed in the Trust document and met its fiduciary duties to the Beneficiaries. In essence, based on the circumstances facing the Trust in 2003, was it prudent for the Trustee to move the trust assets from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit? The Court concludes that this conduct was consistent with the standard established by the prudent investor rule.

In support of the decision and conclusion of the court, the court noted that:

> KeyBank and its representatives acted in good faith to protect the corpus of the Trust based on the downturn in the stock markets and the prospect that the existing policies would lapse before the expected life expectancy of the Settlor.
>
> In hindsight, due to the unexpected demise of the Settlor at age 53, KeyBank's decision resulted in a significant reduction in the death benefit paid to the beneficiaries. However, from the perspective of the Trustee at the time of its decision, it was prudent to protect the Trust from the vagaries of the stock market and from predicted lapse of the existing policies. It might also have been prudent to take a "wait and see" approach, however the prudent investor standard gives broad latitude to the Trustee in making these types of decisions.
>
> Had the VUL insurance policies lapsed, the Beneficiaries would have received no distribution from the Trust. Certainly, that outcome was not within the intent of the Settlor at the time he established the Trust.
>
> Frankly, financial trends outside of the control of the Trustee or the Beneficiaries were the direct and proximate cause of the problem facing the Trust in 2003. While it would have been preferable for the Trustee to provide regular accountings to the Beneficiaries, the receipt of timely financial reports by the Beneficiaries would not have changed the negative financial condition of the Trust.

In commenting on the prudence of KeyBank's process of decision making and lack of financial reporting directly to the trust beneficiaries the court stated and concluded:

> The Beneficiaries want this Court to focus to the defects in KeyBank's decision-making process, and while the Court recognizes that this process was certainly less than perfect with respect to the Cochran Trust, the Court concludes that it would need to engage in sweeping conjecture, which is not supported by the evidence, to find that damages resulted to the Beneficiaries based on the circumstances presented here.
>
> Accordingly, this Court concludes that KeyBank did not breach its fiduciary responsibilities to the Trust or the Beneficiaries, and the lack of financial reporting to the Beneficiaries and the decision to the reinvest [sic] the corpus of the Trust in a guaranteed insurance policy was not the

> proximate cause of damages to the Beneficiaries.

Finally in summarizing the Conclusion of Law and Analysis and the trial court's decision the court stated:

> In conclusion, by insuring that the Trust was funded by a guaranteed death benefit in the sum of $2,536,000.00, KeyBank acted in good faith to protect the interests of the Beneficiaries and to comply with the directives of the Settlor as contained in the Trust document.

The Indiana Court of Appeals' Discussion and Decision

In the "Discussion and Decision" portion of the appellate court opinion, the court first discussed the "Standard of Review." In citing the case of Menard, Inc. v. Dage-MIT, Inc., 726 N.E.2d 1206, 1210 (IND. 2000), the court observed that "[i]n conducting our review we give due regard to the trial court's ability to access the credibility of witnesses. While we defer substantially to findings of fact, we do not do so to conclusions of law." Citing the case of Yoon v. Yoon, 711 n.e.2d 1265, 1268 (Ind. 1999), the court continued with "[w]e do not reweigh the evidence; rather, we consider the evidence most favorable to the judgment with all reasonable inferences drawn in favor of the judgment."

The court's next "Discussion and Decision" section considered "The Prudent Investor Act" and whether the trial court had erroneously concluded that KeyBank's actions leading to the exchange of policies in June of 2003 did not violate the Indiana Uniform Prudent Investor Act (PIA).

Noting the relevant portion of the Indiana Code section under the Indiana PIA that is concerned with trustee delegation, Indiana Code § 30-4-3.5-9(a) or Section 9(a) of UPIA, the court first addressed the appellant's contention that KeyBank violated the PIA by imprudently and improperly delegating certain decision making functions to Roberson and Stuart. Reiterating portions of the case facts, the court noted that "Roberson chose to monitor the Trust throughout its existence. He helped to create it and, in 1999, recommended an exchange of policies." In 2003, KeyBank began to review the viability of the current policies in the trust, hiring Oswald to analyze the current VUL policies. At the same time, and on his own volition, Roberson conducted his own review and eventually proposed to KeyBank that a John Hancock policy be purchased to replace the two VUL policies.

Upon receiving Roberson's proposal, KeyBank again engaged Oswald to conduct an independent review of the John Hancock proposed policy. The court declared that "[t]he fact that Roberson submitted the policy for review does not constitute a delegation of KeyBank's decision-making [sic] duties. Oswald was an outside, independent entity with no policy to sell or any other financial stake in the outcome. Under these circumstances, we do not find that KeyBank delegated any investment or other duties to Roberson." The court further noted "[a]lthough the Beneficiaries direct our attention to evidence in the record supporting their contention that there was, in fact, a delegation, this is merely a request that we reweigh the evidence--a request we decline."

The court next addressed the beneficiaries' contention that KeyBank violated the PIA by disregarding Oswald's recommendations. The court first noted that

KeyBank asked Oswald to review the existing VUL policies and that "[a]fter comparing the policies' respective hypothetical performances given hypothetical interest rates, Oswald rated both policies as a Category Three on a scale form one to five, noting that "additional future premiums may be required" and that the policies "should be audited every two to three years or more often" under certain circumstances. . . KeyBank then asked Oswald to review the proposed John Hancock policy. Oswald found that no further premiums would be required to maintain that policy until Stuart reached the age of 100. Ultimately, Oswald recommended the purchase of the John Hancock policy, rating the policy as a Category One on a scale from one to five, with one being the best. No further audits would be necessary."

Elaborating on the choices facing the trustee with respect to the Oswald reports and the selection of the John Hancock policy, the court concluded and decided:

> Having reviewed these reports, it is evident that Oswald found both options – the existing VUL policies and the John Hancock policy – to be palatable. Each had their own sets of pros and cons. The existing VUL policies may have lapsed before Stuart reached the age of 60 and would likely have required additional premiums to finance – money that Stuart no longer had. The John Hancock policy, on the other hand, offered a significantly reduced death benefit but was guaranteed to remain in force until Stuart reached the age of 100 and would require no additional financing. Oswald found the John Hancock policy to warrant the highest rating and concluded that no further audits would be necessary. Under these circumstances, we cannot say the KeyBank's decision to exchange the VUL policies for the John Hancock policy parted ways from Oswald's advice and recommendations. KeyBank merely chose between two relatively acceptable options – a decision it was entitled to make as trustee. We do not find that it acted imprudently on this basis.

The court then addressed the beneficiaries' faulting KeyBank for failing to investigate alternatives aside from retaining the existing VUL policies or exchanging them for the John Hancock policy. In the appellate court's view "[i]t is very likely that, no matter what the circumstances, a trustee could always do more. Investigate further, engage in more brainstorming, expand the scope of it queries, etc. It is difficult, if not impossible, to draw a bright line demarcating the point at which a trustee has done enough from the point at which it must do more. Here, KeyBank was concerned about the state of the economy, the stock market, and Stuart's limited financial resources. It examined the viability of the existing policies and investigated at least one other option. Of course it could have done more, but nothing in the record leads us to second-guess the trial court's conclusion that, while KeyBank's "process was certainly less than perfect," it was adequate. . . Thus, it was not clearly erroneous for the trial court to conclude that KeyBank did not act imprudently for this reason."

Next the court addressed the beneficiaries' brief argument that the policy exchange that took place in 1999 shortly after KeyBank assumed successor trustee duties was a violation of the PIA by KeyBank. The court noted that at that time the underwriting for the exchange of policies had been approved and Stuart had already submitted to the physical exams, and, indeed, the exchange of policies had been contemplated since the summer of 1998. Additionally, the transaction nearly doubled the total death benefit that would be payable to the trust. The court further noted that at the trial the beneficiaries' experts testified that they had originally committed a calculation error with respect to the 1999 Exchange, and that once the error was corrected that they believed that the risk factors associated with the exchange of policies in 1999 were within the range of "defensible probabilities."[9] The court concluded that "[u]nder these circumstances, there is no evidence supporting the Beneficiaries' argument that KeyBank violated the PIA with its conduct in 1999."

Lastly, under the "Prudent Investor Act" portion of the appellate court's "Discussion and Decision" analysis, the court focused on the Indiana Code § 30-4-3.5-8 of the PIA, or UPIA Section 8, where "[c]ompliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." Essentially elaborating on the trial court's analysis the appellate court stated that "[h]ere, at the time KeyBank was evaluating its options before the 2003 Exchange, it was working with the following facts and circumstances: (1) a rapidly declining stock market; (2) the most recent two years, in which the Trust had lost progressively more money, with every reason to believe that further erosion would occur with every day it held the VUL policies; (3) a grantor in his early 50s with a life expectancy of 88 years; (4) a grantor who had lost a great deal of money because of the economic decline and, consequently, had no further funds to invest in the trust; and (5) a trust that consisted of two life insurance policies that an independent expert estimated could lapse within approximately five years if no further funds were invested."

Echoing the trial court's conclusions, the appellate court stated and concluded that "[u]nder these circumstances, KeyBank's decision to exchange the VUL policies for the John Hancock policy was eminently prudent, reduction in death benefit notwithstanding. That a "wait and see" approach may also have been a prudent course of action does not alter the propriety of the exchange. We now know, in hindsight, that the economy improved and Stuart died unexpectedly less than a year after the 2003 Exchange took place—given those facts, of course, we understand that the Beneficiaries wish that KeyBank had made a different decision. But keeping in mind only the facts and circumstances at the time KeyBank made its decision, we cannot say that its decision violated the PIA."

In the last section of the appellate court's "Discussion and Decision" – titled "Trustee's Duties" – the court first addressed two issues of "Relationship to Beneficiaries"- namely "Annual Reports" and "Duty of Loyalty." Then the court examined the issues of "Delegation" and "Grantor's Intent." The whole section on "Trustee's Duties" was brought about because of the beneficiaries' argument that even if KeyBank did not violate the PIA, it breached a number of fiduciary duties to the beneficiaries. Before analyzing the specific issues listed above, the court provided background on the applicable law relative to the trustee's duties.

Quoting Indiana Code § 30-4-1-1(a), the court stated that "[a] trust is a fiduciary relationship between a person, who, as trustee, holds title to property and another person for whom, as beneficiary, the title is held." The court next observed from the case of Davis v. Davis, 889 N.E.2d 374, 380 (Ind. Ct. App. 2008) that "[a] "breach of trust" is a violation by the trustee of any duty that is owed to the beneficiary, with the duties being established by statute and by the terms of the trust." The court then stated the relevant part of Indiana Code § 30-4-3-6 as follows:

> (a) The trustee has a duty to administer a trust according to its terms.
>
> (b) Unless the terms of the trust provide otherwise, the trustee also has a duty to do the following:
>
> > (1) Administer the trust in a manner consistent with [the PIA].
> >
> > * * *
> >
> > (3) Preserve the trust property.
> >
> > (4) Make the trust property productive for both the income and remainder beneficiary. As used in this subdivision, "productive" includes the production of income or investment for potential appreciation.
> >
> > * * *
> >
> > (7) Upon reasonable request, give the beneficiary complete and accurate information concerning any matter related to the administration of the trust and permit the beneficiary or the beneficiary's agent to inspect the trust property, the trustee's accounts, and any other documents concerning the administration of the trust.
> >
> > * * *
> >
> > (10) Supervise any person to whom authority has been delegated. . .

Quoting Indiana Code § 30-4-5-12(a), the court noted furthermore, "a trustee owes its beneficiaries a duty of accounting, which requires the trustee to deliver an annual written statement of the accounts to each income beneficiary or her personal representative." Finally, in quoting Indiana Code § 30-4-3.5-5, the court observed it is well established that a trustee "shall invest and manage the trust assets solely in the interest of the beneficiaries."

It appears the beneficiaries had two issues with regard to KeyBank as trustee providing timely reports to the beneficiaries. The first dealt with the providing of annual reports to the beneficiaries. The court noted that when the beneficiaries were minors – which they were for most of the relevant period of time – KeyBank sent its annual reports to Stuart, their father. Observing that this was not a perfect solution, since Vance, their mother, was the custodial parent, the court concluded – comparing the case of Davis, 889 N.E.2d at 383-44, which dealt with finding a breach of trust where the trustee willfully withheld information from the beneficiaries and engaged in self-dealing – it never the less established "KeyBank's good faith, at the least."

Continuing to address the annual reports issue, the court again noted that one of the beneficiaries turned eighteen at some point before the 2003 Exchange of polices and KeyBank inadvertently failed to send her a copy of the annual report at that time. However, according to the appellate court, following her birthday she requested documents from KeyBank and a KeyBank representative contacted the beneficiary and Vance and indicated that the documents were ready at a local KeyBank office to be picked up. The court concluded "[y]et again, therefore, we cannot conclude that there is any evidence that KeyBank willfully withheld information from the Beneficiary."

For the second reporting issue, the beneficiaries argued that KeyBank breached its duties by failing to provide sufficient information regarding its plan to carry out the 2003 Exchange of policies. The court strongly disagreed noting that "inasmuch as the Trust itself gave the trustee the power to surrender or convert the policies without the consent of anyone." The court quoted the language from the trust document "[t]he Trustee shall have all of the rights of the owner of such policies and, without the consent or approval of the Grantor <u>or any other person</u>, may sell, assign or hypothecate such policies and may exercise any option or privilege granted by such policies, including . . . the right to . . . surrender or convert such policies . . ." (Emphasis added by the court.) The court declared "[t[here was no requirement, therefore, that KeyBank notify the Beneficiaries of the impending exchange, inasmuch as neither their consent nor approval were required to carry out the transaction."

The court further commented "[e]ven if we were to find that KeyBank's actions herein constituted a breach of its duty to the Beneficiaries, we cannot countenance the Beneficiaries' argument that the lack of receipt of an annual report or failure to provide information about the exchange, without more, supports an award of compensatory damages. For damages to be warranted, we can only conclude that causation must be established." Reiterating the trial court's finding that "the receipt of timely financial reports by the Beneficiaries would not have changed the negative financial condition of the trust" and that the "lack of financial reporting to the Beneficiaries was not the proximate cause of damages to the Beneficiaries," the court stated "[t]here is certainly evidence in the record supporting those findings." The appellate court agreed with the trial court that "financial trends outside of the control of the Trustee or the Beneficiaries were the direct and proximate cause of the problem facing the Trust in 2003," and added that "another contributing problem beyond everyone's control was Stuart's tragic, untimely death." Summarizing the court said "[w]e simply cannot conclude that KeyBank's shortcomings vis-a-vis the provision of annual reports and other information to the Beneficiaries was a proximate cause of any damages to the Beneficiaries."

Addressing the beneficiaries' argument that KeyBank somehow breached its duty of loyalty to them, the court pointed out that the only evidence they pointed to in support of this argument is the fact that KeyBank had various contacts and communications with Stuart between 1999 and 2003. However, according to the beneficiaries, this evidence supports an inference that KeyBank was loyal to Stuart rather than to the beneficiaries as is required by law. The court did not agree with the beneficiaries' argument and stated that "[a] trustee must, as a practical matter, have contacts with the settlor. . . . For example, if changes are going to be made to an insurance policy, those changes generally require that the settlor submit to a physical exam; therefore, such a change cannot be effectuated without communication between a trustee and settler. . . Nothing in the law prohibits contact between a trustee and settlor, nor should it. Here, nothing in the record leads us to conclude that KeyBank breached its duty of loyalty to the Beneficiaries."

Next, the beneficiaries argued that KeyBank breached its duties to them by delegating certain decision making functions to Roberson without adequate oversight. The court declared to the contrary stating that "[a]s discussed above, however, the record supports a conclusion that, in fact, no such delegation occurred. Furthermore, KeyBank engaged its own independent expert to evaluate the VUL policies and the John Hancock policy that was suggested by Roberson. Under these circumstances, we do not find that KeyBank breached its duties to the Beneficiaries in this regard."

Finally, the last issue and argument raised by the beneficiaries was that the trial court erroneously concluded that the 2003 Exchange of policies was consistent with Stuart's intent. Citing Malachowski v. Bank One, 590 N.E. 2d 559, 565-66 (Ind. 1992), the court stated that "[t]he primary goal in construing a trust document is to ascertain and effectuate the intent of the settlor, which may be determined from the language of the trust instrument and matters surrounding the formation of the trust." Noting that "[t]he Beneficiaries suggest that the trial court was improperly considering Stuart's acts or requests made after the trust was executed in reaching that conclusion," the court disagreed citing the trial court's conclusion as follows: "Had the insurance policies lapsed, the Beneficiaries would have received no distribution from the Trust. Certainly that outcome was not within the intent of the Settlor at the time he established the Trust." (Emphasis added by the appellate court.) Summing up the grantor's intent issue the court said, "[n]othing in the record suggests that the trial court was clearly erroneous in reaching that conclusion, and we decline to disturb its ruling for this reason."

The appellate court concluded their opinion by declaring:

> In sum, we find that the trial court did not erroneously conclude that, while KeyBank's decisionmaking process and communication with the Beneficiaries was not perfect, it was sufficient. Although it is tempting to analyze these cases with the benefit of hindsight, we are not permitted to do so, nor should we. KeyBank chose between two viable, prudent options, and given the facts and circumstances it was faced with at that time, we do not find that its actions were imprudent, a breach of any relevant duties, or a cause of any damages to the Beneficiaries.
>
> The judgment of the trial court is affirmed.

COMMENT:

There had to be a first case involving the Uniform Prudent Investor Act (UPIA) and trust-owned life insurance (TOLI) and Cochran v. KeyBank was that first case. This fact alone makes Cochran v. KeyBank a very significant case. However, just being the first case is not the only significant aspect of Cochran. The trial and appellate courts affirmed several significant aspects of both UPIA and trust law, namely, the importance of delegation to an outside independent, third-party entity; having a documented process; adherence to the intentions of the trust settlor as expressed in the trust document; trustee discretion; trustee communications with the trust settlor-insured; and beneficiary communications.

While not addressed or even mentioned by the appellate court, the trail court indirectly – if not directly – affirmed that the trustee cannot, without court approval, limit or modify the duties of the trustee as contained in the trust document. Although KeyBank tried to limit its trustee duties by the "Acceptance of Trust" document, acting contrary to that document by undertaking the evaluation of the policies as part of its duties and making the decision to execute the exchange of policies in June of 2003 imposed on KeyBank the concept of "estoppel," thus, requiring the duty to act prudently. In the past, many corporate and professional trustees have attempted to exonerate themselves, or limit themselves severely or completely, from any duty connected with the management of the TOLI asset. The trial court makes it clear that, without court approval, the trustee cannot in any way limit the duties imposed on the trustee by the trust agreement – and this certainly includes the management of life insurance – and any attempt to do so is unenforceable.

From the point of view of choosing the appropriate and applicable law to apply to the case and to the facts, both the trial and appellate courts acted accordingly and exemplified the epitome of judicial discernment. On the other hand, from the point of view of weighting the evidence and determining the facts relative to the appropriately and properly chosen applicable law, the Cochran trial court[10] set a low bar and espoused a low set of standards for prudence and for compliance with the chosen applicable law.

Ostensively, the delegation to the Oswald firm for the life insurance policies evaluations was a delegation to "an outside, independent entity with no policy to sell or any other financial stake in the outcome." But were the policy evaluations truly independent and did Oswald have no financial stake in the outcome? Additionally, in evaluating the life insurance policies, did the Oswald firm demonstrate reasonable skill, care and caution, technical expertise and a prudent and thorough evaluation?

Randy Whitelaw, a co-author of this newsletter, was the fiduciary practices and life insurance management expert witness for the plaintiffs on the Cochran case. In examining the first question posed above concerning the Oswald firm independence and other aspects of the Cochran case his insights are invaluable. Much of the information described by Mr. Whitelaw was either gained through depositions provided by various witnesses or testimony at trial that was not reported in the case facts described in either the trial or appellate court opinions.

Mr. Whitelaw observed "that the Office of the Comptroller of the Currency (OCC) Regulation 9 provides guidance concerning acceptance of a trust or a trust investment the corporate trustee cannot manage – a Trustee is under no obligation to accept such a trust or trust investment. In 1999, KeyBank's trust unit accepted two investment-linked life insurance policies owned in an Irrevocable Life Insurance Trust (ILIT). The ILIT department did not have the internal expertise to creditably evaluate policy performance and risk manage these policies, nor did the firm that was delegated the responsibility to evaluate those policies."

According to Mr. Whitelaw, the Oswald firm (Oswald) was hired by one of the banks acquired by KeyBank and retained by KeyBank. Oswald's qualifications for being hired as an insurance consultant are unknown. According to the record, Oswald did not have the analytic tools to creditably evaluate policy performance, premium adequacy and policy sustainability of variable universal life insurance products and, hence, its contract with KeyBank excluded evaluation of variable insurance products. Because of this exclusion, the record indicated that Oswald firm preferred not to evaluate the American General and Manulife VUL policies except to provide a 'limited scope' comparison of the originally illustrated cash accumulation account to the policy anniversary cash accumulation account. Additionally, it is unclear whether or not Oswald personnel were securities licensed. Thus, four questions warrant consideration concerning Oswald's VUL policy evaluations:

First, was it prudent for KeyBank to pursue a "limited scope" delegation when the record indicated that Oswald lacked the requisite expertise to creditably evaluate VUL policies and was reluctant to accept the request (and may not have possessed the appropriate securities licenses)? Further, given this product type and the insured's age, what is the relevance of a cash accumulation account comparison?

Second, since the record indicated that KeyBank's investment unit was available to the ILIT unit, why didn't KeyBank involve its investment unit in this analysis to obtain market outlook, asset allocation and Monte Carlo Simulation support assistance?

Third, was Oswald's evaluation of the proposed policy replacement truly independent or an accommodation to either support the results KeyBank wanted to achieve, or retain an attractive client relationship with Key Bank, or a combination?

Fourth, carrier illustrations and policy contracts for flexible premium non-guaranteed products disclaim predictive value and use for policy comparisons, did the Oswald firm truly possess the qualifications, insurance knowledge and technical expertise to creditably provide the requested policy evaluation? In other words, did Oswald exercise reasonable skill, care and caution in their policy evaluation?

These prudent process and accommodation questions were not addressed in either the trial or appellate court opinions.

The Oswald firm's policy "evaluation" reports, as quoted in the trial and appellate court opinions, appear to be more like audits, or verification of facts as shown on existing carrier provided statements and annual reports, and inforce policy illustrations; plus verification of third-party independent rating services such as A.M. Best, Standards & Poor's® and Moody's®. In other words, the Oswald "evaluation" reports for the flexible premium, non-guaranteed VUL policies were primarily based on the use of carrier provided, constant assumption, inforce policy illustrations, which according to a 1992 report by the Society of Actuaries[11] and FINRA regulations[12] is an improper method of policy evaluation. The 1992 Society of Actuaries Task Force Report on Policy Illustrations makes it clear that "[i]llustrations 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 a policy illustration."[13]

So what is the problem with the use of policy illustrations in evaluating non-guaranteed life insurance policies? Again, the Society of Actuaries Task Force Report on Policy Illustrations says it best "…[h]ow credible are any non-guaranteed numbers projected twenty years in the future, even if constructed with integrity? How does the consumer evaluate the credibility of two illustrations if they are from different companies? Or even if they are from the same company if different products with different guarantees are being considered? Most illustration problems arise because the illustrations create the illusion that the insurance company knows what will happen in the future and that this knowledge has been used to create the illustration."[14]

Thus, any evaluation of non-guaranteed life insurance policies based on illustrations – as it appears were the Oswald "evaluation" reports, and, significantly, what the trial and appellate courts relied upon in reaching their decisions – are not credible, to say nothing of demonstrating reasonable care, skill and caution, technical expertise, or any attempt at prudence or a creditable, thorough, complete policy evaluation. In the authors' opinion, a prudent evaluation would have required a life insurance product suitability analysis – based on risk tolerance, which with trust-owned life insurance (TOLI) should have been stated in a written TOLI investment policy statement (TIPS) – and determinations of policy adequacy based upon creditable, unbiased policy evaluation using fact-based, actuarially defensible evaluation techniques.

Actuarial evaluation uses generally accepted actuarial methods, impartial analysis and objective data – not contained in policy illustrations – to access the probability that a non-guaranteed, flexible premium, planned scheduled funding premium – as shown on the life insurance policy illustration – will successfully sustain the policy to contract maturity, or, at the very least, to the insured's life expectancy. If the probability of sustaining the policy is less than 100 per cent, or the trustee's comfortable risk tolerance percentage, then the actuarial evaluation should contain a risk-appropriate correcting premium adjustment.

Additionally, actuarial evaluation – which uses a process of actuarially certified policy bench mark standards combined with Monte Carlo simulation using 1,000 randomized trials[15] - should include: (1) the earliest age in which the policy is expected to lapse and the five year age range of the most concentrated policy lapses derived from the 1,000 randomized trials of the Monte Carlo simulation; (2) how do the inforce total policy expenses – namely the costs of insurance and other expenses of the policy – compare, or vary by percentage, to the product standard benchmark[16] for the product type; and, (3) policy restructure options, which would include the correcting premium adjustment mentioned above to sustain the policy to the selected duration considering the insured's life expectancy, and other options which would include asset reallocation for VUL policies and/or reduction of the death benefit.[17] The Oswald "evaluation" reports never approached this standard.

What is also very questionable, however, is that KeyBank and Oswald, an independent life insurance policy consultant, did not communicate in the VUL policies "evaluation" reports, the remedial and restructure options for the UL type policies of lowering the death benefit amounts and/or changing the asset allocation of the VUL cash value account from an allocation considered “significant risk” subject to “vagaries of the stock market” into a guaranteed principal and interest account that would have offered protection from “a rapidly declining stock market.” At the time, VUL policies were paying guaranteed interest of 4% and such reallocation could have been made at no charge. Of course, such reallocations would have to be suitable to the purposes of the trust based on “an overall investment strategy having risk and return objectives reasonably suited to the trust”[18] that would be based on a risk tolerance assessment, all of which would be contained in a written investment policy statement for the trust. It appears the Oswald “evaluation” reports never took into consideration suitability of the policies, the asset allocation of the policies or the policy remedial and restructure options mentioned above.

At the time of the reports, universal life insurance policies had been around for over 20 years and VUL policies for over 15 years. Thus, the flexible features of UL type policies should have been known to both KeyBank’s ILIT unit and Oswald. Was it prudent to exclude these considerations from KeyBank reports to the insured and trust beneficiaries? Does a limited-scope report demonstrate a prudent process?

Shifting from the inforce VUL policies to the proposed guaranteed universal life (GUL) policy, KeyBank requested Oswald’s opinion concerning the proposed replacement. Not surprising, Oswald did question the reasons and economic justification. After further KeyBank discussion, Oswald did provide the requested opinion conditioned upon the risk class rating assumed in the sales illustration. While this rating was not obtained, the parties, excluding the trust beneficiaries, agreed to pursue the exchange.

Both **Ben G. Baldwin**[19], and, **Barry D. Flagg** and **Patti S. Spencer**[20] have eloquently and succinctly written analyses concerning the Oswald “evaluation” reports and the consequences of ignoring the flexible restructure options available with the existing VUL policies. Both writings note the approximately 20 percent loss in the trust asset account investments represented by the cash values of the VUL policies because of the $107,764 surrender charges incurred with the exchange to the John Hancock Guaranteed Universal Life policy.

Noting that surrender charges typically reduce over time, [generally, reaching zero with most policies somewhere between the eighth and fifteenth policy years], Mr. Baldwin’s analysis and calculations of restructure for the VUL polices would have maintained the $8,007,709 death benefit for the VUL policies until the surrender charges were reduced or reached zero. He would also have immediately reallocated the cash value account into a guaranteed interest, guaranteed principal general account investment option, noting that the saved $107,764 surrender charges would have paid for about 31 months of the costs of insurance and policy expenses even without the supplemental interest from the guaranteed interest, guaranteed principal account, which probably, extrapolating from Mr. Baldwin’s analysis would have amounted to four percent, per year, of the, at least, $500,000 VUL cash value accounts.[21] That interest would likely have paid for an additional year of coverage, thus, putting the policies into their eighth year where surrender charges would be significantly reduced and the death benefit could be lowered at that time.

If the trustee had followed the recommendations of Mr. Baldwin, they would have received a death benefit of $8,007,709 rather than the $2,536,000 they actually received – an additional amount of $5,471,709. Mr. Baldwin further makes the observation that "[i]f this Court knew how much essential and readily available information about the existing VUL policies was not obtained or used by the Trustees and advisors in this case, I expect the result would have been different. Such ignorance about the features, benefits and flexibility of variable universal life is not likely to be acceptable in future cases."[22]

Essentially Mr. Flagg and Ms. Spencer performed a similar analysis and reached the same conclusions as Mr. Baldwin. The approach in their article, however, paid particular attention to justifying expenses under the Indiana version of UPIA and setting reasonable rates of return expectations under the Indiana version of UPIA Section 2.

Indiana Code Section 30-4-3.5-7 (UPIA Section 7) states:

> In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.[23]

While noting that the Oswald report to the trustee on the exchange to the John Hancock Guaranteed Universal Life policy did note the surrender charges of $107,764 – and other new charges, including commissions – Mr. Flagg and Ms. Spencer examined the effect of the surrender charges on the total expenses of the John Hancock policy compared to their quoted "VUL Benchmark Averages" and "Best Available VUL Rates & Terms." They demonstrated and concluded that this exchange was not justified from an expense standpoint, and for other reasons, and noted that "simply reducing the death benefits of existing VUL holdings could likely have preserved between $3,000,000 to $5,000,000 of life insurance (versus $2,526,000 under the John Hancock policy), depending upon just how well existing VUL holdings were priced, and upon the allocation of policy cash values appropriate to the risk and return objectives reasonably suited to the trust."[24]

They further observed that "[w]hile the exchange to the John Hancock policy did provide greater security in the form of premium and death benefit guarantees, knowing TOLI costs is essential to considering the cost/benefit as it relates to other forms of security, like reallocating existing VUL cash values to a fixed/guaranteed account generally allowable free of charge."[25]

Barry D. Flagg and **Steven S. Zeiger** made the astute observation that "the stock market correction in 2001 caused the cash values to decline by $37,000, a 7 percent *unrealized* loss." A 7 percent decline in cash values isn't unexpected from an aggressive asset allocation. We now know that the stock market rebounded, and policy cash values would have recovered if left alone.

"The stock market decline also precipitated a decline in the popularity of VULs. So in 2003, the agent recommended replacing the $8 million VUL with a $2.5 million guaranteed universal life policy. Ironically, in reaching its conclusion, the court observed that this replacement was intended to protect the trust assets from further stock market declines. In fact, it resulted in the trust realizing a 20 percent loss of assets due to a $107,000 surrender charge [the] Cochran [Trust] had to pay to exchange out of the VUL."[26]

While Mr. Whitelaw was the lead expert witness for the plaintiff on trust fiduciary, administration and management of TOLI, renowned life insurance expert **Richard M. Weber, MBA, CLU®, AEP® (Distinguished)** served as the plaintiff's expert witness on life insurance matters. In the authors' humble opinion, Mr. Weber is the conscience for the life insurance profession, having written articles in the hundreds and spoken numerous times to professional groups on the proper and ethical sale of life insurance. In addition, Mr. Weber is one of the best communicators in the life insurance profession who has the remarkable talent to explain the intricate workings, risks and concepts of life insurance products – both guaranteed products and non-guarantee, flexible premium products such as UL and VUL - in simple, yet exact and understandable terms. Contrary to various Cochran case articles alleging that the plaintiff failed to address all of these very basic considerations concerning the prudence of the 2003 exchange of policies, the Oswald "evaluation" reports, and the conduct of the trustee, while not mentioned in the trial or appellate court opinions, Mr. Whitelaw confirmed that all of these points were addressed in their expert opinion report and trial testimony.[27] The trial court chose to not include their testimony in the trial court opinion.

William Campbell Ries, J.D., a well-known attorney in the legal and banking professions with expertise in investment management and fiduciary services, and a frequent expert witness, was the respondent's expert witness. The trial judge apparently weighted the testimony of Mr. Ries and Oswald more creditable than that of Mr. Whitelaw and Mr. Weber. Given the numerous facts mentioned in this article and various other Cochran case articles and commentaries on the Cochran case – some of which have been cited in this writing - such weighting is questionable at best. As noted in the appellate court opinion "[a]t trial, the Beneficiaries' experts testified that they had originally committed a calculation error with respect to the 1999 Exchange and, once the error was corrected, they believed that the risk factors associated with the 1999 Exchange were within the range of defensible possibilities." Could this admittance of a calculation error – although remarkably honorable and ethical – have marred the credibility of the plaintiff's expert witnesses?

Mr. Whitelaw confirmed that KeyBank did not have an investment policy statement (IPS) for the Cochran Trust. Key Bank did have an asset allocation statement apparently signed by the irrevocable life insurance trust (ILIT) unit member responsible for administration of the Cochran Trust, who was not investment licensed, had no investment experience, and had minimal life insurance education and training. As already explained, the asset allocation and fund selection could have been changed in 2001 given the known market downturn from the asset allocation at the time of the policies acquisition, but no such asset allocation change was made. However, the ILIT unit did not obtain investment fund management or asset allocation guidance from KeyBank's investment unit at any time.

According to the deposition of KeyBank's Chief Investment Officer, a "wait and see" strategy was recommended to its clients at the time of the Cochran

Trust policy replacement. While KeyBank had full investment discretion, was it used in a prudent and reasoned manner? How could a trustee demonstrate compliance with the Indiana version of UPIA Section 2(b) that requires "investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust," without a written IPS that contains the risk tolerance and return objectives?

Also of interest, again according to Mr. Whitelaw, it is questionable whether KeyBank trustees for the Cochran Trust followed internal procedures regarding the management and exchange of investment securities. VUL is an investment security by law. Given the limited scope arrangement with Oswald, the VUL asset allocation, fund selection and exchange decisions could have been reviewed by the investment department of KeyBank. Again, according to the deposition testimony of the chief investment officer (CIO), the investment department recommended a wait-and-see 'hold' strategy regarding equity investments because the investment department was forecasting a stock market rebound. Thus, would the investment department have concurred with an exchange resulting in such a significant loss of value to the trust beneficiaries?

Given this discussion of the range of VUL policy management options contractually available to the trustee, it is questionable why they were not considered. Did the ILIT department and Oswald, its third-party life insurance policy performance evaluation vendor, have the requisite expertise to prudently and reasonably accept and manage the VUL policies as well as assess the VUL management options as demonstrated by the policy exchange to the John Hancock Guaranteed Universal Life policy recommended by Stuart Cochran's life insurance advisor, Art Roberson, not to mention considering other carriers and product type options? Yet the appellate court, while acknowledging that "[o]f course it [the trustee] could have done more," declared that "nothing in the record leads us to second-guess the trial court's conclusion that, while KeyBank's "process was certainly less than perfect," it was adequate." As noted by Patrick J. Lannon and Barry D. Flagg "[i]t is difficult to imagine the court reaching the same conclusion had the trustee considered one mutual fund to replace two existing funds, without discussing the trustee's examination of fees, expenses and historical performance for either the universe of possible alternatives or at least a relative benchmark."[28]

While the appellate court properly stated that "[a] trustee must, as a practical matter, have contacts with the settlor. . . Nothing in the law prohibits contact between a trustee and settlor, nor should it." In the Cochran case there may have been a fine line between communications with the settlor-insured and, perhaps, control of the trust by that settlor. The record indicates that the prior successor trustee, Pinnacle Bank, resigned as trustee due to Stuart Cochran's insistence on having third parties involved in the trustee's decision making process – namely Cochran himself, his sister and his insurance advisor, Art Roberson.

Based upon the case facts, it is implied that Mr. Roberson continued to serve as an advisor to both Mr. Cochran and the Trust. For example, in addition to proposing the two VUL policies, Mr. Roberson proposed the 2003 Exchange of the VUL policies to the John Hancock Guaranteed Universal Life policy (and each purchase generates for Mr. Roberson another first year commission). Stuart Cochran apparently agreed with these proposals, otherwise he would not have agreed to the related underwriting requirements. However, as noted by Mr. Whitelaw, Mr. Cochran's decision for the 2003 Exchange may have been influenced by an incorrect communication from the trustee that miss-quoted lapse at age 58 or 13 years sooner than age 71 indicated on policy statements from the carriers; notwithstanding that the communications should have been sent to the beneficiaries or their representatives.

In an email exchange regarding the proposed 2003 Exchange of policies between a representative of the Oswald firm and a KeyBank representative, the KeyBank representative stated that "[i]t is [Stuart's] intention to reduce his life insurance coverage to the amount seen on the John Hancock illustrations." The KeyBank representative never mentioned it was the trustee's or beneficiaries' desire to reduce the death benefit. In a similar vein, in an email to KeyBank an Oswald employee summarized its conclusion by saying "the guarantees in this John Hancock product have a lot of appeal to [Stuart] given the fact of his [emphasis added] substantial investment losses in the current [VUL] policies."

Again, it appears that the 2003 Exchange was based upon decisions made by Mr. Cochran and implemented by the trustee without consideration of the beneficiaries, although Mr. Cochran certainly understood the trust was for the benefit of his daughters. Given the questionable independence of the Oswald firm, as mentioned above, the delegation to and reliance upon this firm's conditional recommendation is procedurally prudent but "questionable," especially considering that the condition was not met. As a practical matter, the 2003 Exchange was initiated by Mr. Roberson, approved by Stuart Cochran, and implemented by the trustee. Thus, perhaps the trustee's independence and loyalty to the beneficiaries was not as cut and dry as the court concluded.

During the period when the beneficiaries were minors (which they were for most of the relevant period of time under question), KeyBank sent its annual trust reports to Stuart Cochran, not to Mary Kay Vance, their mother, who was the custodial parent. While the court concluded that this was "not a perfect solution," it also opined that this communication never the less established "KeyBank's good faith, at the least." Given the trustee's duty to the beneficiaries and the trustee's ability to obtain address information from their father, it remains difficult to understand the court's opinion.

When the oldest daughter turned age 18, KeyBank failed to send her a copy of the annual report. The daughter then requested documents from KeyBank in which the appellate court stated that a KeyBank representative contacted the beneficiary and Ms. Vance, and indicated that the documents could be picked up at a local KeyBank office. However, according to Mr. Whitelaw, this KeyBank communication was in dispute because the information was not available for pick-up at the local KeyBank office because the administration of ILITs was consolidated in the Cleveland KeyBank office. This communication further brings into question KeyBank's ILIT administration practices and loyalty as a fiduciary to the trust beneficiaries.

Lastly, the role of life insurance advisor Art Roberson warrants consideration.

Mr. Roberson was not a fiduciary to the trust, nor did he act as a fiduciary. His continued policy exchange recommendations poise both suitability and client's best interests questions, mindful that the trust is the client and the trustee is responsible for client decisions. Is it reasonable to ask whether his policy exchange recommendations were commission-motivated (first year commissions are significantly higher than subsequent year commissions) or client's best interests motivated? Without an investment policy statement, were his insurance recommendations based on sound risk and return objectives, and other criteria and philosophies typically contained within an investment policy statement and/or advocated by the trustee?

According to the case facts, the trust owned in 1987 whole life, universal life and an annuity with a combined death benefit of $4,753,539 sold by Mr. Roberson which were then the most popular policies at that time. In 1999, he replaced the policies sold in 1987 with two VUL policies, increasing the death benefit to $8,000,000. VUL policies were the popular product among agents and brokers due to the stock market performance at that time. Finally, in 2003 following the stock market downturn and the 9/11 attack, the two VUL policies were replaced by the John Hancock guaranteed product, which was the most popular product in 2003. Based upon his licensing, Mr. Roberson had to be aware of the flexibility and options available with the two existing VUL policies – namely the option of lowering the death benefit and/or reallocating policy asset accounts to a guaranteed interest, guaranteed principal account. It is not clear from the record whether these options were considered or discussed with either Stuart Cochran, the trustee or the Oswald firm.

With regard to the various policy replacements, Ben G. Baldwin observed that "[t]his was the third exchange of Cochran's trust holdings pursuant to the recommendations of the agent, whose methodology more closely resembles "flavor of the day" marketing rather than sound trust investment policy."[29] Similarly, Barry D. Flagg and Steven S. Zeieger noted "[t]he life insurance agent/broker appeared to have sold flavor-of-the-day products to the same client three times in 15 years, but wasn't liable for those recommendations."[30]

Summary

There had to be a first case involving the Uniform Prudent Investor Act (UPIA) and trust-owned life insurance (TOLI) and Cochran v. KeyBank was that case – making it both significant and a watershed case in setting out litigation-tested prudent and reasoned practices. From the point of view of choosing the appropriate and applicable portions of Indiana law – namely the precedent Indiana court cases and the Indiana version of UPIA – the trial and appellate courts properly affirmed the importance of delegation to an outside independent, third-party entity, having a documented process, adherence to the intentions of the trust grantor, trustee discretion, and, beneficiary communications.

On the other hand, from the point of view of determining the facts relative to the properly chosen applicable law, it can be argued that the Cochran trial court determined a low set of standards for prudence and for compliance with the chosen applicable laws. Whether future courts will raise the standards remains to be seen. However, the Cochran v. Key Bank matter has been the subject of many prudent and dispute defensible fiduciary practices and creditable policy evaluation discussions by informed commentators. Hence, the authors hope that both skilled and unskilled ILIT trustees adopt and adhere to a higher standard of care than was demonstrated in the Cochran case.

As a final comment, it is important to note that the Cochran matter identified policy performance monitoring and risk management evaluation issues specific to flexible premium policies that were not directly resolved and should be a cause for concern to all advisors and trustees. While the Cochran offers excellent and dispute defensible fiduciary practices guidance, it offers no informed guidance concerning creditable policy evaluation of flexible premium products. Carrier illustrations do not serve this purpose.

Lastly, today there is a lapsing flexible premium policy crisis and it will get worse before it gets better. As cost of insurance (COI) charges increase, the scheduled annual premium must also be increased for the policy to sustain coverage for the originally planned duration period. Since most Irrevocable Life Insurance Trusts insure seniors and own higher death benefit policies, the COI increase warrants attentive monitoring, dispute defensible policy risk management evaluation,[31] and premium adjustment to avoid an unintended consequence with un-necessary dispute and litigation implications.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Gary Flotron

Randy Whitelaw

CITE AS:

CITES:

In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009)

CITATIONS:

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[1] David Burdette, "Pay Attention to TOLI," *ABA Trust & Investments*, American Bankers Association, 16 May/June 2002.

[2] In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009).

[3] This was the second series of replacements recommended by the insurance adviser. The trust was originally funded with three single premium whole life policies and an annuity as assets contained in the ILIT. These policies were replaced with two variable universal life insurance policies. This former replacement increased the total death benefit from $4,753,539 to $8 million.

[4] See Ben G. Baldwin, Jr., "The Cochran Case: Not Understanding VUL Can Be Costly," *Estate Planning Review-The Journal*, CCH, a Wolters Kluwer Business, March 24, 2011, which describes the serious flaws of the evaluation by the insurance consultant.

[5] In general, trial courts determine the case facts and the weighting of evidence and the applicable law to be applied to the case facts. Whereas, appellate courts review and properly determine the law applied to the case facts. It is rare for an appellate court to questions or overrule a trial court on the determination of case facts and the weighting of evidence presented at trial. See In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009), Discussion and Decision, I. Standard of Review, page 10.

[6] Authors Comment: In this two-part article, it is not the intent of the authors to criticize trial and appellate court opinions. But it is our intent to constructively question the weighting of the factual evidence in the Cochran case. The Cochran v. KeyBank matter is described as a 'watershed' matter because it was the first meaningful current-day litigation to provide meaningful Irrevocable Life Insurance Trust (ILIT) and Trust-Owned Life Insurance (TOLI) guidance in demonstrating "dispute defensible" practices. As a result, a number of well-credentialed legal, tax, financial, investment and life insurance advisors have commented on the court opinion in the context of their expertise so that informed determinations are made that safeguard the interests of all trust parties. Currently there is a lapsing life insurance policy crisis that adversely impacts all flexible premium non-guaranteed death benefit policies, especially TOLI policies owned in an ILIT. Since Cochran v. KeyBank was the first current-day "watershed matter," our purpose is to identify matter-specific issues that warrant further "prudent process" consideration. That purpose with this two-part article, including end note references, offers excellent dispute defensible guidance to address the lapsing policy crisis and avoid a client crisis.

[7] Supra Note 4, and see Barry D. Flagg and Patti S. Spencer, "Cochran v. KeyBank – TOLI Case Law Guidance (Part 2 of 2)'" LISI Estate Planning Newsletter # 1499 (August 5, 2009).

[8] Interestingly, the Indiana version of the Uniform Prudent Investor Act did not take effect until July 1, 1999 after the appointment of KeyBank as trustee and the exchange of policies in 1999.

[9] For clarification purposes, following the correcting calculations for the 1999 transaction that resulted from a software bug, the experts confirmed that the revised calculations "in no way alters our opinions or conclusions regarding the 2003 transaction which is at the heart of this complaint."

Further, there is no mention of this "defensible probabilities" comment being made in the Trial Court opinion nor recall by the experts of the context in which it may have been made.

[10] See Note 5.

[11] *Final Report of the Task Force for Research on Life Insurance Sales Illustrations under the Auspices of the Committee for Research on Social Concerns*, Transactions of the Society of Actuaries 1991-92 Reports, Society of Actuaries, 1992. Herein after this report will be referred to as the Society of Actuaries Task Force Report on Policy Illustrations.

[12] FINRA Rule 2210 – IM-2210-2. Communication with the Public About Variable Life Insurance.

[13] Supra Note 11 at pages 159-60.

[14] Ibid at page 140.

[15] Acknowledgement needs to be given to Richard M. Weber and Christopher Hause of Ethical Edge Insurance Solutions, LLC who are the inventors and developers of the Historical Volatility Calculator software and pioneers in the Monte Carlo simulation and actuarially certified policy standards technique.

[16] The product standards benchmark is compiled annually from the Society of Actuaries and other credible reports and sources data on the current mortality rates and policy expenses, broken down by gender, smoking and health status, policy type and size, etc., representing approximately 80% of all life insurance sold in the United States. Thus, this benchmark can be used as a standard to compare carrier mortality costs and expenses.

[17] For a more in-depth discussion of this subject see "Flexible Premium Non-Guaranteed Policy Evaluation Using Monte Carlo Simulation and Actuarially Certified Benchmark Policy Standards: Going Beyond the Linear Paradigm," co-authored by Gary L. Flotron and E. Randolph Whitelaw, which is included as an Appendix to Chapter 7 of *The Life Insurance Policy Crisis – The Advisors and Trustees Guide to Managing Risk and Avoiding a Client Crisis*, by E. Randolph Whitelaw and Henry Montag, American Bar Association, 2016.

[18] Indiana Code Section 30-4-3.5-2(b) and UPIA Section 2(b).

[19] Supra Note 4.

[20] Supra Note 7.

[21] Supra Note 4, pages 49-50.

[22] Ibid pages 50-51.

[23] It is interesting to note that neither the trial nor appellate court quoted or considered this code section of the Indiana version of UPIA.

[24] Supra Note 7.

[25] Ibid.

[26] Barry D. Flagg and Steven S. Zeiger, "A Shot Across the Bow," *Trusts &Estates*, December 2010, trustandestates.com.

[27]Authors Comment: Some readers may question whether the trial and appellate court elected to ignore these VUL policy management options that are basic to any informed exchange decision. It is important to consider that this exchange was initiated by the insured and likely based upon the recommendation of his trusted life insurance agent. Equally important to consider, the trustee had full investment discretion and the ILIT lacked an Investment Policy Statement. The Trial and Appellant Court decisions combined with excellent and informed post-decision analysis set out the long overdue standard of care clarification appropriate to safeguard the interests of all ILIT parties. A thoughtful ILIT Investment Policy Statement accompanied by creditable (dispute defensible) annual policy performance monitoring and risk management are essential components of a prudent process that maximizes the probability of a favorable outcome to the trust estate. Said differently, a non-guaranteed liquidity funding program designed for a 10 to 50 year time horizon requires attention and asset management expertise.

[28] Patrick J. Lannon and Barry D. Flagg, "Cochran v. KeyBank – TOLI Case Law Guidance (Part 1 of 2)'" LISI Estate Planning Newsletter # 1486 (June 29, 2009).

[29] Supra Note 4, page 51.

[30] Supra Note 26, page 33.

[31] Supra Notes 11, 12, 13 and 14. Carrier illustrations for non-guaranteed flexible premium products disclaim predictive value as does the policy contract, FINRA guidance, and Society of Actuaries guidance. It should be noted that the Office of the Comptroller of the Currency Handbook on Unique and Hard to Value assets owned in trust provides questionable trustee guidance concerning the use of carrier illustrations for predictive value purposes.

2 Comments Posted re. *Gary Flotron & Randy Whitelaw: A Comprehensive Perspective on Four UPIA-TOLI Cases, Plus One That Includes the UTC, and Their Astounding Implications for ILIT Trustees, Part 1 of 2*

Lee Slavutin 21-Jun-16 10:56 PM

Dear Gary and Randy,

Tremendous amount of valuable information here, thank you.

Could you distill the 5 or 6 best practices (or whatever number you see fit) that we could take away?

Like a checklist?

Lee Slavutin 21-Jun-16 10:57 PM

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Like a checklist?

Post a comment on this newsletter:

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2438

Date: **20-Jul-16**
From: **Steve Leimberg's Estate Planning Newsletter**
Subject: **Gary Flotron and Randy Whitelaw: A Comprehensive Perspective on the Four UPIA-TOLI Cases, Plus One That Includes the UTC, and Their Astounding Implications for ILIT Trustees, Part 2 of 2**

In Estate Planning Newsletter #2428, **Gary Flotron** and **Randy Whitelaw** discussed in detail the first of the four Uniform Prudent Investor Act (UPIA) and trust-owned life insurance (TOLI) cases – namely the *Cochran v. KeyBank, N.A.,*which is more formally known as *In re Stuart Cochran Irrevocable Trust*, and in which co-author **Randy Whitelaw** was the lead expert witness for the plaintiffs.

In Part 2, the authors will describe and do a comprehensive analysis of each of the subsequent three UPIA-TOLI cases – namely *Paradee v. Paradee*, *French v. Wachovia Bank*, and *Rafert v. Meyer*. The *Rafert v. Meyer* case also applies the Uniform Trust Code (UTC) in addition to UPIA to TOLI. Each of these cases has provided guidance to trustees – both professional and amateur – and astonishing implications as to what constitutes prudent trustee behavior. Of course, there will undoubtedly be more cases in the future which will provide us with further refinements in the drafting, duties of trustees, administration and operation of ILITs and TOLI.

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E. Randolph "Randy" Whitelaw, AEP® (Distinguished) is the Managing Director of Trust Asset Consultants, LLC (TAC), a fee-based life insurance counseling firm, and Co-Managing Director of The TOLI Center, LLC (TTC), a fee-based life insurance policy administration and risk management firm.

TAC provides counseling and expert witness litigation support to individual and business policy owners, professional advisers, affluent family groups, and trustees, skilled and unskilled, of irrevocable life insurance trusts seeking both life insurance and fiduciary practices counseling. TTC provides policy owners, fiduciaries, professional advisors, affluent families and businesses with a service-based life insurance plan administration and policy risk management platform. He lectures nationwide on life insurance planning, suitability and dispute defensible risk management, and regularly authors in-depth peer-reviewed articles on the same topics. He is also the co-author with Henry Montag of the soon to be published book by the American Bar Association titled **The Life Insurance Policy Crisis - The Advisors and Trustees Guide to Managing Risk and Avoiding a Client Crisis**. Mr. Whitelaw was the lead expert witness for the plaintiffs in the *Cochran* case discussed in this newsletter. In 2013, he was inducted into the NAEPC Estate Planning Hall of Fame® and awarded the Accredited Estate Planner® (Distinguished) designation.

Now, here is Part 2 or their commentary:

Paradee v. Paradee[1]

EXECUTIVE SUMMARY:

This case involves breach of trust and disregard for fiduciary duties by three non-professional ILIT trustees. A single premium, second-to-die, blended whole life policy was the primary trust asset during most of the period in question, thus making it one the four UPIA-TOLI cases. However, an abuse of fiduciary duties might have easily have occurred in this case if the trust corpus was made up of other assets.

FACTS:

W. Charles Paradee, Sr. had an estranged relationship with his son, W. Charles Paradee, Jr. partially due to his remarriage after the death of his first wife and the mother to Charles, Jr. In 1978, at the age of 71, Paradee, Sr. married Eleanor Clement Paradee, who was age 54. However, Paradee, Sr. maintained a close and loving relationship with his only grandchild, W. Charles "Trey" Paradee, III. In December 1989, Charles Sr. created an irrevocable life insurance trust for the benefit of his grandson Trey naming his life insurance agent, Eugene N. Sterling, with whom Charles, Sr. and Eleanor had been longtime clients, as trustee. The trust was structured to take advantage of the so called "Gallo Exemption," which was to expire at the end of 1989, and funded with contributions from Charles, Sr. and Eleanor of $183,089 and $183,000, respectfully.[2] The contributions were used to purchase the single premium second to die whole life policy mentioned above on the lives of Charles Sr. and Eleanor, with a death benefit of $1,150,700. At the time of the trust creation, Trey was nine years old. Under Article I of the trust, Trey had the power to remove the existing trustee and appoint himself as trustee once he turned age 30.

Eleanor's influence over Charles Sr. and over the family finances steadily increased. In 1991, Charles, Sr. almost died of heart failure and began to deteriorate mentally as well. At that time, Eleanor despised Charles, Jr. and, at best, had apathy towards Trey. In July 1993, Eleanor sent a letter to Sterling, the trustee, instructing him to revoke the trust and return the cash value to the senior Paradees. Sterling sought counsel from the attorney who drafted the trust. Eleanor sought counsel from that same attorney who informed her that the trust was irrevocable. She made it clear that "irrevocable" meant "Irrevocable," and the Paradees could not access the cash value by revoking the trust. However, the attorney and Eleanor investigated the possibility of a trust loan, and the attorney discussed this idea with Sterling who sought counsel from another attorney on the structure of the loan. Sterling ignored the advice of the second attorney, and borrowing $150,000 from the cash value of the policy at an 8.75% variable loan interest, made an unsecured loan with fixed interest at 8.0% per year, without specifying whether the interest was simple or compounded, to the corporation owned by Charles, Sr.[3] Additionally, Sterling ignored the terms of the loan which required interest to be paid monthly and made no effort to collect the interest on a monthly basis. Instead, he established a practice of writing to the Paradees and requesting that interest be paid annually in February. Such interest was paid annually in 1994 through 1997.

One year after receiving the loan, Eleanor again instructed Sterling to revoke the trust and pay out the policy cash value to the Paradees. Sterling replied to Eleanor that the trust was irrevocable and the prior year's loan "was really stretching it." In December 1997 Eleanor again tried unsuccessfully to terminate the life insurance policy by having the family accountant contact the attorney who apparently then contacted Sterling directly. In February 1998, Eleanor informed Sterling that the Paradees could not pay the interest on the trust loan and, again, requested that Sterling surrender the insurance policy for its cash value. Sterling wrote to the second attorney stating: "I need guidance on what to do. Can I comply with the wishes of the Senior Paradee's [sic] without jeopardizing my position?" The second attorney responded with a letter, ostensibly written to Sterling but intended for the Paradees, advising Sterling of his personal liability and strongly urging him *not* to comply with Eleanor's request. Upon reading the letter, the Paradees paid the interest.

Charles, Sr. passed away on July 1, 1998. Under the terms of the loan, the trust had the right to recover the principal and interest at the death of Charles, Sr. or Eleanor. Sterling made no effort to collect. Trey turned 30 on July 18, 1999. Article1 Section C of the trust provided that "after my [Charles, Sr.] death, and upon reaching age 30, my grandson, W. Charles Paradee III, shall be entitled to serve as trustee hereunder…." Sterling did not notify Trey. On September 24, 1999, Manufacturers Life Insurance Company, the insurer of the trust-owned policy, demutualized and distributed shares of stock to eligible policy owners. Because of the policy loan, the trust received less shares of the now Manulife Financial Corporation (Manulife) than it would have been entitled to without the policy loan.

In early 2003, Eleanor asked the attorney to contact Sterling to find out the current face value of the policy, whether it was paid up and whether there was "[a]nything we can do about it." Sterling died on April 2, 2003 and the attorney reviewed the trust to determine who would become the successor trustee. The attorney advised Eleanor that Trey could serve as his own trustee, having reached the age of 30. Once again on April 21, 2003 Eleanor asked her advisers to look into how she could access the remaining trust funds. Ignoring her attorney's advice, Eleanor somehow managed to appoint herself as trustee. In 2003, for the first time, the corporation which was now controlled by Eleanor and to whom the trust loan was actually made, failed to pay the interest due on the loan. Similarly, interest was not paid in 2004 and 2005 resulting in March 2005 policy lapse. At that time, the trust assets consisted of the promissory note for the loan, the Manulife stock from the demutualization, and a cash bank account consisting of the dividends paid on the stock and on the stock dividends accumulated in the trust bank account. During Eleanor's tenure as trustee, the attorney advised Eleanor that (1) she had a duty to notify Trey about the trust, (2) the trust was obligated to pay income to Trey, and (3) she should use trust assets to maintain the policy. Eleanor declined to follow the attorney's advice.

In July 2007, Eleanor resigned as trustee and appointed William J. Smith, the family's longtime handyman and general domestic helper, as trustee. Smith did not understand his role as trustee nor his obligations to Trey, and initially viewed the trust as just another one of Eleanor's accounts. Like Eleanor, he initially did not inform Trey of the trust's existence or that Trey was the sole beneficiary of the trust, or inform Trey that he had a right to act as his own trustee. Furthermore, Smith did not distribute the trust income to Trey. Sometime later in 2007, Smith came to understand Trey's interest in the trust and told the attorney he wanted "to do what is right," and requested a letter instructing him on what to do. For some unknown reason,[4] it took the attorney two years to get around to that task. On August 18, 2009, Trey received a letter from the attorney informing him about the trust. Trey promptly exercised his right to become trustee and demanded that the loan be paid. On the last day in September of 2009, the corporation controlled by Eleanor paid the trust the principal and interest on the loan. Trey subsequently sued Eleanor and Smith, as trustees and as individuals, for breach of trust.

Court Opinion and Decision. Not surprisingly, given the above facts and total disregard for the interest of the trust beneficiary, lack of loyalty to the beneficiary, lack of prudence by all of the trustees to one extent or another, and disregard for fiduciary duties – all tenants of UPIA and common law – the court found in favor of Trey and assessed damages against the surviving former trustees along with particularly heavy damages against Eleanor that included her payment of Trey's attorney costs and expenses due to her egregious behavior and influence over the actions of the first and third trustees.

COMMENT:

Besides demonstrating egregious and flagrant behavior that should not be emulated by any trustee, this case highlights the perils of appointing sole, or only, non-professional, amateur, accommodation trustees who are unfamiliar with the fiduciary duties and responsibilities that accompany trusteeship. In all probability, these results could have been avoided by appointing either a professional trustee or a co-professional trustee and non-professional trustee.

***French v. Wachovia Bank*[5]**

EXECUTIVE SUMMARY:

This case deals with the broad issues of the duty of loyalty and prudence, and specifically, with a trustee engaging in self-dealing and acting in bad faith. Although in reading the case from the district and appellate courts, one cannot help but conclude that James "Jim" French, the trust settlor, and, perhaps, the four French children and trust beneficiaries, were difficult to please and had a lot of *chutzpah*. Or, to use a spaghetti western analogy[6], the French family had *a fistful of dollars* and were after *a few dollars more*. (Not certain how to assign *the good, the bad and the ugly* roles.)

FACTS:

Jim French founded the J. L. French Company, a manufacturing firm located in Sheboygan, Wisconsin in 1968 and sold it in 1996 for approximately $200 million. This sale netted French more than $100 million, individually and through his late wife's estate, and each of the four French Children realized more than $17 million. In 1991 he executed two interlocking irrevocable trusts for the benefit of his four children. Kathy Gray, an estate planning attorney and partner of Quarles and Brady, LLP, in Milwaukee, Wisconsin advised the family on estate planning matters and drafted the trust. Irrevocable Trust 1 holds a variety of investments, including two life insurance policies, and provides no distribution during French's lifetime but only upon his death. Irrevocable Trust 2 provided that all income of the trust to be paid to Trust 1 and that, upon French's death, the assets of Trust 2 would be distributed to Trust 1. At the end of 2004, Trust 2 held primarily stocks and bonds and was valued at approximately $24 million. Trust 1 was valued at more than $5 million, not counting the value of the life insurance policies. The only trust that is relevant to this matter is Trust 1 that held the two life insurance policies; hence, all further references to the trust will be for Trust 1.

As the grantor of an irrevocable trust, Jim French was not the trustee and had no authority over the trust or the trustee. However, he exercised authority as the consensus spokesperson for the French family and his children, the trust beneficiaries, and they deferred to him on trust matters. The law firm of Quarles & Brady, Jim French's attorneys, were also counsel to the beneficiaries with respect to the trust.

Initially, a Sheboygan attorney was the independent trustee of this trust. After losing confidence in the attorney's stewardship, French moved the trust to First Bank, and subsequently to Northern Trust Company. By 2004 French had grown dissatisfied with Northern Trust's conservative investment philosophy and modest rate of return. Of particular concern were the two life insurance policies held by the trust. One policy was a $ 5 million death benefit issued by Pacific Life Insurance Company with an annual premium of $164,000. The other policy was a $5 million death benefit issued by Prudential Life Insurance Company. The Prudential policy was described in the case as a "second-to-die whole life policy" having a premium scheduled to increase by more than $40,000.[7] As of May 2005, the existing policies had a cash value of approximately $2.2 million dollars.

In 2004, French began looking for a new trustee with a better investment strategy. French's daughter, Paula, urged French to talk to her stockbroker at Wachovia Securities, in Sheboygan, about moving the trust to Wachovia Bank. In early 2004, French held an initial meeting with Fred Church, a vice president of Wachovia Bank, at French's vacation home in Naples, Florida. Kathy Gray was also present at that meeting. Besides indicating he was looking to move his trusts, French requested that Church investigate the insurance policies held in Trust 1. Church and his associate, Steve Schumacher, an insurance broker with Wachovia Insurance Services in Tampa, Florida, subsequently commenced an evaluation of the trust portfolio, including the life insurance policies, to identify potential areas for improved profitability. On July 22, 2004 Church wrote to Gray confirming Wachovia's willingness to serve as trustee and identified options to improve the trust's insurance assets.

On August 3, 2004, Gray and her partner John Bannen, an attorney and insurance specialist at Quarles & Brady, met with Church in Milwaukee to discuss the range of insurance policy options. Because of a communication snafu, French did not have adequate notice and could not attend the meeting. He was upset and remained so even after Bannen summarized the meeting in a detailed memorandum. In September, French instructed Gray to discontinue the insurance analysis, and for a time Bannen and Church did nothing further. The case facts mention that "French is considered a 'difficult client,' one who keeps his own counsel and who seems afraid of being taken advantage of by professional advisors."

In mid-October, Church received word from Gray that French wanted to retain Wachovia as trustee, and Wachovia took over as trustee on December 29, 2004. According to Church, French called him in January 2005 asking him to resume investigations of options on the insurance policies as well as stating that he was looking for a "better deal" on the insurance in the form of either more insurance for the same premium or the same coverage for less premium. French denies that this conversation took place. Also, according to Church, he and Schumacher met with Jim French in his Naples vacation home on January 2005 to discuss insurance. French advised that he was interested in lower insurance premiums. At the close of the meeting, Church advised French that, if the purchase of new policies would proceed through Wachovia Insurance Services, a conflict waiver would be necessary.

Working extensively with Bannen, Church and Schumacher identified several options that Bannen summarized to French in a memo dated March 31, 2005. One option was to replace the existing policies with new no-lapse life insurance policies issued by John Hancock Life Insurance Company. This type of policy had a guaranteed death benefit with a substantially lower premium. Banner, in his memo, highlighted the pros and cons of the proposed replacement. The pros of the proposed arrangement were that the trust would get the same insurance for far less money. The lower, fixed premiums for the two proposed John Hancock policies would have an estimated savings to the trust of $620,000. The no-lapse guarantee ensured that the contracts would pay the promised death benefit as long as the premiums were paid timely.

The cons of the proposed arrangement were that the trust would lose the flexibility of the Pacific Life and Prudential policies, which accumulated cash value that could be recouped if the policies were surrendered before French's death. But Bannen and Church could not foresee any scenario under which early surrender would be necessary or desirable. The trusts had $30 million in other assets and were well diversified, made no distributions during French's lifetime, and the beneficiaries already were very wealthy. Church deemed the loss of flexibility unimportant to the trust's overall goals. The main point of having life insurance in the investment mix was to reap the death benefit, not the cash surrender value, that would never exceed the death benefit in any event.

In March, Bannen discussed insurance issues with Wachovia Bank representatives at least six times. During this process, Bannen found Wachovia Bank to be responsive in providing him with all of the requested information. Church concluded that Bannen was providing the French family with a level of analysis and due diligence that they had not experienced with other trust cases.

Church and Schumacher met with French on March 31, 2005 to discuss the options, and Bannen participated by phone. The following week French signed the John Hancock applications as the insured. On April 12, 2005 the managing director of Wachovia's Trust Department signed the applications and executed the required IRS forms documenting the exchange[8]. Schumacher submitted the applications to John Hancock but held back on authorizing the surrender of the Pacific Life and Prudential policies pending final approval from French. The new John Hancock policies were issued at the end of the month.

Meanwhile, Church sent Gray a proposed conflicts waiver identifying Wachovia Insurance Services, an affiliate of Wachovia Bank, as the insurance broker for the exchange, and also disclosing that Wachovia Insurance would receive a commission on the transaction, although it appears the amount of the commission was not disclosed. Bannen understood that Wachovia Insurance would earn a commission on the proposed 1035 exchange and advised French of the same. Gray also understood there would be a commission. A discussion ensued between Bannen, Gray and Church about the possibility of rebating the commission, or, alternatively, commensurate fee concessions by the trustee. It was determined that neither of these options was legally feasible. French balked at the terms of the conflicts waiver, which included a broad release of "any claim" arising out of the Wachovia's purchase of new insurance on behalf of the trust. French refused to sign, and instructed his children the beneficiaries of the trust also to refuse to sign.

Wachovia determined, after a review by legal counsel of the terms of the trust instrument, that it did not need either French's authorizations to proceed with the exchange, or the conflicts waiver. On May 18, 2005 the transaction proceeded as planned, and, on behalf of the trust, Wachovia surrendered the Pacific Life and Prudential policies. Wachovia received a commission of $512,000 from the transaction, which included the redeemed cash value of the surrendered policies, plus 2% of the annual premium for the next nine years, resulting in an additional commission of $36,000. No party disputes that the commission, though sizable, is consistent with industry standards.

Over the summer of 2005, French and his children, through counsel, complained to Wachovia about the process surrounding the insurance exchange. The family retained a different Milwaukee law firm, and on November 4, 2005 the new lawyers asked Wachovia to reverse the transaction. Of course, by then it was too late. After another change of counsel, the French children, as trust beneficiaries, sued Wachovia[9] for breach of fiduciary duty. They contended that Wachovia breached its fiduciary duties by engaging in prohibited self-dealing that violates the prudent investor rule as codified in Wisconsin via the Uniform Prudent Investor Act; and, if the prudent investor rule does not apply, acting in bad faith with regards to the insurance replacement. Not surprisingly, the trusteeship was changed to M & I (Marshall & Ilsley Corporation, now part of BMO Harris Bank) with the commencement of the lawsuit against Wachovia.

Court Opinion, Analysis and Decision. Both the U.S. District Court and the U.S. Court of Appeals for the Seventh Circuit found for the defendant/appellee Wachovia and, under Wisconsin law that was applied, ordered the plaintiffs/appellants to pay court costs and legal fees of the defendants.

Both courts cited the common law, statutes and other authorities on the duty of loyalty and the prohibition against self-dealing before examining the terms of the trust. It was noted that the trust instrument may waive the general rule and authorize the trustee to engage in transactions that involve self-dealing. The courts found that this was the case with the trust instrument and the language was quite clear. As the district court aptly stated in its decision about the applicable trust clause, the clause "specifically allows the trustee to deal "without regard to conflicts of interests." It is hard to imagine how the authorization to self-deal could be described more clearly." In an effort to avoid the clarity of this clause, the Frenches tried to focus on other general clauses in the trust instrument but both courts rejected their contentions. Thus, both courts rejected the claim that the trustee violated the duty of loyalty and engaged in self-dealing because of the specific clause in the trust authorizing the trustee to deal without regard to conflicts of interest.

The court next addressed the acted in bad faith allegation. Again citing common law, statues and other authorities, but this time on the standard of prudence and the prudent investor rule, and other sections of UPIA, and noting, that the trustee is always obligated to administer the trust in good faith because exculpatory clauses in trust instruments do not remove breaches of trust committed in bad faith, the court examined the process of the insurance exchange and found that there was no evidence of Wachovia acting in bad faith. "Indeed, all the evidence points in the opposite direction: The insurance exchange was undertaken in good faith, and indeed Wachovia satisfied the higher standard of the Uniform Investor Act, as the district court held."

Lastly, the Frenches argued that they were entitled to know the exact size of the commission before the transactions were consummated. The court noted "that the trustee has a duty to keep the beneficiaries "reasonably informed….about other significant developments concerning the trust and its administration, particularly material information needed by beneficiaries for the protection of their interests." However, the court noted, there are no hard and fast rules to determine when a development is sufficiently "significant" to trigger the duty to notify the beneficiaries. Rather, the trustee is obligated to "exercise reasonable judgment in determining what matters have such significance." Also, noting only "important adjustments being considered in investment or other management strategies" need to be disclosed.

The court concluded that the transaction of the insurance exchange was not so significant that the bank had a duty to provide detailed information about it in advance. The exchange of one insurance policy for another that maintains the identical death benefit is not a significant adjustment in investment strategy. Regardless, Jim French specifically instructed Wachovia to look for other insurance options, and the Frenches were kept in the loop from start to finish in the analysis of the transaction. The French family lawyers worked hand in hand with Church and Schumacher over many months to evaluate the proposed exchange. The court noted "Jim French signed the application forms and was kept informed in every step of the way, and the Frenches had notice that Wachovia Insurance would earn a commission. Indeed, their lawyers negotiated before the fact for a rebate or a reduction in Wachovia's fees. The record does not support a finding of fiduciary breach based on Wachovia's failure to give the beneficiaries advance notice of the size of the commission."

COMMENT:

Frankly, the authors find it hard to believe that French did not know a commission was going to be paid on the insurance transaction. Jim French had obviously purchased other insurance policies during his lifetime and had to know that life insurance brokers do not work for free. If the commission paid on the sale was going to be a concern for him, he should have inquired about this sooner when he could have, perhaps, taken other steps. But suppose the transaction was not completed though the Wachovia Insurance Services affiliate, but through an outside independent insurance broker. UPIA would require the trustee to perform due diligence and act prudently in selecting the insurance broker and monitoring the transaction including the commissions paid. Nevertheless, the insurance replacement in this case appears to have met the goals stated for the transaction. While the transaction was clearly self-dealing by the trustee, without the conflicts of interest waiver there would have been a breach of trust; hence, it was the specific language of the trust instrument authorizing the transaction to be completed through an affiliate of Wachovia that saved Wachovia from breach of the fiduciary duty of loyalty.

Summary. There are two lessons to be learned from the *French v. Wachovia* case. First, avoid any possible conflict of interest and self-dealing, even if allowed by the trust instrument. Second, when the trustee lacks life insurance management and evaluation skills, these tasks should be delegated to a competent, skilled, independent and outside provider. If there is a third lesson from the *French v. Wachovia* case it is to try to avoid difficult clients.

***Rafert v. Meyer,*[10] the Fourth and Latest UPIA-TOLI Case and the First to Apply the UTC**

EXECUTIVE SUMMARY:

The *Rafert v. Meyer* case raised the bar, as a minimum, in states that have adopted the Uniform Trust Code and/or have common law cases with similar provisions contained within the UTC, and have not adopted exculpation statutes for unfunded ILITs, meaning that terms of a trust cannot prevail, restrict or eliminate the duty of the trustee to act in good faith and in accordance with the terms and purposes of the trust and the interest of the beneficiaries. This, undoubtedly, includes the duty to monitor and manage trust assets and to keep qualified trust beneficiaries reasonably informed concerning trust administration and material facts necessary for them to protect their interests. Additionally, it confirms that an exculpatory term drafted or caused to be drafted by the trustee is invalid unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor. The case also raises the issues of oversight liability for the ILIT drafting attorney when that attorney remains involved either as trustee or in trust administrative functions.

FACTS:

Jlee Rafert directed attorney Robert J. Meyer to prepare and draft an irrevocable trust that named Meyer as trustee of the trust. The corpus of the trust consisted of three life insurance policies insuring Rafert totaling $8.5 million in face amount. The life insurance policies were payable on Rafert's death to the trustee for the benefit of Rafert's four daughters. Article II of the trust instrument provided:

> The Trustee shall be under no obligation to pay the premiums which may become due and payable under the provisions of such policy of insurance, or to make certain that such premiums are paid by the Grantor or others, or to notify any persons on noon-payment [sic] of such premiums, and the Trustee shall be under no responsibility or liability of any kind in the event such premiums are not paid as required…..

Furthermore, Article IV of the trust instrument provided:

> … The Trustee shall not be required to make or file an inventory or accounting to any Court, or to give bond, but the Trustee shall, at least annually furnish to each beneficiary a statement showing property then held by the Trustee and the receipts and disbursements made.

The case facts specifically mentioned that "Meyer did not meet with Rafert to explain the provisions of the trust or who would be responsible for monitoring the insurance policies owned by the trust." Rafert executed the trust on March 19, 2009 and the trustee subsequently signed three applications for life insurance that named Rafert as the insured and the trust as the owner of the policies. In each of the applications, Meyer gave the insurers a false address in South Dakota for Meyer as trustee. Since the creation of the trust, Meyer was a resident of Falls City, Nebraska,[11] and never received mail at the South Dakota address. No reason in the facts of the case is disclosed or given for the South Dakota address. In 2009, Rafert paid initial premiums on the policies totaling $262,006. No mention in the case facts about Crummey withdrawal provisions or rights in the trust but the case facts imply that Ms. Rafert paid the premiums directly to the insurers as opposed to contributing the money to the trust for the trust to pay premiums on the policies.

In 2010 the policies lapsed for nonpayment of premiums due. TransAmerica, one of the insurers, sent notices in 2010 to Meyer at the false address in South Dakota of premiums due and a subsequent notice that the policies were in danger of lapsing. TransAmerica sent a final notice and letter to Meyer in November 2010 stating that the policy had lapsed effective August 11, 2010, but that the policy allowed for reinstatement. Similarly, Lincoln Benefit, another one of the three insurers, sent a notice to Meyer at the South Dakota address that a premium was due on May 26, 2010 and a subsequent letter that the policy was in its grace period and was in danger of lapsing. On February 23, 2011, a final notice was sent to Meyer stating that the grace period had expired but that the policy could be reinstated. The Raferts – Jlee Rafert and her four daughters who were beneficiaries of the trust – assert that Lincoln National, the third of the three insurers, would have sent similar notices to the false address.

Jlee Rafert, her four daughters and Meyer did not receive notice of the policy lapses from the insurers until August 2012. How they actually received notice at that time is unclear and not stated in the case facts. At that time, Jlee Rafert paid $252,841 for premiums by issuing checks to the corporation owned by the insurance agent. However, the premiums were never forwarded to the insurers by either the agent or his corporation.

Jlee Rafert and her four daughters sued Meyer for breach of his duties as the trustee and for damages that occurred as a result of the breach. They alleged that Meyer breached his fiduciary duties as trustee, and that as a direct and a proximate result of the breach of Meyer's duties, the policies lapsed, resulting in the loss of the initial premiums. Furthermore, the Rafert daughters, as qualified beneficiaries, had an immediate interest in the premiums paid by Rafert. As a result of Meyer's providing the insurers with a false address, the grantor and beneficiaries did not receive notices of the lapses of the three policies until August 2012.

Meyer responded by moving to dismiss the Raferts' complaint "asserting that he did not cause the nonpayment of the premiums, that he had no notice from the insurers of nonpayment, and that his failure to submit annual reports to the beneficiaries had no causal connection to the damages claimed, because the lapses had occurred after his report would have been submitted." The district court dismissed the complaint with prejudice, finding that pursuant to the terms of the trust, Meyer did not have a duty to pay the premiums or to notify anyone on the nonpayment of the premiums; nor, did he have any responsibility for the failure to pay the premiums. The lower court concluded the pleadings failed to allege how Meyer's actions had caused the policy lapses.

The Raferts appealed stating the district court erred in granting Meyer's motion to dismiss their complaint. They claimed the court erred in concluding that the Raferts had not stated a plausible claim that Meyer had breached his mandatory duties as trustee under the Nebraska Uniform Trust Code (Code) to act in good faith and in the interest of the beneficiaries. Furthermore, they claimed the court erred in finding that the Rafert Appellants did not state a plausible claim that Meyer breached his mandatory duty to keep the qualified beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests.

Nebraska Supreme Court Opinion and Analysis. The Nebraska Supreme Court reversed the decision of the district court, which dismissed the Appellant's complaint against Trustee Meyer, and remanded the case for further proceedings back to the lower district court consistent with the Supreme Court opinion. Justice Wright cited various provisions of the Nebraska Uniform Trust Code (Code) and Nebraska court cases in his analysis. Among the summary findings of the pertinent court cases and relevant sections of the Code cited are the following:

> As a general rule, the authority of a trustee is governed not only by the trust instrument but also by statutes and common-law rules pertaining to trusts and trustees. [*Wahrman v. Wahrman*, 243 Neb. 673, 502 N.W.2d 95 (1993).] A trustee has a duty to fully inform the beneficiary of all material facts so that the beneficiary can protect his or her own interests where necessary. [*Karpf v. Karpf*, 240 Neb. 302, 481 N.W.2d 891 (1992).] "[A] trustee owes beneficiaries of a trust his undivided loyalty and good faith, and all his acts as such trustee must be in the interest of the [beneficiary] and no one else." [Id. At 311, 481 N.W.2d at 897.] Every violation by a trustee of a duty required of him by law, whether willful and fraudulent or done through negligence, or arising through

mere oversight or forgetfulness, is a breach of trust. [*Johnson v. Richards*, 155 Neb. 552, 52 N.W.2d 537 (1952).] A violation by a trustee of a duty required by law, whether willful, fraudulent, or resulting from neglect, is a breach of trust, and the trustee is liable for any damages proximately caused by the breach. [*Trieweiler v. Sears*, 268 Neb. 952, 689 N.W.2d 807 (2004).] It is generally held that an exculpatory clause will not excuse the trustee from liability for acts performed in bad faith or gross negligence. [George Gleason Bogert & George Taylor Bogert, The Law of Trusts and Trustees § 542 (2d rev. ed. 1993).]

Code Section 30-3805 (UTC 105) (Reissue 2008) Default and mandatory rules.

> (a) Except as otherwise provided in the terms of the trust, the … Code governs the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary.
>
> (b) The terms of the trust prevail over any provisions of the [C]ode except:
>
> ………
>
> (2) the duty of the trustee to act in good faith and in accordance with the terms and purposes of the trust and the interest of the beneficiaries;
>
> ……..
>
> (8) the duty under subsection (a) of section 30-3878 to keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests, and to respond to the request of a qualified beneficiary of an irrevocable trust for … information reasonably related to the administration of a trust; [and]
>
> (9) the effect of an exculpatory term under section 30-3897.
>
> ……

Code Section 30-3866 (UTC 801) (Reissue 2008) Duty to administer trust.

> Upon acceptance of a trusteeship, the trustee shall administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries, and in accordance with the … Code.

Code Section 30-3878 (UTC 813) (Reissue 2008) Duties to inform and report.

> (a) A trustee shall keep the qualified beneficiaries of a trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. ……
>
> …….

Code Section 30-3897 (UTC 1008) (Reissue 2008) Exculpation of a trustee.

> (a) A term of trust relieving a trustee of liability for breach of

> trust is unenforceable to the extent that it:
>
> > (1) Relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or
> >
> > (2) was inserted as the result of an abuse by the trustee for a fiduciary or confidential relationship to the settlor.
>
> (b) An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.

The Raferts alleged that Meyer breached his duties as trustee by providing a false address to the insurers, failing to keep the Appellants informed of the facts necessary to protect their interests, failing to furnish annual statements, failing to communicate the terms of the trust to Jlee Rafert, and failing to act in good faith and in accordance with the terms and purposes of the trust and in the interests of the beneficiaries.

Meyer contended that his duties were limited by Articles II and IV of the trust and that providing a false address to the insurers and failing to furnish annual reports did not cause the premiums not to be paid. Meyer claimed that he had no obligation as trustee to monitor or notify any person of the nonpayment of premiums and that the district court correctly relied upon the language of Article II in dismissing the Appellants' action.

The Supreme Court disagreed. It noted that the Code provides deference to the terms of the trust, but this deference does not extend to all the trustee's duties, and those duties to which the Code does not defer are described above in Section 30-3805. Furthermore, the court noted that in drafting the trust Meyer could not abrogate his duty under Section 30-3805 to keep Appellants reasonably informed of the material facts necessary for them to protect their interests.

The court observed that notice of nonpayment of the premiums would have profoundly affected Appellants' actions to protect the policies from lapsing. Notice that the policies had lapsed would have affected the subsequent payment by Jlee Rafert as settlor to the insurance agent. Meyer admittedly provided a false address on each of the insurance applications. This had the obvious result that the insurers' notice regarding premiums due would not reach any of the parties. Despite this fact, Meyer took the position that Article II limited his liability for any claims related to the nonpayment of premiums. Further, Meyer went on to suggest that he did not have the duty to inform Appellants even if he had received notices of the nonpayment of premiums.

The court succinctly stated:

> Such a position is clearly untenable and challenges the most basic understanding of a trustee's duty to act for the benefit of the beneficiaries under the trust. Perhaps the most fundamental aspect of acting for the benefit of the beneficiaries is protecting the trust property. Article II cannot be relied upon to abrogate Meyer's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Citing Code Section 30-3897(a) the court stated its conclusion remained the same whether Article II of the trust was treated as an exculpatory clause or as a term limiting Meyer's duties of liabilities. Meyer acted in bad faith and reckless indifference to the purpose of the trust or the interests of the beneficiaries by providing a false address to the insurers.

The court observed and mentioned:

> This is not a situation where a gratuitous trustee, who had no involvement in the drafting of the trust or the administration of the insurance policy, undertook only to distribute insurance proceeds after the insured's death. The trustee's duties must be viewed in the light of the trustee's alleged involvement in these matters. If there was none, the result might be different.

Noting the alleged facts of the case by the Appellants that Meyer drafted the trust agreement but never met with Rafert or explained the terms of the trust and the respective duties of each party and citing Code Section 30-3897(b), the court concluded that if Article II of the trust is an exculpatory clause, it was invalid because Meyer failed to adequately communicate its nature and effect to Rafert.

The court then considered Meyer's duty to furnish annual reports to the beneficiaries. Although Meyer argued that the lapse of the policies occurred before the time such reports were due, the court stated that annual reporting was a minimum requirement in the ordinary administration of the trust. "A reasonable person acting in good faith and in the interests of the beneficiaries would not wait until such annual report was due before informing the beneficiaries that the trust assets were in danger of being lost. Meyer's duty to report the danger to the trust property became immediate *when the insurers issued notices of nonpayment of the premiums*." Citing Code Section 30-3805(b)(8) the court stated "[a]s trustee, Meyer had a statutory duty 'to keep the qualified beneficiaries of the trust reasonably informed … of the material facts necessary for them to protect their interests.'" The court then noted "[h]ere, again, according to the allegations, Meyer was not an otherwise uninvolved and gratuitous trustee."

Finally, the court noted that Meyer's action prevented the Raferts from knowing the premiums had not been paid, and it was reasonable to infer that Meyer's actions prevented the Appellants from acting to protect their interests. It can reasonably be inferred that a false address given to the insurers caused the notices of the defaults in payments not to reach the Raferts, and, it was reasonable to infer that had they known of the lapses they would have taken the necessary action to protect their interests. The court then reiterated that Meyer had a statutory duty to inform Appellants of the material facts necessary for them to protect their interests, and, the duty arose when the insurers issued the notices of nonpayment of the premiums.

COMMENT:

The first observation that one can gleam from this case is that the Uniform Trust Code (UTC) trumps the Uniform Prudent Investor Act (UPIA) Section 1(b). UPIA Section 1(b) – or the Nebraska Uniform Trust Code equivalent Section 30-3883 – states "[t]he prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust, a trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust." However in states like Nebraska that have either adopted the Uniform Trust Code (UTC)[12] and/or have common law cases with similar affects to provisions contained within the UTC, and have not adopted exculpation statutes[13] for unfunded ILITs, there are certain trustee duties that cannot be restricted or eliminated by the provisions of the trust.

Among the duties that cannot be restricted or eliminated by the terms of the trust are "the duty to act in good faith and in accordance with the terms and purposes of the trust and the interest of the beneficiaries;" [UTC Section 105(b)(2) and Nebraska UTC Section 30-3805(b)(2)]; and, that "[a] trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests" [UTC Section 813(a) and Nebraska UTC Section 30-3878(a)].

Furthermore, "[a] term of trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it: (1) relieves a trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interest of beneficiaries;" and, "[a]n exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor." [UTC Section 1008 and Nebraska UTC Section 30-3897.]

The purpose of an unfunded ILIT prior to the death of the settlor, or the settlor and the settlor's spouse, is to maintain a life insurance policy, or policies, on the life of the settlor or the life of the settlor and the settlor's spouse. Thus, a trustee acting in good faith and in accordance with the terms and purposes of the trust and the interest of the beneficiaries would, clearly, have a duty to monitor and manage the life insurance policy or polices which are the only asset(s) of the trust. Furthermore, UPIA Section 2, or Nebraska UTC Section 30-3884, requires a trustee to "invest and manage trust assets as a prudent investor would," and, "as a part of an overall investment strategy." In the opinion of the authors, how can an ILIT trustee have an overall investment strategy that is "dispute defensible" without some type of written plan such as a trust-owned life insurance investment policy statement?

The "prudent investor" standard is a relative term. Thus, a professional trustee's prudent standard would be compared to other professional trustees, and, an amateur, or accommodation trustee, prudence would be compared to other amateur trustees. Justice Wright in *Rafert v. Meyer* made it clear that attorney Meyer was not a "gratuitous trustee" and thus Meyer was being held to a higher standard. While Justice Wright described a gratuitous trustee as one "who had no involvement in the drafting of the trust or the administration of the policy, undertook only to distribute insurance proceeds after the insured's death," and, stated "[t]he trustee's duties must be viewed in the light of the trustee's alleged involvement in these matters," noting "[i]f there was none, the result might be different," it is left thoroughly unanswered how the results might have been different in the case if a gratuitous, amateur or accommodation trustee who had not drafted, nor had any part in drafting, the trust instrument.[14]

While the case addresses Meyer's role as a drafting attorney of an ILIT who serves as trustee performing administrative functions, it did not explicitly address the issue of liability of an attorney who drafts the ILIT and remains involved by performing trust administration services, direction and oversight to the amateur, accommodation trustee named in the trust instrument. However, the Supreme Court of Nebraska opinion clearly implies that a drafting attorney, who provides various trust administrative services beyond the pure drafting of the trust, will become responsible for these oversights and held liable for properly informing the amateur trustee of his or her duties and how these duties should be performed.

Regarding UTC Section 1008(b) and Nebraska UTC Section 30-3897(b) which provides "[a]n exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor" begs the questions as to what is fair under the circumstances. The comment to UTC Section 1008 Subsection (b) states that: "[in] determining whether the clause was fair, the court may wish to examine: (1) the extent of the prior relationship between the settlor and trustee; (2) whether the settlor received independent advice; (3) the sophistication of the settlor with respect to business and fiduciary matters; (4) the trustee's reasons for inserting the clause; and, (5) the scope of the particular provision inserted."

Meyer never discussed or explained Article II of the trust to Jlee Rafert but how would the case have turned out if he did? Would the exculpatory Article II clause have been fair in the circumstances? Given that the court stated its conclusion remained the same whether Article II of the trust was treated as an exculpatory clause or as a term limiting Meyer's duties of liabilities, one could possibly infer that Meyer would have abrogated his duties to act in good faith and in accordance with the terms and purposes and the interests of the beneficiaries. Thus, Article II would not be fair under the circumstances. The broader question is how can any trust term or clause that restricts the duty of a trustee of an ILIT to monitor and manage the trust's life insurance policy or policies be fair?

The court held Meyer to a high standard in determining that he acted in bad faith and reckless indifference to the terms and purposes of the trust by failure to notify the beneficiaries of the trust of the premiums due on the policy. On the other hand, one wonders how Jlee Rafert could not have known that further premiums would have been required on the polices owned by the trust on her life. Furthermore, while Meyer negligently gave a false address to the insurers, the insurance agent who took the applications had to have met with Jlee Rafert and Meyer and would have known both of their Nebraska addresses and phone numbers. As agent-of-record on the policies, he would have received notices of premium nonpayments and pending policy lapses. It is puzzling that the agent did not contact Rafert or Meyer in Nebraska.

Unlike the higher standard of duties to beneficiaries which was applied to Meyer, the duties of an insurance agent or broker are limited to using reasonable care, diligence, skill, good faith and judgment in procuring the insurance requested.[15] In the June 25, 2014 decision of the Court of Special Appeals of Maryland in *UBS Financial Services, Inc. v. Thompson*,[16] the court essentially concluded that an insurance agent or broker has no post-sales duties to the policy owner, stating "… either Mr. Witherspoon [the broker] or UBS [the insurance brokerage corporation] had a duty to inform appellees that the premiums were not being paid. On the contrary, the circumstances indicate that the ultimate responsibility to pay the premiums on the life insurance policy rested on the parents and appellees, as owners of the policy."[17]

It is interesting to note that the facts of the case in the opinion mentioned that "Meyer did not meet with Rafert to explain the provisions of the trust or who would be responsible for monitoring the insurance policies owned by the trust." While the court certainly commented on the necessity to communicate the exculpatory provisions, the court may have indirectly addressed the question of "who would be responsible for monitoring the insurance policies" by stating that "the most basic understanding of a trustee's duty [is] to act for the benefit of the beneficiaries under the trust." The court continued by saying "[p]erhaps the most fundamental aspect of acting for the benefit of the beneficiaries is protecting the trust property." Obviously, to protect the trust property, the trustee needs to monitor and manage the trust property.

The facts of the case noted that Jlee Rafert paid premiums to the corporation owned by the insurance agent of $252,841 sometime in August 2012, or shortly thereafter, to reinstate the policies. However, reinstatement of life insurance policies requires more than just the payment of premiums, and sometimes interest. Evidence of insurability must also be furnished in order to reinstate life insurance policies. Also, there is generally a time limit from the time of lapse to reinstate a life insurance policy, usually three years, and if the policies lapsed in 2010 the reinstatements could have been accomplished in 2012 with the payment of the premiums and the providing of evidence of insurability. Again, what happened to the life insurance agent and why had he not contacted Jlee Rafert and Meyer about the need to provide evidence of insurability?

Finally, the court remanded the case back to the lower court for proceeding consistent with the Supreme Court decision. Essentially this means to assess the damages from Meyer's breach of his fiduciary duties to the beneficiaries of the trust by his actions, or lack of his actions, as trustee of the trust. The Appellants claimed that as a direct and that as a proximate result of Meyer's breach of fiduciary duties the policies lapsed, resulting in the loss of the initial premium. However, the bulk of the first year premiums paid into a life insurance policy go toward the heavy first year policy expenses, including commissions and other marketing and underwriting costs. There is, generally, no cash surrender value in the first policy year. If the policy could be reinstated there would be no loss in the initial premiums and the first year expenses absorbed by the first year premiums. Meyer had no duty to pay the premiums on the policies. His only duty was to keep the beneficiaries informed of the status of the policies, which he failed to do.

As grantor of the trust Jlee Rafert would have paid the premiums on the policies, either to the insurance company directly or by gifting the premiums to the trust. So if the policies could have been reinstated, the only direct damage would have been interest on lost policy earnings for the policies. If Jlee Rafert could not reinstate the policies but was insurable, then it would seem the damages would be the costs associated with taking out new policies at an older age and the lost policy values that would have accrued if the policies did not lapse. If, on the other hand, Jlee Rafert was uninsurable, the damages from the breach of fiduciary duties would be substantially higher than if she had been insurable, possibly as high as the total face amount of the lapsed policies. Of course, there could be other damages accessed, including punitive damages, other than the direct loss resulting from the lapse of the policies.

Summary. The *Rafert v. Meyer* case raised the bar, at least in states that have adopted the Uniform Trust Code and/or have common law cases with similar affects to provisions contained within the UTC, and have not adopted exculpation statutes for unfunded ILITs, in that terms of a trust cannot prevail, restrict or eliminate the duty of the trustee to act in good faith and in accordance with the terms and purposes of the trust and the interest of the beneficiaries. This, undoubtedly, includes the duty to monitor and manage the assets of the trust and to keep qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Additionally, it confirms that an exculpatory term drafted or caused to be drafted by the trustee is invalid unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor. The case also raises the issues of oversight liability for the ILIT drafting attorney when that attorney remains involved either as trustee or in trust administrative functions.

Conclusion

There are now four cases involving UPIA and TOLI each of which gives us guidelines regarding administration of ILITs. There will, undoubtedly, be more cases in the future which will provide us with further refinements in the drafting, duties of trustees, administration and operation of ILITs and TOLI.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Gary Flotron

Randy Whitelaw

CITE AS:

CITATIONS:

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[1] W. Charles Paradee, III v. Eleanor Clement Paradee et al., No, CA NO.4988-VCL (In the Court of Chancery of the State of Delaware, October 5, 2010).

[2] While not mentioned in the case facts, this appears to be a split-gift transaction. Whether it was to take advantage of two annual exclusions because of Crummey withdrawal rights, because of previously split-gifts for the year, or, to reduce and preserve remaining applicable gift tax exclusion amounts and generation skipping transfer tax exemptions for Charles, Sr. and Eleanor is, again, not disclosed in the case facts. Note, also, that the Gallo exemption was $2,000,000 per person.

[3] Interestingly, the attorney who had originally drafted the trust, and who was first consulted by Sterling and Eleanor, was asked by Sterling to document the trust loan. The attorney had one of her law partners take care of it.

[4] Full disclosure, one of the authors personally knows – although not well - the attorney and family accountant mentioned in the case. While a little shocked at their behavior in this case, since both are extremely knowledgeable and experienced professionals, it should be noted that in the early years of 2000 the attorney's spouse, who was also her partner in a small law firm at the time, came down with terminable cancer. Thus, the attorney was spending considerable time as care taker for the spouse during these years.

[5] French v. Wachovia Bank, N.A., 2011 U.S. Dist. LEXIS 72808 (E.D. Wisconsin 2011), 2013 U.S. App. LEXIS 14399.

[6] Apologies to **Keith Schiller** who has written a number of excellent commentaries for **LISI** with the theme of demonstrating legal and estate planning lessons derived from the movies and titled "Estate Planning at the Movies."

[7] It is unclear from the facts of the case whether or not the Prudential Insurance Company policy was really a whole life policy as described in the

case. Whole life policies, generally, have guaranteed level premiums that do not increase. The facts of the case indicated that "[t]o maintain the policy the trust had to pay increasingly steep premiums." If the policy was a whole life policy, the policy was probably a blended policy with a combination of a base whole life policy, with a face amount smaller than $5 million, with dividends applied to purchase term insurance to equal the total face amount of $5 million, less the base whole life face amount and less the amount of paid-up additional insurance from dividends, with the balance of any dividends used to purchase paid-up additions. Although not specifically stated in the case facts, it is implied that at the time French's wife was deceased; thus making her the first-to-die of the insureds in the second-to-die policy. The issued date of the policy is not specified in the case facts. But assuming the policy was issued at the time of the creation of the trust, or shortly thereafter, the policy would be 12 to 13 years old. The issue age for French and his wife were also not specified. More than likely, the dividend scale used in the original illustration for the policy did not hold up, making the dividends in the later years insufficient to purchase the required amount of term insurance to maintain the total $5 million death benefit, thus, requiring the steeply increasing premium contributions.

John Bannen, an attorney with Quarles & Brady with particular expertise in life insurance, in his analysis of the Prudential policy described the policy as "volatile," which is a term more commonly used to describe variable universal life insurance policies.

[8] The 1035 exchange of the second-to-die Prudential policy to a single life John Hancock policy is permissible as a tax-free exchange because Mr. French was the surviving life on the second-to-die policy. See Private Letter Rulings 9248013 and 9330040.

[9] Wachovia Bank served as trustee though 2007 when the French family moved the trusts to M & I.

[10] *Rafert v. Meyer*, N.W.2d, 209, 2015 WL 832590 (Neb. Feb. 27, 2015).

[11] Falls City, Nebraska is located near the southeast corner of Nebraska not far from the southern border with Kansas and close to the border with Missouri. South Dakota is located above the northern border of Nebraska.

[12] According to the Uniform Law Commission of The National Conference of Commissioners on Uniform State Laws, Legislative Fact Sheet – Trust Code, as of June 22, 2015, 30 states and the District of Columbia have enacted the Uniform Trust Code (UTC) either in whole or modified. The 30 states are Alabama, Arizona, Arkansas, Florida, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming.

[13] 14 states have enacted statutes exculpating trustees of irrevocable life insurance trusts (ILITs). These statues either limit the liability for management of life insurance policies and/or waive the duty of diversification. These statutes may be limited to life insurance only on the grantor, the grantor or the grantor's spouse as joint insureds, or both policies on the grantor or the grantor's spouse. The implication is that the statutes only apply to unfunded ILITs or ILITs that received premium contributions for the insurance policies as gifts to the trust. The 14 states are Alabama, Arizona, Delaware, Florida, Maryland, North Carolina, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia and Wyoming. All of these states with the exception of Delaware and South Dakota have adopted the Uniform Trust Code. West Virginia had adopted an exculpatory statue for ILITs but repealed the statute in 2011. See Trent S. Kiziah, "Statutory Exculpation of Trustees

Holding Life Insurance Policies," 47 Real Property, Trust and Estate Law Journal, Fall 2012, pages 327–365.

[14] It should be pointed out that while the issue in *Rafert v. Meyer* revolved around the trustee acting in bad faith and reckless indifference to the terms and purposes of the trust by failing to monitor payments due on the life insurance policies, UPIA Section 9, UTC Section 807 and Nebraska UTC Sections 30-3872 and 30-3888, provide for the prudent delegation of trustee functions by the trustee of a trust that a prudent trustee of comparable skills could properly delegate under the circumstances. Thus, matters that require life insurance expertise can be delegated to qualified individuals as was done in *French v. Wachovia* and *Cochran v. KeyBank*.

[15] See *Mark Tanner Constr., Inc. v. HUB Int'l Ins. Services, Inc.*, 224 Cal. App. 4th 574, 584 (2014), and, *Indiana Restorative Dentistry, P.C. v. Leaven Ins. Agency, Inc.*, 999 N.E.2d 922, 933 (Ind. 2013), as reference in *USB Financial Services, Inc., Et Al v. Nancy Lee Kathryn Thompson, Et Al*, No. 0352, September Term, 2013, Court of Special Appeals of Maryland (June 25, 2014).

[16] *UBS Financial Services, Inc., Et Al v. Nancy Lee Kathryn Thompson, Et Al*, No. 0352, September Term, 2013, Court of Special Appeals of Maryland (June 25, 2014).

[17] Id., page 13.

0 Comments Posted re. *Gary Flotron and Randy Whitelaw: A Comprehensive Perspective on the Four UPIA-TOLI Cases, Plus One That Includes the UTC, and Their Astounding Implications for ILIT Trustees, Part 2 of 2*

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Equity Indexed Universal Life Insurance—A Call to Action

E. Randolph Whitelaw, AEP (Distinguished) and
Charles M. "Mark" Whitelaw

"Serious problems cannot be dealt with at the level of thinking that created them."
—Albert Einstein

For those of us with dispute resolution, expert witness litigation support, and life insurance product suitability analysis consulting practices, Equity Indexed Universal Life Insurance (EIUL) has been a gift, albeit an unexpected and disappointing gift. Despite all the efforts that have been made over the past 30 years to eliminate "win the illustration beauty contest marketing," EIUL takes illustration abuse to new and unnecessary heights that continue to expose sales agents to reputation and litigation risks.[1]

EIUL is a very attractive flexible premium nonguaranteed death benefit product that is ideally suited for investment-motivated business, estate, and wealth management planning. EIUL has become the next generation life insurance product of choice. In the first quarter of 2014 EIUL represented 39% of Universal Life sales (LIMRA). It allows the consumer to select from a menu of equity and fixed income indices for policy crediting purposes with no down market risk exposure. It allows a licensed life insurance sales agent to sell an equity-based product without securities licensing. It allows the issuing carrier to change policy crediting features at a future date. It is ideally suited for premium finance programs because the advance rate (i.e. margin) against the policy cash accumulation account is 90% or higher versus 50% against securities. Given its design, EIUL illustrates very attractively at a time when crediting rates for universal life policies are at either a 30-year low point or the policy's guaranteed minimum.

Why suggest the need for a call to action? Given EIUL's design, what is the need to play the beauty contest game with this product? If the prospective purchaser (often an ILIT trustee who lacks life insurance product expertise) engages an unbiased fee-based advisor for a second opinion concerning the agent-illustrated outcomes, the questionable and unsupportable assumptions will be identified as discussed in this article. Is this second opinion likely? Yes, increasingly so, articles caution consumers that there is a high probability EIUL sales proposals have been based upon unrealistic crediting rates. Additionally, the National Association of Insurance Commissioners (NAIC) is in the process of adopting comprehensive new rules governing the illustrations to be used in selling EIUL,[2] and EIUL sales practices are under investigation by

New York State Financial Services Superintendent Benjamin Lawsky. Recognizing that a sales agent is held to a fiduciary standard, or a suitability standard at the least, why would a sales agent knowingly expose himself or herself to reputation and, possibly, litigation risk? And, if an EIUL policy has already been issued with questionable assumptions, would it not be more prudent to reillustrate an in-force policy using credible assumptions and document client communication in a dispute-defensible manner?

Let's remember that illustration credibility for flexible premium nonguaranteed death benefit products has plagued the life insurance industry for 30 years, undermined the perceived professionalism of the traditional retail distribution channel, and generated unnecessary disputes and litigation. This article does not question the very attractive design of this product. Rather, it emphasizes the need to credibly identify, communicate, and manage its risks.

As a practical matter and despite all the illustration and policy contract predictive value and policy comparison disclaimers, the "as sold" illustration remains the only numbers-oriented material provided by the sales agent to communicate that, over time, policy values should successfully achieve the buyer's planning needs. However, credible policy evaluation options do exist[3] and they should be considered by agents as part of the call to action to avoid allegations of questionable, if not predatory,[4] practices.

What to expect in this article? This article reviews EIUL's pricing, crediting, allocation, and agent disclosure issues. Further, it reviews logical investment questions utilizing traditional investment analytics and FINRA (Financial Industry Regulatory Authority) methodologies for "hypothetical illustrations of mathematical principles."

This article intentionally frames the call to action needed from a dispute resolution and litigation perspective. Every life insurance licensed sales agent reading this article should consider a "what if" scenario—if you are a party to a dispute or FINRA arbitration, how do you explain the reasonableness of the "as sold" illustration assumptions and policy contract features that allow the issuing carrier to change the policy crediting rate calculation in the future? And, how do you respond to the obvious follow-up question: What is the basis for your determination that this policy is suitable for your client's needs and serves the client's best interests?

From a fiduciary standard perspective, inattention to fiduciary issues, such as the Duties to Disclose (how the product actually works and its risk that need to be managed) and to Delegate (how the policy can be credibly designed and risk managed), is a choice. The tools are available to do the right thing in the right way in order to minimize reputation and litigation risks. By analogy, the misleading illustrations cat is out of the bag. In-force EIUL should be reillustrated at a 4.5% to 5% crediting rate assumption unless a compelling argument can be made by an investment advisor, preferably the client's investment advisor, for use of a higher crediting rate assumption.[5] Call to action client communication is a choice or, given the NAIC and New York State Financial Services efforts, is it?

The EIUL Story

Approximately twenty years ago, attending an affluent markets study group meeting, we were introduced to Equity Indexed Universal Life (EIUL) as an alternative to Variable Universal Life (VUL) for the premium finance ILIT (Irrevocable Life Insurance Trust) marketplace.

The carrier-marketed benefit was three-fold:

- EIUL can be marketed by any life insurance licensed agent whereas VUL requires Series 6 securities licensing.
- EIUL is a declared interest rate life insurance product with a crediting rate informally tied to the S&P 500 index.
- EIUL is not subject to the 50% maximum loan to equity limitation per Regulation U (12 CFR 221.7) and, hence, allows for a significantly more favorable loan-to-policy cash value advance rate.

It was stressed that this new EIUL product was not intended to be a market-linked substitute to Variable Universal Life (VUL) if the consumer's objective is investment-motivated and the policy is not premium financed. The rationale given was: (1) an investment-motivated consumer is better served with access to 60-100 VUL fund allocation opportunities, and (2) EIUL 0% return floor does not offset the caps on positive returns and loss of Total Return participation (dividends and interest reinvested). Given this background, since the 2008-2009 financial markets crisis, EIUL has been aggressively marketed to consumers as a "no downside risk" market-driven life insurance alternative that is suitable for all financial planning and investment needs.

EIUL is one of the most, if not the most, complicated life insurance products for licensed life insurance sales agents and consumers to understand, and possibly investment advisors. Further, it requires attentive annual policy performance monitoring and risk management, but these services are not provided by either the issuing carrier or its contracted sales agent. As a result, the purchaser:

(1) assumes performance risk for risks that may not be understood and may not be explainable by the sales agent,
(2) is unaware of the policy evaluation capabilities needed to monitor annual policy performance, and
(3) is unaware or uncertain of the negative policy value implications of carrier changes to the crediting process.

Couple the missing management function with this product's complexity, and you have a recipe for questionable and misleading sales practices warranting investigation.

EIUL Basics

Equity Indexed Universal Life is a declared interest rate policy, with the crediting rate informally tied to one or more market indices such as S&P 500, Heng Seng, EURO STOXX 50, etc. Like all other forms of universal life products, EIUL employs a "buy term and invest the rest" design with monthly risk charges based on the insured's age, sex, and risk class, and net-amount-at-risk (policy death benefit minus cash value).

Unlike all other Universal Life product forms, EIUL interest crediting is based on a look-back period, typically one to five years. The cash value account earns 0% or 1% until the end of the look-back period at which time the look-back crediting is based on the selected market indices, but not less than 0%. Said simplistically, if the selected market indices go up, the policy owner participates in the gains. And, if the selected market indices go down, the policy owner does not participate in losses.

But that's where the simplicity ends. For example, consider these confusing features and options:

- Fixed Strategy—an annually declared interest rate like traditional Universal Life.
- Crediting methodologies are based on the point-to-point movement of the index, not the Total Return with dividends reinvested.
- Crediting methodologies may incorporate:

- Thresholds—Policy is credited with 100% of the excess over a 5%-6% minimum.
- Caps—100% participation up to a maximum of 12%-14%.
- Participation rates—60%-80% participation with no maximum.
- Proportional crediting between multiple indices—Participation methodology taking the two best performing indices of three.

- Policy owner asset allocation between Fixed and Indexed methodologies.
- Each premium typically creates a new crediting block. If a policy premium is paid monthly utilizing 5-year methodologies, a maximum of 60 blocks are in play at any time.
- These are "use it or lose it" crediting blocks. If the policy owner needs to access cash values via surrender, withdrawal or loan, then the potential accrued Index crediting is forfeited.

No other product type has this level of sophistication or "crystal ball" investment and cash management decision making.

Agent Disclosure Considerations

Since EIUL is a "declared interest" product, the agent does not have to be securities-licensed because the policy owner is not investing in an index as is the case with a variable universal life policy. When the agent is not securities-licensed and the consumer is investment-motivated, three "buyer beware" issues should be considered by the consumer. The agent:

- Cannot address the consumer's needs because he/she does not have access to a full array of investment-linked life insurance products.
- Cannot address the consumer's questions comparing indexed look-back methodologies and historical market performance, index fund Total Returns, etc.
- Is not governed by FINRA (Financial Industry Regulatory Association) regulations regarding communication, conduct, hypothetical illustrations, and comparative analysis.

And, because the product is designed for distribution by nonsecurities licensed agents, the issuer's disclosure materials are prohibited from providing the investment-motivated consumer with this level of expected disclosure.

A reality check is needed—is this scenario simply a "politically correct" way to deceive the consumer? The nonsecurities licensed agent can promote the 0% floor but is prohibited by states from discussing market performance, Total Return, the relationship between EIUL calculated rates and Total Return in an S&P 500 index fund or asset allocation alternatives. Hence, nonsecurities licensed agents are prohibited from disclosing or addressing common sense consumer questions.

Market Returns vs. Policy Crediting Rates

EIUL illustrations commonly use a 25- to 35-year look-back analysis as the methodology to calculate the illustrated policy crediting rate (and by implication answer the consumer's question—"what if the policy had been available the past 25 years?")

This calculated rate warrants three consumer questions:

- How did the S&P 500 index fund in my 401(k) compare to the EIUL rate?
- How did the return of other asset allocation strategies compare to the Indexed methodology?
- If I am assuming a 7% S&P 500 Total

Return for my long-term financial planning, what is the appropriate interest rate that should be used in this EIUL illustration?

These questions simply consider risk and return. The consumer is being asked to accept the underlying volatility/standard deviation of the S&P 500. The indexed strategy merely limits the severity of the volatility—good and bad. Said differently, is the downside protection worth the potential loss of gains?

To respond to these "common sense" consumer questions, consider the performance of an EIUL policy assuming a S&P 500 methodology, a 0% floor, 12% cap and a 25-year look-back period through 12/31/2014 to other options in Table 1.

- The 10.98% S&P 500 Index Fund return was 3.68% or 50.4% higher return than the EIUL Methodology.
- Other Allocation strategies provided comparable or greater net return than the EIUL methodology with less annual return volatility.
- The differential between the 11.25% S&P 500 Total Return and the 7.30% EIUL methodology is 3.95% or 35% less. Depending upon how the consumer wanted to factor the market return, the EIUL illustration rate should be 3.05% or 4.55% to be consistent with their other financial planning alternatives. These rates assume the consumer is using a 7% Total Return for their personal financial planning. Hence, 7.00% less the 3.95% rate differential calculates to 3.05% or 7.00% less the 35% percentage differential calculates to 4.55%.

What if the agent is also securities licensed? Even though EIUL is not a security, it is understood that registered reps must comply with FINRA conduct regulations in all transactions. Using the 7.30% EIUL illustration rate could violate FIRNA regulations. FINRA limits gross market returns in insurance illustrations and "hypothetical illustrations of financial principles" to 10.00%. This 25-year look-back shows the 7.30% EIUL interest rate is based on an 11.25% gross market return. Utilizing the two differentials previously mentioned, the maximum EIUL illustration rate from a FINRA member is 6.05% to 6.50%.

Again, a reality check is needed. Product complexity and incomplete issuer support do not provide securities licensed reps the information to properly address investment management questions and comply with FINRA regulations.

Monte Carlo Simulations—EIUL Crediting vs. S&P 500

Monte Carlo is an investment simulation that:

- Calculates a range of values based upon (1) a long-term average rate-of-return and (2) a defined standard deviation (volatility).

Table 1

S&P 500		Returns Net of Fund Fees or Indexed Methodology				
Total Return	Point-to-Point	S&P 500 Index Fund	EIUL Methodology	Conservative Allocation	Moderate Allocation	Growth Allocation
11.25%	8.90%	10.98%	7.30%	7.23%	7.78%	8.33%

- Is based on hundreds or thousands of trial simulations[6] utilizing random returns within the specified standard deviation—returns do not factor investment management practices or historical experience/trends.
- Is utilized to provide a range of (1) survival periods of specified assets and expenses or (2) future values of an asset.

As an example, we considered an individual age 45 with a life expectancy of age 87 resulting in a 42-year trial period. Table 2 shows the results of a 1,000-trial simulation using both 8% and 10% rates-of-return, a S&P 500 fund standard deviation of 12.24%, a Total Return to Point-to-Point differential of 2.52%, an Index fund fee of 0.27% and a 12% EIUL cap.

The Indexed methodology results in slightly greater downside protection in the Table 2 interest trials (Column 8 vs Column 5). The loss of dividends reinvested and caps result in the Indexed methodology having significantly lower average returns (Column 7 vs Column 4) and returns in high interest trials (Column 9 vs Column 6). The Monte Carlo simulations demonstrate that the EIUL downside risk protection does not offset the lost gains. For example, EIUL illustrated 0.39% to 1.25% (Column 8 vs Column 5) greater return in the low trials, 2.16% to 3.52% (Column 7 vs Column 4) less Average return, and 7.70% to 7.84% (Column 9 vs Column 6) less High Trial returns.

EIUL Policy Costs vs. Other UL Based Alternatives

Shifting from the investment to the policy cost side of the equation, life insurance policies have four variable pricing/cost components:

- Crediting methodologies or Separate Accounts
- Surrender Charges or Surrender Refunds
- Premium Loads and Administration Fees
- General Population or HCE (Highly Compensated Employee) Class Risk Pools

As a result, there can be significant pricing differences among products offered by the same issuer for the same risk class.

For example, consider the same issuer, a male insured age 50 with a preferred nonsmoker rating, $1 million death benefit protection, and a $56,255 annual premium. We assume an investment-motivated design that utilizes a maximum annual premium to demonstrate the related maximum potential premium load related costs-of-insurance.

As shown in Table 3, declared interest products such as universal life and equity indexed universal life have higher initial costs than variable

Table 2

1	2	3	4	5	6	7	8	9
Specified Rate-of-Return	Average Total Return	Average Point-to-Point	Index Fund Average	Index Fund Low Trial	Index Fund High Trial	EIUL Crediting Average	EIUL Low Trial	EIUL High Trial
8.00%	7.98%	5.47%	7.71%	1.60%	15.91%	5.55%	2.85%	8.07%
10.00%	10.05%	7.51%	9.78%	2.34%	16.58%	6.26%	2.73%	8.88%

products, thus providing the issuer with an added investment hedge against its investment risk, policy crediting rate, and guaranteed minimum rate.

The underlying current mortality costs in a policy are subject to change to offset these issuer investment risks. A recent example is in-force universal life—policies with 3%-4% minimum guarantees and treasury yields at 1%-2%. As a result, issuers increase the current mortality costs on in-force polices to offset the negative spread. The same type of pricing risk is inherent in EIUL products if the issuer's investment strategy does not outperform the policy Indexed methodology. And, if the issuer increases current mortality costs and the actual annual crediting rate is less than originally illustrated, then policy cash value is less than expected, meaning the risk of lapse is accelerated. Variable products are less susceptible to this risk as most consumers are utilizing the separate accounts (funds) and not the fixed account.

Ongoing "Good News" vs. "Bad News"

No one likes delivering "bad news" and EIUL policies position the agent in the awkward position of delivering more "bad news" from the consumer's perspective than "good news."

- The loss of dividends reinvested and Indexed methodologies mean the policy is delivering lower returns than the S&P Fund in all positive markets—"bad news."

Five-year indexed methodologies generate multiyear consumer uncertainty—"bad news."

- Only when the market is down can the agent deliver "good news"—the 0% floor.

Using the 25-year look-back as an example:

- 12% Cap—experienced 12 years (48% of this time period).
- 0% Floor—experienced 7 years (28% of this time period).
- Between 0% and 12%—the remaining 6 years (24% of this time period).

Only 28% of the time would an agent be confident of delivering "good news"—the 0% floor saved the customer from a negative return—and 72% of the time the client received less than the Total Return reported on their S&P 500 index fund.

However, what about the loss of dividends reinvested? In 2011, the EIUL policy would have

Table 3

Cumulative Costs of Insurance

Year	Corporate Variable Universal Life	Retail Variable Universal Life	Retail Equity Indexed Universal Life	Retail Equity Indexed Universal Life—GDB	Retail Universal Life
1	$6,460	$9,906	$12,637	$17,202	$14,505
5	33,916	54,805	55,677	75,666	44,702
10	63,722	95,232	93,096	114,095	85,324
15	100,197	141,488	130,989	142,798	131,615
20	154,994	201,370	179,708	181,032	191,563

credited 0% whereas the S&P 500 Total Return was 2.11%. So there is only 24% "good news."

This look-back also demonstrates how the underlying volatility of the S&P 500 is retained by the policyowner. This volatility pass-through results in 76% of the time the client receiving either 0% or 12%—all or nothing" relative to the 0% floor and 12% cap. By comparison, a conservative allocation during the same 25-year period generated comparable returns; however, negative returns were experienced in only three years, with positive returns experienced in twenty-two years.

Superintendent Lawsky's Key Concerns Warranting Investigation

This investigation into EIUL sales practices is questioning if EIUL illustrations are overly optimistic. Most readers would probably agree that basing life insurance illustrations on a constant rate 11.25% average market total return is optimistic.

Additionally:

- The lack of disclosure and guidance on the relationship between market total returns and EIUL methodologies has resulted in misrepresentations in the planning value of EIUL products to other financial planning instruments.
- EIUL and the 0% crediting floor have been marketed by some agents as a way to communicate "invest with no investment loss risks." While that may be true for the crediting rate, it does not account for the costs-of-insurance side of the equation, and other risks such as opportunity cost and purchasing power risk.
- One of the more popular sales today is using EIUL as a supplemental retirement asset for generating "tax-free" cash flows. Again, is an 11.25% average market total return realistic for this type of sale?

Lastly, should a nonsecurity product be permitted to be illustrated based upon a higher average market gross return than a security?

Suitable EIUL Planning Uses

EIUL remains a suitable product for the affluent premium finance consumer given the 50% Regulation U maximum impact that accompanies selection of a variable universal life product.

Questionable/Unsuitable Uses

On the flexible premium nonguaranteed death benefit product spectrum, EIUL is positioned between Universal Life and Variable Universal Life. If full disclosure is made to an investment-motivated consumer concerning the investment volatility, ongoing policy management risks and increased costs, arguably it would appear that a variable universal life product (retail or institutionally priced) would be a better fit.

Hence, the use of EIUL for traditional low-premium management or high-premium investment alternative planning needs is questionable and warrants a thoughtful suitability evaluation based upon credible product and policy evaluation. And, if such evaluation was not undertaken at the time of policy purchase, then it should be considered now. If this initiative is not undertaken by the agent of record, then engagement of an independent and unbiased fee-based consultant should be considered.

Suitability Letter

Whether a sales agent is held to suitability or fiduciary standard, product selection suitability must be justified. This justification should take the form of a letter generated by the sales agent that confirms the agent's understanding of the consumer's objectives and addresses the following points:

- Why is the agent/rep/firm qualified to serve as the writing agent for the consumer's "buy and manage" needs?
- Why is the recommended product more suitable for the consumer's planning need in comparison to other product alternatives?
- Why is the issuing carrier more suitable in comparison to other carrier alternatives?
- What are the product and performance risks that require ongoing monitoring and risk management, if any? Does the issuing carrier provide the requisite ongoing policy administration and risk management services? If not, does the agent provide these services and, if so, at what cost?
- If the requisite post-sales risk management services are not provided by the issuing carrier or sales agent, who will provide the annual policy performance monitoring and risk management services, and at what cost? If the performance monitoring is illustration-based and illustrations disclaim predictive value, why does the agent consider this scope of service credible?

As a practical matter, an investment-motivated consumer is likely aware of fund selection and management responsibilities, risk/return trade-offs, etc. EIUL is a buy-and-manage financial asset. The manage function is usually not provided by the issuing carrier and not a post-sales responsibility of the carrier's contracted sales agent. Hence, it is incumbent upon the sales agent to include this disclosure in the suitability letter and assist the consumer in obtaining the management function.

Conclusions

EIUL is a sophisticated flexible premium nonguaranteed death benefit product ideally suited for an investment-motivated consumer who understands its risks and how they can be credibly and prudently managed to maximize the probability of a favorable planning outcome. While EIUL is an attractive niche product, it is not suitable for every life insurance planning scenario. Further, it is not a simple product for agents or advisors to understand, thus complicating their client suitability recommendation and performance monitoring risk management guidance.

An increasing number of informed articles speak to these concerns and especially misleading, if not abusive, illustration practices. As mentioned early in this article, the policy evaluation tools are available for sales agents and advisors to credibly evaluate in-force policies and reassess product and/or product design suitability in the context of updated consumer goals.

Life insurance licensed agents who have sold EIUL policies are held to a fiduciary standard or a suitability standard at the least. It seems timely for agents to review their presales client marketing communication along with the as-sold illustration executed by the consumer as part of the policy delivery process, a current in-force reillustration and the policyowner's current life insurance planning objectives. Given the benefit of 20/20 hindsight and EIUL cautionary warnings, is the as-sold policy's crediting rate consistent with the rates discussed in this article? Is the policy performing as originally illustrated and, if not, why? Should credible policy evaluation be recommended to the client for annual performance monitoring and in-force policy risk management? And, finally, if this product type is no longer suitable for the consumer's objectives and risk tolerance, what restructure options should be considered and why?

If the sales agent does not maintain ongoing client communication or has retired, the consumer should consider engagement of a fee-based life insurance consultant experienced with EIUL to address the above questions. If the policy is owned in an Irrevocable Life Insurance Trust (ILIT), the trustee or consumer's legal and/or tax advisors assisting the trustee in trust administration matters should recommend engagement of a fee-based consultant and obtain an unbiased review of these questions.

As a final comment, EIUL is not a "buy-and-forget" product—it is a "buy-and-manage" product and requires annual performance monitoring and risk management no different from universal life and variable universal life. It is essential to eliminate the gap between product and management sophistication, especially recognizing that the tools are readily available to do so—they just need to be used. ●

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Endnotes

(1) This article intentionally maintains the prudent practices risk identification and management theme of E. Randolph Whitelaw's prior FSP articles, TOLI teleconference, and Lunch/Bunch program. Life insurance is a "buy-and-manage" financial asset usually purchased for a 5 to 50 year duration period, yet the issuing carrier does not offer post-sales risk management services, the sales agent does not have carrier-imposed contractual post-sales risk management servicing responsibilities, and the consumer-purchaser is rarely introduced to a fee-based third-party provider that offers "credible" policy performance monitoring and risk management services. As a result, the agent's marketing practices and suitability determinations are usually considered questionable if the policy underperforms originally illustrated values, and the reason for a lapsing policy. Hence, illustration presentation and marketing practices warrant a fresh look, especially the need for post-sales client communication and the form it should take for flexible premium nonguaranteed death benefit products given the performance risk transfer to the policy owner.

(2) Arthur D. Postal *IUL Illustration Proposal Goes Up for Public Comment,* InsuranceNewsNet, February, 2015

(3) FSP members have access to an HVC program and its EIUL evaluation module.

(4) For the purpose of this article, "predatory practices" is defined as the conscious and willful inattention to, avoidance of, and disregard for known client suitability objectives, life insurance state licensing guidance, and life insurance carrier contracting guidance.

(5) As a practical matter, multiple illustrations can be considered using different crediting rate assumptions in order to communicate a range of performance opportunity depending upon asset allocation and index selection. Arguably, some readers will consider a 5% credit rate assumption very con-

servative given the more recent equity markets performance. Whatever the differing opinions, multiple illustrations reinforce the transfer of performance risk to the purchaser, the risks to be managed and the resultant policy value expectation differences. This multiple illustration suggestion does not replace the need for delivery and execution of an "as sold" illustration. Rather, it helps to frame purchaser expectations and demonstrate agent suitability disclosure.

(6) The Monte Carlo Simulation involves 1,000 multi-year trials that in aggregate should average the specified rate-of-return. Monte Carlo is a time-tested investment management tool to help quantify the variation of returns and outcomes based on the standard deviation of an investment strategy or fund. A low standard deviation will have trial returns very close to the mean and a high standard deviation will have a wide range of value relative to the mean.

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Sample Irrevocable Life Insurance Trust Investment Policy Statement

by

E. Randolph Whitelaw, AEP® (Distinguished)

Sample Irrevocable Life Insurance Trust

Investment Policy Statement

This Investment Policy Statement sets forth guidelines and procedures for systematic review and long-term management of the trust's assets. The purpose of this Investment Policy Statement (herein IPS) is to:

- Clarify the trust's objectives and the grantor's expectations;
- Specify the grantor's risk tolerance level pursuant to the trust's objectives;
- Set forth the trustee's risk management criteria to achieve the trust's objectives; and
- Establish a procedure for timely monitoring and systematic review of performance results;

This IPS evidences the careful consideration given by both the grantor and the trustee to the formulation and implementation of a prudent asset management strategy. It will serve as a guide to the trustee, outline procedures for prudent administration of trust assets invested in the sole interest of the beneficiaries, and set out the responsibilities of outside advisors and/or providers engaged in the trust operation. This statement will be revised and modified as appropriate on a periodic basis to reflect such factors as changes in the trust objectives, asset performance and suitability, trustee risk management procedures, beneficiary objectives, and tax laws.

Purpose of the Trust: The primary purpose of the Sample ILIT, as stated in Article [TBD] in the trust agreement, is to invest prudently in life insurance policies on the life of the grantor.

Trust Time Horizon: The trust was created in [date] and the insured was age [TBD] at the time of initial policy issue. The insured is attained age [TBD] and has a life expectancy of [TBD] years based on current mortality tables. The trust-owned policy(ies) should be/were designed to sustain coverage to contract maturity/insured age [TBD].

Contributions to the Trust: The grantor intends to annually transfer funds to the trust as annual exclusion gifts to the trust beneficiaries. Pursuant to the trust's terms, the trustee receives the transfers and sends notice to the beneficiaries of their temporary right to withdraw their respective pro rata shares of these gifts. To the extent these withdrawal rights lapse, the trustee may use the funds remaining to pay the annual life insurance premiums. These transfers from the grantor are voluntary and are not required under the trust or under the contract between the grantor and the trustee. There is no guarantee that the grantor or anyone else will contribute additional funds to the trust in future years.

Trust Distribution Provisions and Beneficiaries: The trust names the grantor's [number such as 4] children as equal beneficiaries. All are to receive equal distributions from the trust upon the grantor's death.

Diversification: In achieving the goals of the larger estate planning program, the trust shall limit the assets to insurance and investment products that can best accomplish the grantor's intent. The trustee shall diversify unless it is prudent not to do so. *(Note: Depending upon trust objectives, the trustee can set out asset allocation guidelines to allow for reasonable percentages of insurance coverage underwritten by 'no load' and 'commission paying' universal life, whole life, and variable carriers as well as mutual and stock insurance carriers. Also, for variable policies, the asset allocation* *strategy should be similar to traditional investment IPS documents. The selected strategy's volatility-simulated net expected return should reasonably approximate the accumulation rates projected on the policy illustration.)*

Product Suitability and Risk Management Guide: This Guide outlines the risk/return expectations and asset management strategies to be employed by the trustee during the term of insurance policy administration. Exhibit #1 summarizes the different guaranteed and non-guaranteed policy types available to the trustee and the scope of periodic monitoring appropriate for each requiring the assistance of the Investment Advisor/Life Insurance Analyst. Selection of a policy type with non-guaranteed features should be based on an actuarially certified Benchmark Model Report's policy design parameters. Ongoing premium adequacy and policy performance monitoring should be actuarially certified.

- **Carrier Risk**: Unless constrained by health difficulties or other underwriting considerations, the trustee shall select among life insurance companies ranked among the largest 150 based on admitted assets, and shall be guided primarily by ratings issued by independent evaluation agencies including: A.M. Best, Fitch Credit Rating Company, Moody's, and Standard & Poor's. Preference shall be given to carriers with more favorable ratings from no less than three of these agencies. In the event of a ratings downgrade of the issuer, the trustee shall review the magnitude of the downgrade as well as its cause and shall determine what portfolio modifications, if any, are warranted.

- **Premium Adequacy and Contract Underperformance Risk**: The trustee shall make a policy suitability determination based on the trust's objectives and the grantor's risk tolerance. Selection and acceptance of a non-guaranteed death benefit contract requires annual actuarially-certified evaluation that scheduled premiums are adequate to sustain the policy to contract maturity or a time period approved by the grantor but no less than the insured's life expectancy as calculated by an independent life expectancy firm or set out in the 2001 CSO table. In the event that the contract is underperforming its acceptance benchmark evaluation, the trustee will communicate this underperformance to trust beneficiaries and policy management options to achieve the trust's objectives and grantor's expectations.

  Carrier illustrations shall be obtained for informational purposes only. In 1994, the National Association of Insurance Commissioners stated, "Illustrations are not and cannot be predictions or estimates of future performance."

- **Liquidity Risk**: The trustee has a duty to investigate policy costs and determine that they are reasonable and appropriate. The trustee shall evaluate "load" insurance contracts that pay a commission to the selling agent and "no-load" contracts that do not generate a commission. At the time of initial policy acceptance and subsequent policy restructure, the trustee shall obtain written disclosure of commission payments and surrender charges, and retain the cost evaluation in the trustee's records.

  The decision to purchase a commission-paying product may result in acquisition of a policy that offers little or no cash value for a lengthy period of time or the period of the contract. The trustee shall determine if the level of risk posed by illiquidity is appropriate to the purpose of the trust and the risk tolerance of the beneficiaries.

- **Underwriting Risk**: The trustee shall employ a Request for Proposal (RFP) process to solicit preliminary pricing inquiries from underwriting departments. The RFP will set out policy design parameters based on an actuarially-certified Benchmark Model Report, and evaluate proposals by comparison to the Benchmark Model. *(Note: The RFP process is especially important for the purchase of larger policies that involve reinsurance companies.)*

Delegation of Responsibilities: The trustee may delegate trust administration and operation responsibilities to various parties as described below:

Trustee: The trustee shall be responsible for the safe custody and investment of trust assets. The trustee's responsibilities include:

- Ongoing consultation with the grantor-insured to verify objectives, health status, and beneficiary needs;
- Determining an appropriate investment strategy to achieve the grantor's objectives;
- Monitoring investment performance to assure that performance results meet the guidelines set forth in this statement;
- Receiving all contributions and paying all benefits under the terms of the trust documents; and
- Performing administrative functions and fiduciary duties required of a trustee under applicable law and regulations.

Attorney: The attorney shall be responsible for performance of all tasks required under the terms of the engagement with his or her client in a manner which complies with the standards of practice prevailing in the community at the time such services are performed. The attorney's responsibilities include:

- Drafting and review of trust documents to determine that they are suitable and appropriate to the needs and objectives of the grantor-insured;
- Review of ownership and beneficiary designations of all trust-owned assets to determine that they confirm with the planning objectives of the grantor-insured; and
- Review of any transfers of existing assets to the trust to determine the tax and legal consequences thereof. This review encompasses any policy exchange that seeks to comply with the rules and IRC §1035.

The attorney shall not be responsible for rendering opinions that may be deemed to be investment or insurance advisory opinions.

Investment Advisor/Insurance Analyst: The advisor/analyst shall assist the trustee with the development and implementation of the Investment Policy Statement. The advisor/analyst shall be responsible for performance of all tasks required under the terms of the engagement with the trustee, including:

- Determining the amount of insurance required to meet the goals and objectives of the trust;
- Recommending suitable insurance carriers;
- Evaluating the risk/reward tradeoffs of selected insurance carriers;
- Determining appropriate policy types, designs, and funding levels;
- Supervising the life insurance agent to facilitate underwriting and policy implementation; and

- Monitoring and evaluation of the insurance portfolio's performance.

Life Insurance Agent: In addition to complying with the duties imposed by applicable insurance licensing regulation, the life insurance agent shall assist the trustee and advisor/analyst to apply for, underwrite, implement and service appropriate insurance contracts. The agent shall be responsible for performance of all tasks under the terms of the engagement with the trustee, including:

- Disclosure of any employment contract constraints, compensation schedules and other provisions that may materially influence the information and advice provided to the trustee, grantor, or other members of the estate planning team. The investment advisor/life insurance analyst shall provide a disclosure checklist for agent completion and retention in the attorney's and trustee's files;
- Provision of financial data and independent rating-company evaluations of selected carriers, contract illustrations, and other data necessary for the trustee to evidence " the exercise of reasonable care, skill and caution" required by law. The advisor/analyst shall consult with the agent regarding the scope of such materials and shall evaluate these materials.
- Investigation into health, avocation, and financial factors which may have significant affect on the pricing of insurance contracts so that the trustee can determine that coverage is available and is appropriately priced. The agent will consult with the advisor/analyst in the performance of these tasks;
- Completion of applications or pricing inquiry forms to selected insurance carriers, subject to advisor/analyst pre-submission review;
- Delivery of insurance contracts and collection of the premium amounts necessary to implement and sustain coverage;
- Preparation of annual in-force policy illustrations. The advisor/analyst will direct the agent regarding the required information and review such information as part of the ongoing systematic monitoring program; and
- Assistance in all policyholder service activities such as changes in premium schedules, processing of policy loans and distributions, beneficiary changes and so forth.

Policy Monitoring: The trustee intends to prepare/obtain annual reports that will reasonably conform to the standards of performance accounting enumerated in the Fiduciary Accounting Guide promulgated by the American Law Institute – American Bar Association. *("Performance accounting, as applied in the trusts and estates area, has the twin objectives of promoting full and useful disclosure and fair representation of investment results on client assets and of instilling and maintaining client confidence in the corporate or individual's fiduciary investment abilities. These objectives may be best achieved when the fiduciary includes easily understood performance indicators in the client's periodic fiduciary statements.")* This annual report will compare the policy values reported by the carrier to the policy acceptance benchmark values, and review the carrier's independent ratings. Additionally, the trustee will provide an annual policy monitoring report to beneficiaries that identifies unfavorable trends and establishes a 'watch' period during which the concern will be assessed and, if necessary, corrected to achieve the trust's objectives.

Policy Modification: If continued retention of a policy appears imprudent because of contract underperformance, the trustee shall consider among the following options:

- Increased premium funding for under-performing contracts or decreased premium funding for over-performing contracts;

- Replacement of the coverage and acquisition of a new policy either by IRS § 1035 policy exchange or by other suitable means;
- Election of an appropriate non-forfeiture provision with the option to devote premiums allocated to the policy to acquisition of supplemental coverage of a type and amount suitable to the trust; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections or surrender of the contract for its cash surrender value.

If continued retention of a policy appears imprudent because of a high likelihood that the grantor's gifting program underlying the premium funding will be discontinued, the trustee shall consider among the following options:

- Election of an appropriate non-forfeiture provision; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections, or surrender of the contract for its cash surrender value.

If continued retention of a policy appears imprudent because of carrier downgrades by independent rating agencies, the trustee shall consider among the following options:

- Replacement of the coverage and acquisition of a new policy either by IRS § 1035 policy exchange or by other suitable means;
- Election of an appropriate non-forfeiture provision with the option to devote premiums allocated to the policy to acquisition of supplemental coverage of a type and amount suitable to the trust; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections or surrender of the contract for its cash surrender value.

Review of this Investment Policy Statement: Each time the life insurance policies or other trust assets are reviewed for performance and suitability, the trustee may also review the Investment Policy Statement. If changes are needed, the trustee should revise the Statement and communicate these changes to the trust beneficiaries.

______________ ____________________________________

Date Trustee

Exhibit #1 – Product Suitability Matrix

The following matrix sets out a TOLI trustee's primary policy acceptance and management considerations, and the annual policy performance verification expected by beneficiaries and their professional advisors.

	Guaranteed Products				Non-Guaranteed Products			
Trustee Acceptance Considerations Policy Management Features	**Whole Life**	**No Lapse Guarantee Universal Life**	**Level Premium Term**	**Yearly Renewable Term**	**Adjustable Life**	**Universal Life**	**Variable Universal Life**	**Variable Life**
Premium Schedule	Fixed	Fixed	Fixed Period	Increasing	Flexible	Flexible	Flexible	Fixed
Specified Death Amount	Fixed	Fixed	Fixed	Fixed	Flexible	Flexible	Flexible	Fixed
Account Value Management	Carrier	Carrier	None	None	Trustee	Trustee	Trustee	Trustee
Asset Allocation Required	N/A	N/A	N/A	N/A	No	No	Yes	Yes
Illustration Credibility	Yes	Yes	Yes	Yes	No	No	No	No
Actuarial Evaluation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Volatility Simulation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes

Trustee Management Requirements								
Investment Policy Statement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
TOLI – Specific Procedures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product Suitability	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Premium Adequacy Risk	No	No	No	No	Yes	Yes	Yes	Yes
Monitoring Cycle	N/A	N/A	N/A	N/A	Annual	Annual	Annual	Annual
Carrier Solvency Risk	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Asset Allocation Review	N/A	N/A	N/A	N/A	N/A	N/A	Annual	Annual
Conversion Review	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A
Rating and Rider Review	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Regulatory Review (Institutional)	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual

Professional Advisor Annual Verification								
Product Suitability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Premium Adequacy	N/A	N/A	N/A	N/A	100%	100%	100%	100%
Death Benefit Adequacy	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Carrier Solvency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Investment Performance Rebalancing	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Yes

Creditable Evaluation of Life Insurance

Gary L. Flotron, MBA, CLU®, ChFC®, AEP®

Chapter 5 of *Explaining the Unexplainable: Understanding Life Insurance and the Risk Transfer Paradigm Shift that Precipitated a Policy Crisis and Necessitated the Rethinking of Policy Management and Evaluation*; Publication Date Spring or Summer 2019

Chapter 5

Creditable Evaluation of Life Insurance

The Extreme Disconnect. There is an extreme disconnect between the most commonly used method of flexible premium, non-guaranteed policy evaluation used today and what a 1992 report by the Society of Actuaries[102] and FINRA regulations[103] say is an improper method of policy valuation. That is, the majority of financial planners and life insurance professionals are evaluating non-guaranteed life insurance products by comparing the different carrier's life insurance policy illustrations. Yet the 1992 Society of Actuaries Task Force on Policy Illustrations makes it clear that "Illustrations 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 a policy illustration."[104]

So, what is the problem with the use of policy illustrations in evaluating non-guaranteed life insurance policies? Again, the Society of Actuaries Task Force on Policy Illustrations says it best "…How credible are any non-guaranteed numbers projected twenty years in the future, even if constructed with integrity? How does the consumer evaluate the credibility of two illustrations if they are from different companies? Or even if they are from the same company if different products with different guarantees are being considered? Most illustration problems arise because the illustrations create the illusion that the insurance

[102] *Final Report of the Task Force for Research on Life Insurance Sales Illustrations under the Auspices of the Committee for Research on Social* Concerns, Transactions of the Society of Actuaries 1991-92 Reports, Society of Actuaries, 1992. Herein after this report will be referred to as the Society of Actuaries Task Force Report on Policy Illustrations.
[103] FINRA Rule 2210 - IM-2210-2. Communications with the Public About Variable Life Insurance.
[104] Society of Actuaries, supra note 102 at page 159-60.

company knows what will happen in the future and that this knowledge has been used to create the illustration."[105]

The problem is the number of "moving parts" in a non-guaranteed life insurance policy and the interaction of these moving parts. Stated differently it is the volatility of these moving parts, particularly interest or earnings credited, that do not stay stagnant, and the interaction of the cost of insurance with the volatility of the earnings.

Improper Policy Evaluation Methods. From the discussion in Chapter 2 of this book, it should be evident that we cannot use traditional **constant** rate policy illustrations to either predict non-guaranteed policy values or to compare one policy to another, even if it is the same type of policy. In the last several years, many independent life insurance brokerage operations and some producer groups have marketed what is commonly called policy audit reports or premium optimization reports that purport to unbiasedly compare various policies, generally of the same policy type, issued by different insurance carriers. The problem with these "optimization" reports is that they are all based on the individual carriers' **constant** assumption policy illustrations. Thus, the policy audit reports or optimization reports have the same lack of credibility problems as individual policy illustrations. In fact, any policy evaluation methodology system that uses non-guaranteed **constant** earnings or interest crediting rates to predict future policy performance or compare policies or to rank policies based upon "subjective" non-disclosed criteria, such as a one to five scale, is not a valid method of policy evaluation and is not "dispute defensible"[106] in a court of law.

Monte Carlo Simulation and Actuarially Certified Policy Standards Analysis.[107] It is clear that any acceptable form of non-guaranteed, flexible premium life insurance policy evaluation must address this volatility of earnings issue and

[105] Ibid at page 140.
[106] "Dispute defensible" is a term coined and used by E. Randolph Whitelaw, AEP® (Distinguished), the Managing Director of Trust Asset Consultants, LLC, to describe proper or best practices in the evaluation of life insurance and administration of the trust estate in the irrevocable life insurance trust (ILIT). "Randy" is a national expert and consultant in this subject matter and has served as an expert witness in litigation on these matters, including the watershed case of Cochran v. KeyBank.
[107] Full and very grateful acknowledgement needs to be given to Richard M. Weber, MBA, CLU®, ChFC®, AEP® (Distinguished) and Christopher Hause, FSA, MAAA, CLU® of Ethical Edge Insurance Solutions, LLC who are the inventors and developers of the Historical Volatility Calculator software and pioneers in the Monte Carlo simulation and actuarially certified policy standards technique.

calculate a premium that, while not guaranteed, can reasonably evaluate the effect of volatility in rates of return with statistical probabilities of confidence. The evaluation must be unbiased, creditable, impartial and fact-based. Similarly, as a certified public accountant uses generally acceptable accounting principles to prepare financial statements, the evaluation of a non-guaranteed, flexible premium life insurance policy should be an actuarial certified evaluation using generally accepted actuarial methods.

In all reasonable types of evaluation, a comparison must be made to a known, objective (non-subjective), quantitative measurable standard or benchmark. Is such a comparison available for non-guaranteed life insurance and, if yes, what can be used as the policy standard or benchmark model? To answer this question, consider the three main pricing components of life insurance policies: (1) cost of insurance, (mortality costs); (2) administration and operation expenses including startup costs and commissions; and, (3) investment returns whether the interest credited to the policy or the earnings of separate accounts.

Is a benchmark model available for life insurance? Yes. The Society of Actuaries accumulates and annually publishes actual, current and past, experience data from life insurance companies that represent almost 80% of all life insurance sold in the United States. This data includes mortality experience and policy expenses, including lapse experience. Further, other statistical type studies are available from credible sources used to derive industry norms. The data is broken down by not only issue age of policies and sex but also by smoking status, underwriting classifications, policy type, policy size, etc. This readily available data facilitates construction of statistical expectations for mortality costs and policy expenses from which policy standards can be created as well as policy pricing benchmark models. In fact, Asset Share model software programs used by actuaries to design and price life insurance products have incorporated this type of benchmark model for these two components in life insurance pricing.

That said, what can be used as a benchmark for investment returns, taking the form of either interest credited or separate accounts earnings? We know that policy investment returns are not constant and, therefore, inappropriate. Rather we need to consider the volatility of investment earnings over time. This can be accomplished by employing a technique adopted by corporate trust companies and large investment portfolio managers the past 40 years to statistically estimate probable portfolio returns, known as Monte Carlo Simulation. It statistically evaluates an unknown future outcome based on numerous random samples of prior experience.

Insurance company reserves that backs up a policy's cash value is nothing more than a portfolio of securities. If the policy is a whole life or traditional universal life policy, the general asset account backing up those policies is mostly a fixed income portfolio made up of government and corporate bonds and securities. If the policy is a variable universal life policy, the separate sub-accounts - which themselves are portfolios of types of securities – make up the account value of the policy and depend on the asset allocation chosen by the policy owner based on the policy owner's risk tolerance.

As a result, actuarially certified policy standards for cost of insurance and expenses can be combined with the use of Monte Carlo Simulation to derive expected returns that account for volatility. The result is a bench mark model that can predict results to which a statistical probability of confidence can be attached. This benchmark is in effect a generic life insurance policy standard. It cannot be purchased but nonetheless represents industry norms and expectations that can be reasonably compared to life insurance company generated policy illustrations.

To create one hypothetical "trial illustration," we start with the actuarially certified policy standards database for the cost of insurance and policy expenses. Depending on the type of universal life insurance policy, we create a database of past rates of investment returns ranging from the 1920s to the present. For example, in the case of an all equity asset allocation variable universal life policy, there is a database of the Standards and Poor's® (S & P) 500® index returns, with dividends, by month from the 1920s to the present. Since regular and variable universal life policies are credited each month with investment earnings, we do the same with the "trial illustration," except the rate of investment return for each month will be randomly selected.

To understand the monthly investment return randomization calculation process, think of all these rates of returns as electronic bingo cubes with a single bingo cube for each monthly return data. To calculate policy values for the first month we randomly select an investment rate of return bingo cube from the database that acts like an electronic drum cage holding the bingo cubes. We calculate the policy values at the end of the first month using the randomly selected "bingo cube" rate of investment return and applying it to the proposed premium payment, face amount of the policy, and, the cost of insurance and expenses from the actuarially certified policy standards database. We replace the first bingo cube back into the electronic drum cage and repeat the entire process for the second policy month, then the third month and so forth, accumulating policy account values along the way. This is done until either the policy matures – or reaches the planned policy duration period - or the policy lapses due to insufficient policy account values. For example, if we have a 50-year-old insured and a policy maturing at age 100, the above process would be repeated 600 times to create one hypothetical trial policy illustration assuming the policy does not lapse. That is, 12 months in a year times 50 years. For variable universal life policies, asset allocations are rebalanced every 12 months. This is how one "trial illustration" is created.

However, one created hypothetical policy trial illustration - even though the investment returns have been randomized for each month of the policy - has no creditability. In order to be statistically creditable, we generate 1,000 separate hypothetical trial illustrations. We note the number of times each trial illustration made it to the testing point for premium adequacy and policy sustainability – such as life expectancy, life expectancy plus 5 years, or policy maturity – and count that as a "success". We also note the number of times the trial illustrations did not make it to the testing point and count that as a "failure." Thus, with these 1,000 hypothetical trial illustrations – each with randomized investment rates of return by month – we are able to compute the probability of a propose premium's success in adequately sustaining the policy to the chosen testing point.

As an example, assume an irrevocable life insurance trust (ILIT) is created by Ms. Toli Ilit, a 62-year-old female with a preferred non-smoker underwriting risk classification, who has a calculated life expectancy of age 91. Twelve years ago, the trust purchased a $1,000,000 variable universal life insurance policy from GLF Life Insurance Company when the insured was age 50. Ms. Ilitl is an aggressive investor with a relatively high-risk tolerance and, hence, has an asset allocation for the policy of 80% equity investments and 20% bond or fixed income investments, which she wants to continue throughout the life of the policy. Based on an original policy illustration projected at 8%, the planned and current annual funding premium is $7,88.15 with premiums being payable to age 119, with the policy maturing at age 120. The account value for the 12th policy year was originally illustrated to be $118,465; however, the actual account value in the 12th policy year is $114,280. An in-force policy re-illustration projected at 8% and assuming continuation of the current funding premium shows that the policy will lapse at age 97, six years past Ms. Ilit's life expectancy.

Given the past 12 years of market volatility, the trustee is concerned with the policy's performance. The trustee wants to know what the probability of the timely payment of the current scheduled premium would be to sustain the policy to the insured's life expectancy and to age 100. The trustee's premium adequacy risk tolerance is a 90% sustainability probability confidence. If the current funding premium is inadequate, what is the correcting premium to achieve a 90% probability of success. Tables 13 to 15 provide a data and assumptions summary.

Table 13

Creditable Evaluation of Life Insurance

Example of Actuarial Evaluation of In-Force Policy

Insured Information	
Name:	Ms. Toli Ilit
Current Age:	62
Gender:	Female
Risk Classification:	Preferred Non-Smoker
Life Expectancy (Calculated):	91

Table 14
Creditable Evaluation of Life Insurance
Example of Actuarial Evaluation of In-Force Policy (Continued)

In-Force Policy Information	
Carrier:	GLF Insurance Company
Year of Policy Issue	2006
Issue Age:	50
Face Amount:	$1,000,000
Policy Type:	Variable Universal Life
Asset Allocations (Equity/Bond):	80%/20%
In-Force Policy Account/Cash Value:	$114,280 (Originally Projected $118,465)

Table 15
Creditable Evaluation of Life Insurance
Example of Actuarial Evaluation of In-Force Policy (Continued)

In-Force Policy Illustration Data & Risk Tolerance	
Current Annual Funding Premium:	$7,888
Premium Paying Years:	58
Illustration Interest/Crediting Rate:	8.00%
Ilustrated Lapse Age:	97
Premium Adequacy To Sustain Policy Risk Tolerance (Confidence Level):	90%

We generate 1,000 randomized hypothetical illustration trials to determine the probability of the policy sustaining to the insured's life expectancy of age 91. Of those 1,000 trial illustrations 840 of the illustrations sustained the policy to age 91 and 160 failed to sustain the policy to age 91, resulting in an 84% probability the current premium will successfully sustain the policy to life expectancy.

The earliest lapse occurred at age 82 and the highest concentration range of lapses was between ages 89 through 93. By comparison, the GLF Life Insurance Company in-force illustration projected lapse at age 97.

The same process was used to solve for the correcting funding premium to sustain the policy to pre-determined testing points. For example, the correcting funding premium to sustain the policy to insured life expectancy, assuming a 90% probability in this example, is $9,089 which represents a 15% increase over the current funding premium of $7,888. Additionally, based upon actuarially certified policy standards, the cost of insurance and expenses obtained from the GLF Life Insurance Company in-force policy illustration were calculated to be slightly (-4%) less favorable than the policy standards benchmark. The average rate of return of the 1,000 randomly generated hypothetical illustration trials was 9.32% but, like a policy illustration, does not account for volatility. However, the correcting funding premium, using 1,000 randomly generated hypothetical policy illustration trials does take into account volatility, and, hence, results in the significant correcting funding premium increase.

In testing whether the illustrated GLF Life Insurance Company variable life insurance policy will sustain to the insured's age 100, we again generate 1,000 random hypothetical illustration trials. Of those 1,000 trial illustrations 620 of the illustrations sustained the policy to age 100 and 380 failed to sustain the policy to age 100. Thus, from this we derive a 62% probability of successfully sustaining the policy to age 100 with the current premium.

Of these 1,000 randomly generated hypothetical illustration trials the earliest lapse occurred at age 82 and the highest five-year concentration range of lapses was between ages 88 through 92, statistically comparable to the lapse data derived from testing for sustaining to life expectancy for the current funding premium.

Using the process to solve for the correcting funding premium to sustain the policy to age 100, such that there is a 90% probability that the premium will sustain the policy to the testing point, we find that premium to be $13,008, or an increase of 65% over the current funding premium of $7,888. The pricing deviation of the actuarially certified policy standards for the cost of insurance and expenses from the GLF Life Insurance Company in-force policy illustration remains at -4% as previously calculated in the testing for sustaining the policy to life expectancy. The average rate of return of the 1,000 randomly generated hypothetical illustration trials in testing the premium adequacy of the policy sustaining to age 100 was 9.34%, again statistically comparable to the average rate of return derived from testing for sustaining to life expectancy for the current funding premium. A summary of the actuarial evaluation of the in-force policy example results is contained in Figure 20.

It is important to note that the goal of the Monte Carlo Simulation Actuarially Certified Policy Standards analysis is to objectively determine the relative credibility of an illustration as opposed to predicting the actual performance of a specific policy.   In addition, the correcting premium is not a guaranteed premium but rather a suggested premium that meets, in the example above, the 90% statistical confidence level requirement to help the client set more reasonable expectations for ongoing policy review and management.

All statistical analysis has margins of error, generally in the range of plus or minus 5% or less as is the case with this analysis process. While this tool and technique is not perfect – and improvements and sophistication of the technique and the data behind the technique will improve over time – it is the best method available to set benchmarks for policy expectations that are actuarially certified. Further, it is a far superior tool to the linear, constant assumption policy illustration, which is known to be neither credible nor appropriate for predictive value determinations.

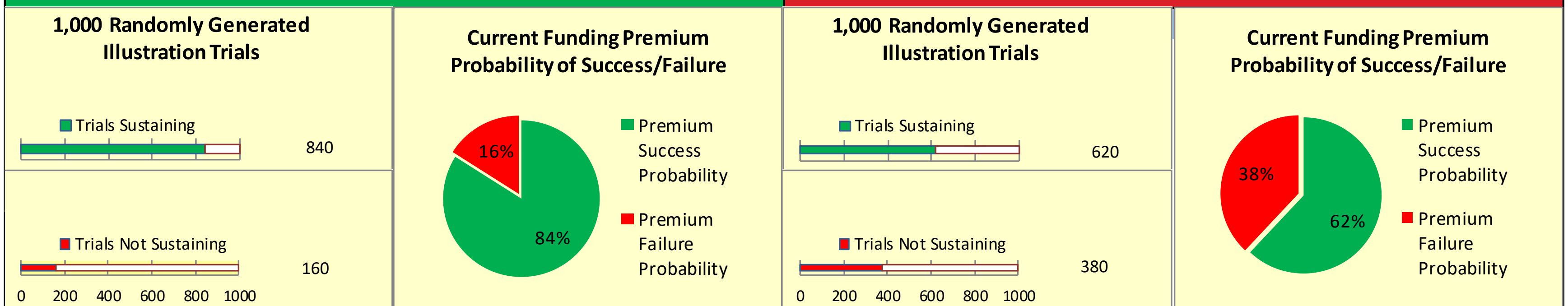
Figure 20

Creditable Evaluation of Life Insurance

Example of Actuarial Evaluation of In-Force Policy (Continued)

Probability of Current Funding Premium Sustaining Policy To:

Life Expectancy				Age 100			



Life Expectancy				Age 100			
Current Funding Premium:	$7,888	Correcting Funding Premium @ 90% Confidence Level:	$9,089	Current Funding Premium:	$7,888	Correcting Funding Premium @ 90% Confidence Level:	$13,008
Life Expectancy Age:	91			Life Expectancy Age:	91		
Earliest Lapse:	82	Correcting Funding Premium Increase/(Decrease) Over Current Funding Premium:	15%	Earliest Lapse:	82	Correcting Funding Premium Increase/(Decrease) Over Current Funding Premium:	65%
Highest 5 Year Period of Concentrated Lapses:	89-93			Highest 5 Year Period of Concentrated Lapses:	88-92		
Calculated Average Return:	9.32%	Pricing Deviation Actuarial Policy Standards Database Relative to Illustrated Policy	-4%	Calculated Average Return:	9.34%	Pricing Deviation Actuarial Policy Standards Database Relative to Illustrated Policy	-4%

Creditable Evaluation of Life Insurance in Perspective. Since the purpose of policy illustrations for flexible premium non-guaranteed death benefit products is to explain how a policy works, they cannot be relied upon or should not be used to predict or project policy performance, nor used to evaluate or compare one policy to another. Such a use of the policy illustration is improper and clearly not "dispute defensible."

Having described the criteria required to properly evaluate non-guaranteed, flexible premium life insurance products, an analysis of the actuarially certified policy standards combined with Monte Carlo Simulation method of policy evaluation was presented and shown ideally to meet the criteria of proper evaluation for non-guaranteed flexible premium life insurance products. An example demonstrated the ability of this actuarially certified evaluation technique to access the probability - within a confidence probability of a successful outcome, or risk tolerance, set by the policy owner or trustee of a life insurance trust - that a carrier's illustrated scheduled premium could adequately sustain the policy to contract maturity or other desirable testing points such as life expectancy or life expectancy plus five years. Furthermore, the actuarially certified evaluation provides the most likely five-year range of policy lapse given the current scheduled premium, as well as the earliest possible lapse; an evaluation of the competitiveness of policy pricing of cost of insurance and policy expenses relative to the benchmark policy standards; and, the correcting premium to sustain the policy to the desired age or to contract maturity given the policy owner/trustee's risk tolerance.

Policy performance monitoring and prudent risk management is a continuous process that requires an <u>annual</u> actuarially certified policy evaluation. Further, prudent risk management includes <u>annual</u> suitability of the selected life insurance product, plus the suitability and solvency of the life insurance carrier.

In summary, the proper evaluation of non-guaranteed, flexible life insurance products is available, is affordable and is "dispute defensible."

Dispute Defensible ILIT Administration and TOLI Policy Evaluation Checklist

by

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Dispute Defensible ILIT Administration and TOLI Policy Evaluation Checklist

State Uniform Prudent Investor Act (UPIA) provisions generally place fiduciary-level responsibilities on trustees - whether institutional or personal - yet nowhere has there been as much a "disconnect" between duties and activity as with Irrevocable Life Insurance Trust (ILIT) policies. Fiduciaries are expected to demonstrate a prudent and reasoned asset management process to maximize the probability of a favorable outcome to the trust estate, and yet it is estimated that 90% of Trust-Owned Life Insurance (TOLI) policies are administered by unskilled trustees who lack life insurance and policy management expertise, and have likely volunteered to the task out of friendship or family duty. No matter how well-intended, unskilled trustees provide minimal, if any, credible performance monitoring of these life insurance policies, and are in turn vulnerable to questionable unwarranted policy replacement proposals[1].

An ILIT involves the interaction of a number of parties with different responsibilities and loyalties. As a 'buy-and- manage' financial asset, life insurance carriers and their contracted agents provide the 'buy' function, <u>but not the management function</u>. As a result, it is essential for ILIT beneficiaries or their representatives to understand the role and requisite expertise of each party. Further, since delegation of the life insurance product and policy evaluation expertise is to be expected, vendor "due diligence" at the time of selection and annually thereafter, is critical in demonstrating and documenting informed asset management determinations and a dispute defensible process.

The purpose of the following checklist is to summarize how an ILIT fiduciary - skilled or unskilled - can nonetheless document a prudent ILIT administrative process that can in turn facilitate dispute defensible policy evaluation determinations.

Checklist

Trust Agreement Administration: Most attorneys provide the grantor and trustee with a memo that summarizes all administration activities and, often, the form they

[1] Most ILIT fiduciaries lack life insurance and credible policy evaluation expertise. As a result, they either do not monitor policy performance annually or delegate this responsibility to life insurance producers and third-party administrators, trusting that they offer the needed expertise. Unfortunately most employ policy analysis methodology known to be inappropriate for predictive value determinations. While the prudent process tools for credible evaluation are readily available, such as FSP's Historic Volatility Calculator, they just are not used.

should take. Is this Memo available and does it set out criteria for the management of life insurance assets and annual accounting to trust beneficiaries?

Trust File Documentation: As a minimum, the ILIT file should contain a
(1) copy of the attorney memo,

(2) signed copy of the trust agreement,

(3) policy contract and a signed copy of the 'as sold' policy delivery illustration,

(4) current TOLI Investment Policy Statement,

(5) signed grantor letter guidance at the time of policy issue concerning the policy purpose and long-term performance expectations,

(6) carrier and product suitability evaluation prepared and signed by the writing agent that summarizes

> (a) carriers and products considered,
>
> (b) specific reasons for the selected carrier/product,
>
> (c) performance risks that require annual monitoring,
>
> (d) form of analysis appropriate for this monitoring, and
>
> (e) compensation earned (including commission, override and office support),

(7) copy of annual performance monitoring reports, and

(8) copy of annual beneficiary communication.

'Hold Harmless' Protection: If the Trust Agreement or Trustee arrangement or state statutes provide for 'hold harmless' protection, how are customary asset management decisions made, recognizing that the trustee has the sole responsibility for trust and asset management decisions? If the Trust Agreement has a successor trustee provision and the existing trustee is not providing any administrative services, successor trustee appointment should be considered.

Investment Policy Statement: If a TOLI Investment Policy Statement (TIPS) has not been prepared and currently maintained, it should be established and set out carrier and product suitability monitoring criteria. Further, if the ILIT owns a non-guaranteed death benefit policy, the TIPS needs to establish credible and dispute defensible policy evaluation criteria along with vendor screening and annual monitoring criteria. Finally, the TIPS should provide restructure guidance and criteria if the policy becomes un-needed or unaffordable.

Policy Performance Monitoring Evaluation: In 1992, the Society of Actuaries clarified that the purpose of an illustration was only to show how a policy works, not to provide predictive value and policy comparison determinations. In 2006, the 4-Part ACTEC article explained in detail the inappropriate use of current assumption illustrations as well as the appropriate use of benchmarks and policy standards in making informed fact-based risk management determinations: *"Just as the use of appropriate benchmarks levels the playing field between investment managers and facilitates accurate measurement of investment skills and risks* so, also, *benchmarks can put competing insurance products on a level playing field to generate meaningful risk/reward insights and comparisons."*

Policy Restructure: A TOLI policy is usually purchased for a 10-50 year duration. Trust objectives, tax legislation, carrier financial strength and life insurance products continually change. Restructure should be expected especially if the policy is no longer suitable per current trust objectives, or affordable, or needed. The TIPS should set out the restructure process and criteria.

Life Insurance Expertise: If the trustee lacks life insurance carrier, product and policy performance monitoring expertise, this expertise should be delegated to a third-party. A request for proposal should be used for delegation of the policy evaluation function to affirm the credibility of the vendor's reports. For example, policy evaluation should be fact-based using generally accepted actuarial principles and should not solely rely on in-force or sales illustrations.

Red Flags to Monitor and Consider a Second Opinion:

- An empty trust file;
- A file lacking an annually reviewed Investment Policy Statement;
- Non-existent or infrequent policy performance monitoring reports;
- Policy performance reports that employ subjective ratings such as competitive/non-competitive or "1-to-5" ratings based upon proprietary (aka unexplainable) methodology, or analysis known to be inappropriate for policy comparisons and predictive value determinations;
- An unsolicited policy replacement recommendation, and
- No beneficiary communication.

Initial Client Questions & Document Checklist

(CPAs and Attorneys providing personal or business advice to their clients may want to add the following questions to periodic reviews of client assets.)

1. Do you have life insurance on your and/or your spouse's life - including policies owned by you personally, by a business, by an insurance trust, by a retirement plan, or by a charity?

2. What is the death benefit of the policy(ies)?

3. Why did you purchase the policy(ies) and why that amount(s)?

4. Does the "why" still exist?

5. What kind of life insurance do you have on your life? There are lots of variations - whole life, universal life, guaranteed death benefit, variable, indexed and term.

6. How are you paying the premiums? Out of personal income? Out of an investment portfolio's resources? Gifts to insurance trusts? Or are you *not* currently paying premiums on any of these policies?

7. If there is a life insurance trust - who is the trustee?

8. When is the last time you had the policy(ies) independently reviewed, and what process was utilized for this review? Was the process dispute defensible?

9. How much estate tax do you want to pay?

10. Other than possibly funding estate taxes costs with life insurance, what are you doing to minimize the effect of loss of estate value at death?

If there are policies that should be reviewed, the following information will be very useful. Of course, this information can be independently obtained from the insurance company if not readily available from the client:

- Most recent annual statement for each policy
- Initial policy illustration
- Any "in-force" policy illustrations recently provided to you
- Copy of the policy