Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1499

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From: Steve Leimberg's Estate Planning Newsletter
Subject: **Cochran v. KeyBank - TOLI Case Law Guidance (Part 2 of 2)**

In **LISI** Estate Planning Newsletter #1486, **Patrick J. Lannon** and **Barry D. Flagg** discussed *In re Stuart Cochran Irrevocable Trust*, a case involving a claim of breach of fiduciary duty against an ILIT trustee.

In Part 2, **Barry D. Flagg** and **Patti S. Spencer** discuss *Cochran* from the perspective how trustees managing trust-owned life insurance (TOLI) can avoid this kind of litigation altogether by applying "best-practices" from the Uniform Prudent Investor Act (UPIA).

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She is a frequent lecturer and is the author of numerous articles on estate planning topics. Ms. Spencer was named one of Pennsylvania's Top 50 Business Women for 2000 and has been elected as a fellow to the American College of Trust and Estate Counsel. For 2007-2009 she was named a Pennsylvania Super Lawyer®, an honor awarded to the top five percent of state-wide lawyers. Her book, Your Estate Matters, AuthorHouse July 2005, is a 476-page book which grew out of her weekly newspaper column. It answers, in a no-nonsense way, questions about the estate planning, taxation, estate settlement and financial issues faced by most ordinary Americans. Her forms book, Pennsylvania Estate Planning, Wills and Trusts Library: Forms and Practice Manual, a 1,000-page two-volume set published by Data Trace is a state-specific estate planning reference for attorneys.

EXECUTIVE SUMMARY:

The allegation of breach of fiduciary duty in this *Cochran* case revolves around the suitability (or lack thereof) of certain existing TOLI holdings that were exchanged/replaced with certain other TOLI holdings. While the trustee prevailed in *Cochran*, "the cautious trustee will recognize that the actions of KeyBank were considered by the court to be less than ideal"[1] and that "this case could easily have gone the other way on the issue of ‘prudent process.'" As such, this article examines the "prudent process" prescribed by UPIA as it relates to the suitability of TOLI holdings.

The UPIA provides invaluable guidance to the specific activities trustees can and should take regarding TOLI, including:

1) the "duty to monitor"[2] the performance of trust holdings,

2) the "duty to investigate" the suitability of trust holdings, and

3) the duty to manage trust holdings using the information gathered

> in duty #1 and duty #2 to minimize costs and maximize benefits relative to acceptable levels of risk.[3]

The UPIA also provides that Trustees can delegate such investment and management functions, and when properly delegated are "not liable for the decisions or actions of the agent to whom the function was delegated."[4]

The suitability of any TOLI holding is a function of many factors, but should include consideration of:

1) the financial strength and claims-paying ability of the insurer,

2) the competitiveness of TOLI expenses,

3) the stability of the insurer's pricing representations,

4) the liquidity/accessibility of TOLI cash values, and

5) the reasonableness of performance expectations.

While some of these suitability factors were considered in *Cochran*, both the trustee and the plaintiff failed to consider #2 (the competitiveness of TOLI expenses) and #5 (the reasonableness of performance expectations).

In addition, the independent outside consultant hired by the trustee also failed to consider both expenses in and performance expectations for either existing or proposed TOLI holdings, and instead based their findings on certain illustrations of hypothetical policy values common to the life insurance industry but considered "misleading" and actually prohibited by the chief regulatory body of the financial services industry.

While the ability of the Trustee to delegate investment and management responsibility under the UPIA provides an important tool for a trustee to use in managing ILIT risk, it is essential that any delegation, whether formal or informal, or in whole or in part, be "prudent" (i.e., conform to the "prudent process"). For instance, certain service providers to the

TOLI industry advertize "complete policy reviews" in their marketing material, but then actually disclaim suitability in their reports that go into the permanent trust file.

Any TOLI review that does not consider suitability is simply not complete under the definition in UPIA; ILIT trustees should "check the fine print" of their policy review reports and adopt alternative means of determining and documenting suitability. The balance of this commentary discusses how "best-practices" for determining and documenting both the competitiveness of TOLI expenses, and the reasonableness of performance expectations, could prevent similar litigation.

FACTS:

In the case of *In re Stuart Cochran Irrevocable Trust*, ILIT trust beneficiaries sued KeyBank N.A. as trustee, alleging violations of Indiana's version of the UPIA and breach of trust. In the case, beneficiaries challenged the trustee's replacement of two variable universal life insurance policies providing $8,000,000 in death benefits with a $2,536,000 guaranteed universal life policy shortly before the unexpected death of the insured at age 53. Additional facts were discussed in Estate Planning Newsletter #1486.

COMMENT

The duties of a trustee of an Irrevocable Insurance Trust ("ILIT") have been viewed in the past as merely paying premiums and sending Crummey notices. The insured/settlor often had already selected the insurance product that was either transferred to the ILIT or acquired by the trustee.

Many corporate trustees accepted ILIT's only as an accommodation to clients with whom they had significant relationships, recognizing that the fee potential of an ILIT was small compared to the potential liability. Many serve as trustee to attract and/or retain other assets under management, either during the life of the client and/or upon receipt of life insurance proceeds.

In today's litigious environment, with more regulatory pressure, consumer pressure for transparency, increasing fiduciary litigation, and the passage of legislation like the UPIA, prior practice needs to change. In most states, it is now clear that the trustee of an ILIT has the same fiduciary responsibilities as a trustee of any other trust.

The *Cochran* case is the first case concerning breach of fiduciary duty by the Trustee of an ILIT; at least it is the first such case known to these authors. Its holding can hardly be considered evolved case law, but it does give insight that is important for trustees in developing best-practices for the handling of ILITs.

The holding in *Cochran* was in favor of the trustee and was driven largely by the way the trial court framed the question: "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?" In reaching this result, the court held that while the trustee's "process was not perfect," it was sufficient.

This highlights the standard of the UPIA, which is aimed at the prudence of the process used by a trustee in evaluating investments, not in a backward looking measure of asset performance. As case law evolves in this area, it remains to be seen whether the courts will still consider the "process" in the *Cochran* case to be sufficient. It is, therefore, constructive to consider what issues that court may have discussed.

According to the court in *Cochran*, "[t]he ultimate question. . . is whether the actions of the Trustee … were consistent with the Settlor's intent as expressed in the Trust document and met its fiduciary duties to the Beneficiaries." The actions of the Trustee challenged by the Beneficiaries in this case revolve around the trustee's replacement of existing policy holdings that would have paid an $8,000,000 death benefit with a different type of policy that instead only paid a $2,536,000 death benefit. We can presume that in general, a settlor would rather give a larger death benefit to the trust's beneficiaries than a smaller one.[5]

Thus, the decision in *Cochran* hinges on the suitability of the different types of policies as the court understood them. In fact, the court concluded "[i]n essence, based on the circumstances facing the Trust in 2003, [it was] 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."

Will future courts come to the same conclusion if the plaintiff presents a suitability analysis that goes beyond the narrow determination of whether existing policy holdings should be maintained as-is or replaced, i.e., which policy appears better? And what if the plaintiff presents evidence of how the pricing and performance characteristics of a given policy relates to trust objectives, i.e., which policy best measures up to the definition of suitability as determined by the "prudent process"? If this kind of evidence is not presented, the question is raised as to how trustees can meet their fiduciary obligations under the UPIA and manage the risk associated with this type of fiduciary appointment.

A trustee may want to adopt one or more of the following approaches:

- Trust documents can be drafted that exonerate the trustee from liability for retaining policies that have been transferred or for purchasing policies chosen by the grantor or his or her advisors. This language must be carefully crafted so as not to cause inclusion of the insurance policy in the settlor's federal gross estate.

- Delegate some/all of the following:

    - The duty to monitor the insurers' financial strength and claims-paying ability, the policy's funding adequacy and/or lapse risk, changes in the insureds' health, etc.,

    - The duty to investigate suitability, justify expenses and determine the reasonableness of performance expectations for existing and/or proposed TOLI holdings, and/or

    - The duty to manage TOLI holdings involving evaluation of financial risks and rewards overall, analyzing policy type, design and options, assessing reasonableness of illustrations, and ensuring appropriate diversification, etc.

- Subscribe to independent research to be able to internally monitor the insurers' financial strength and claims-paying ability[6], and/or internally measure pricing and performance against relevant benchmarks[7], and/or internally document suitability[8], and/or build internal expertise and resources to manage TOLI holdings. Many banks already subscribe to such research services and have such expertise and resources in other areas of the bank.

  For instance, some trustees use licensed insurance agents/brokers working elsewhere in the bank to assist in the management of policy holdings, e.g., exchanging unsuitable holdings for suitable holdings. On the other hand, other trustees are understandably reluctant to involve agents/brokers in suitability determinations due to conflict-of-interest issues that can arise when a commission is paid on the replacement of an existing policy.

  However, trustees can solicit the assistance of licensed agents/brokers while maintaining their independence by following a well-defined "prudent process" which incorporates independent research. After all, there is nothing wrong with a bank being compensated for portfolio trades/exchanges provided the bank can quickly and easily demonstrate that such trades/exchanges are in the best-interest of trust beneficiaries.

Some states have recognized the problem of trustees investing in life insurance and have gone so far as to provide statutory protection,[9] albeit likely at the expense of clients and beneficiaries as in the case of *Cochran*. For trustees who cannot depend on state statutes to protect them, and who are reluctant to rely on exculpatory or indemnification language in the trust document that is untested in the courts, there is no alternative but to comply with the terms of the UPIA, either in-house or by appropriately delegating the responsibilities.

The problem is compounded by the fact that ILIT's are usually "dry" except for the policies that they hold. The trustee depends on annual contributions both to pay premiums and to pay its fee. Delegating the investment management function to an outside consultant will require a source of funds to pay for the service. Trustees should, therefore, make sure that they are compensated adequately to pay for such research and/or services either in the form of currently-collected fees, or by accruing fees to be collected upon and from the eventual payment of the death benefit, i.e., provided the trustee can demonstrate/document that the TOLI asset is a "performing asset."

Relying on the selling or servicing agent/broker for such advice can be problematic. While many agents/brokers market themselves as independent, some may have duties to promote their employer's interests and/or are limited by terms of their contracts with a limited number of insurers.

By way of example, in 1987, the agent(s)/broker(s) in the *Cochran* case first sold several universal life (UL) and/or whole life (WL) insurance policies and annuities with death benefits totaling $4,753,539. Then, in 1999, these UL/WL policies were replaced with variable life (VL) policies (the most "popular" product among agents/brokers at that time[10]), and the death benefit increased to $8,000,000 based on illustrations of hypothetical policy performance for each policy.

Finally, in 2003, the VL policies were replaced with another UL policy (a guaranteed form of UL that was again the most "popular" product among agents/brokers at that time), but this time with death benefits totaling only $2,536,000, again based on illustrations of hypothetical policy performance for each policy.

The fact that these agents(s)/broker(s) received commissions on these replacements underscores the potential for issues involving conflicts of interest. At the same time, the use of illustrations of hypothetical policy performance as the basis for such replacements which resulted in a "loss" of more than $2,000,000 in death benefits otherwise payable to the trust certainly is significant. Had the trustee followed the financial analysis and fiduciary principles discussed below, it is conceivable that the original $4,753,539 in UL/WL policies would not have been replaced, the beneficiaries would have received an additional $2,000,000, and the trustee would not have been sued.

A trustee may delegate investment and management functions as is prudent under the circumstances. A trustee must also exercise prudence (i.e. care, skill and caution) in selecting the agent (or "delegatee"), establishing the scope and terms of the delegation, and reviewing the agent's performance.

The trustee should document all delegations and the scope and terms of any delegation. To the extent that agents/brokers are interested in serving the TOLI market, and to the extent that an ILIT trustee is interested in working with a particular agent/broker, then potential conflicts of interest must be disclosed, discussed and reconciled in advance.

In the future, agents and brokers may be asked to serve as "prudent delegatee" under which they become responsible (i.e., liable) for the proper management of TOLI holdings in accord with the "prudent process." Such a delegation also mitigates trustee risk (i.e., liability), as discussed above.

Whether the trustee performs internally the duties to monitor, investigate, and manage, or delegates some or all of these duties to an independent consultant or agent/broker, the trustee should have a well defined "prudent process" that considers at least:

1) the insurer's financial strength and claims-paying ability,

2) the expenses charged to the trust by the insurer of the TOLI holding(s),

3) the stability of such pricing representations by the insurer,

4) the liquidity/availability of TOLI cash values to the extent relevant to trust objectives, and

5) the reasonableness of the rate of return expected on invested assets underlying TOLI holdings.

The court in *Cochran* addressed some of these issues. Below, we examine two key elements of suitability as defined by the "prudent process" under the Uniform Prudent Investor Act (UPIA) that were not examined in the *Cochran* opinion.

Justifying TOLI Expenses

Indiana's version of the UPIA provides that 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." For many years, the premium for TOLI policies was seen by the ILIT trustee as the "cost," due largely to underlying policy expenses not being disclosed. In the absence of more complete information, the premium was seen as the "cost" of the policy by default.

However, the premium does not represent the cost of the policy, any more than a $2,000 contribution to an Individual Retirement Account represents the cost of the IRA. The costs in either case are the expenses deducted from the premium paid or the contribution made.[11]

In fact, the *Cochran* case makes clear that the premium is not the cost of a TOLI holding since premiums were not being paid, and instead cost of insurance charges and policy expenses were being deducted from trust assets that were TOLI cash values. While the trustee's consultant did make the trustee aware of new expense charges, including commissions and surrender charges (of $107,764) that would be incurred on the exchange, there is no evidence that the consultant or the trustee investigated, measured or justified the cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (M&Es) and premium loads in either existing policy holdings or the alternatives under consideration.

Failure to measure and quantify these trust expenses prevented the trustee from making basic management decisions like considering whether it would have been in the beneficiaries' best interest to simply reduce the death benefits under the existing policies.

For instance, while we do not know what General American and Manulife were charging in this case, the average costs per $1,000,000 of face amount for an institutionally-priced variable universal life (VUL) product insuring a 52 year-old male that could qualify for at least a preferred-health risk class, where such costs correspond to a Moderate-

Conservative investor temperament, would be as follows:

Cost of Insurance (COI) Charges	$145,136
Fixed Administration Expenses (FAEs)	$13,923
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps
Premium Loads	7.50%
Total Cost per $1.00 of Death Benefit	18.6¢

Source: www.PolicyPricingCalculator.com

Of course, average costs based on representative industry benchmarks are just that, average. As such, the costs being paid by the trustee could have been as much as 40% lower given findings from a Tillinghast Towers Perrin study[12], a third-party administrator (TPA) survey of trust-owned life insurance (TOLI) policy holdings[13] and research from THEInsuranceAdvisor.COM database.

As such, if General American and Manulife were charging costs that were consistent with best-available rates and terms (BART) for an institutionally-priced variable universal life (VUL) product insuring a 52 year-old male that could qualify for at least a preferred-health risk class, where such costs again correspond to a Moderate-Conservative investor temperament, then these costs per $1,000,000 of face amount could have been as low as those cited below:

Cost of Insurance (COI) Charges	$101,102
Fixed Administration Expenses (FAEs)	$8,354
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps
Premium Loads	7.50%
Total Cost per $1.00 of Death Benefit	12.0¢

Source: www.PolicyPricingCalculator.com

Unfortunately, because it appears both the trustee and the plaintiff failed to measure such expenses, we cannot know what the trustee was actually being charged, and will therefore use costs of between 12.0¢ and 18.6¢ per $1.00 of death benefit for the existing VUL holdings. On the other hand, the cost under the John Hancock policy purchased to replace the two existing VUL policies in this case was likely 15.2¢ per $1.00 of death benefit, and similar to the figures in the chart below for $1,000,000 of face amount:

Cost of Insurance (COI) Charges	$123,876
Fixed Administration Expenses (FAEs)	$21,461
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	0bps
Premium Loads	4.00%
Total Cost per $1.00 of Death Benefit	15.2¢

Source: THEInsuranceAdvisor.COM CPE Research Reports

While the costs in the John Hancock policy were better than average before considering the costs of the exchange, to determine which policy options offered lower costs, the trustee would have to add the $107,764 in surrender charges that would have to be incurred on the termination of the existing VUL policies, as shown below:

	VUL Benchmark Averages	Best-Available VUL Rates & Terms	New John Hancock Holding
Cost of Insurance (COI) Charges	$145,136	$101,102	$123,876
Fixed Administration Expenses (FAEs)	$13,923	$8,354	$21,461
Cash-Value-Based "Wrap Fees" (e.g., M&Es)	55bps	55bps	0bps
Premium Loads	7.50%	7.50%	4.00%

Surrender Charge	N/A	N/A	$107,764
Total Cost per $1.00 of Death Benefit	18.6¢	12.0¢	25.9¢

In other words, had the trustee simply measured cost of insurance charges and policy expenses for both existing holdings and alternatives under consideration, they would have found that the cost to exchange was considerably greater than the average cost to maintain such TOLI, and as much as twice the cost of maintaining the current policy holdings. Only when a trustee knows such TOLI costs can the trustee consider other potentially more cost-effective TOLI management decisions, like simply reducing the death benefits of existing VUL holdings in lieu of exchanging to the John Hancock product in this case.

For instance, simply reducing the death benefits of existing VUL holdings could likely have preserved between $3,000,000 and $5,000,000 of life insurance (versus the $2,536,000 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.

While 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.

Accordingly, "prudence" as defined under the Prudent Investor Act is not concerned with whether a trustee is right or wrong in hindsight, and instead requires that trustees follow a "prudent process" which includes "mak[ing] a reasonable effort to verify facts relevant to the investment and management of trust assets."

At the risk of stating the obvious, the amount a trustee is paying for cost of insurance charges (COIs) and other policy expenses are clearly "facts relevant to the investment and management of trust assets." If COIs and expenses are high, then the value of the death benefit will be lower (for a given amount of premium and cash value) and/or the security of that death benefit will be less (i.e., the risk of lapse will be greater), and are therefore certainly "relevant to the investment and management of trust assets."

As such, had the plaintiff argued that the trustee failed to justify trust expenses, the court may very well have come to a different decision, finding instead that the trustee did in fact breach their fiduciary duty to investigate. Time will have to tell since the court's decision in this case was "based on the circumstances presented," and the plaintiff neglected to present arguments based on the duty to "incur [only those] costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."

As a matter of "best-practices," ILIT trustees should, therefore, simply request that illustrations of hypothetical policy performance include the insurer's underlying representations as to the amounts they expect to charge for cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., VUL M&Es) and premium loads (generally available upon request); these should be measured against corresponding representative industry benchmarks averages (available free of charge at www.PolicyPricingCalculator.com). As discussed above, doing so in *Cochran* may very well have avoided litigation altogether.

Setting Reasonable Rate of Return Expectations

The *Cochran* case also fails to mention risk profile, investor temperament, asset allocation, diversification and other considerations generally taken into account under the UPIA. Had the plaintiff presented arguments involving the trustee's efforts (or lack thereof) to ascertain the proper risk profile, investor temperament, asset allocation, and/or diversification, the court may again have come to a different decision. For instance, the plaintiff argued that the trustee "violate[d] the Indiana Uniform Prudent Investor Act (PIA). Ind. Code § 30-4-3.5-1 et seq. In relevant part, the prudent investor rule, as set forth in the PIA, provides as follows:

> (b) A trustee's investment and management decisions respecting individual assets must be evaluated … as a part of an overall investment strategy having risk and return objectives reasonably

> suited to the trust [emphasis added].
>
> (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:
>
> (5) The expected total return from income and the appreciation of capital.

The plaintiff neglected to further any arguments as to the proper risk profile, investor temperament, asset allocation, and/or diversification that would be consistent with "overall investment strategy having risk and return objectives reasonably suited to the trust." There also was no mention in the record as to the actual asset allocation of the existing VUL policy holdings, only that "[t]he net investment loss for the policy year ending on January 4, 2003 was $36,672.43" and that the "analysis" prepared by the outside consultant assumed "a hypothetical gross interest rate of 8%."

An 8% gross rate likely equates to 7%+ net rate of return, after deduction of estimated fund management expenses (FMEs). Whereas certain segments of the life insurance industry compare investment performance based on gross rates of return, this is unique to the life insurance industry, and differs from prevailing reporting practices in other sectors of the financial services industry that generally compare performance on the basis of net rates of return.

As such, implicit in the use of a 7%+ expected net rate of return is that a Moderate-Conservative asset allocation comprised of 80% fixed-income and 20% equity investments[14] was consistent with the overall investment strategy having risk and return objectives reasonably suited to the trust.

However, if a Moderate-Conservative asset allocation is consistent with the overall investment strategy having risk and return objectives reasonably suited to the trust, then the exchange to the John Hancock guaranteed UL (GUL) product could not have been. Such a VUL to GUL exchange is analogous to exchanging a family of mutual funds diversified across inversely-correlated asset classes to a bank certificate of deposit (CD) where the interest rate is fixed for 40 +/- years. While such an exchange in an investment trust could be suitable, few trustees would make or approve such an exchange without considerable documentation as to the change in the trust's risk profile. That documentation seemed to be missing in *Cochran*.

On the other hand, if the trustee had determined that a Moderate-Conservative cash value allocation was not suitable, then the trustee should not have approved the exchange in 1999 from UL/WL policies in which assets underlying policy cash values are required by regulation to be invested predominantly in fixed-income investments, to VUL policies where cash values can and were allocated to far more volatile equity-type investments.

In other words, with no mention in the record that the risk profile had changed between 1999 an 2003, the actions of the trustee could not have been consistent with the overall investment strategy and corresponding risk and return objectives in both 1999 when the trustee approved the UL/WL to VUL exchange, and then again in 2003 when the trustee exchanged the VUL holdings back to UL.

The failure of the trustee to consider the asset allocation and corresponding expected rate of return as it related to the overall investment strategy and corresponding risk and return objectives again prevented the trustee from considering basic management decisions. For instance, had the trustee concluded that trust's risk profile had in fact changed, and that the asset allocations within existing VL holdings were no longer appropriate, then the trustee could have approached such a change in this insurance trust in they in same way they would have in an investment trust, and simply re-allocated policy cash values to the fixed account. The fixed account in most VUL products guarantees against loss of principal and a minimum rate of interest (e.g., typically 4%), and changing allocations within most VUL policies is free of charge.

So, while the court concluded that the trustee's "decision to exchange the VUL policies for the John Hancock policy was eminently prudent" given "a rapidly declining stock market" and that "the Trust had lost progressively more money, [and had] every reason to believe that further erosion would occur every day it held the VUL policies," trust assets could have been equally well-protected against "a rapidly declining stock market" by simply re-allocating cash values to a fixed/guaranteed account for free. In addition, the $107,764 charge certain to be incurred on the exchange to John Hancock actually eroded more trust assets (i.e., a loss of 20%[15]) than the potential for "further erosion" in existing VUL policies (e.g., a loss of 6.7% in the year leading up to the exchange).

As such, had the plaintiff argued that the trustee failed to allocate trust assets in a manner consistent with the risk profile appropriate to the trust, which they could have done at no expense, then the court may very well have come to a different conclusion. The court's decision in this case was "based on the circumstances presented", and the plaintiff neglected to present arguments based on the trustee's duty to consider "[t]he tradeoff in all investing between risk and return [that UPIA] identifie[s] as the fiduciary's central consideration. UPIA § 2(b)."

As a matter of "best-practices", ILIT trustees should, therefore, avoid comparing illustrations of hypothetical policy values as a basis for making suitability determinations, and instead should simply request historical returns for invested assets underlying TOLI cash values; trustees should measure such performance against asset class benchmark performance for the asset allocation corresponding to the overall investment strategy having risk and return objectives reasonably suited to the trust. While past performance is no guarantee of future results, justifying expenses and using past performance to set reasonable expectations is a familiar practice in investment trusts, and doing so here in *Cochran* may very well have avoided litigation altogether.

Reliance on Illustrations of Hypothetical Policy Values?

The sole basis for the court's understanding that existing VUL holdings posed "significant risk and likelihood of ultimate lapse" and that the replacement policy provided "a smaller but guaranteed death benefit" was the illustrations of hypothetical policy values presented by the outside consultant. Such illustrations of hypothetical policy performance are the commingling an insurer's representations as to what they actually expect to charge for cost of insurance charges, as well as expenses intermixed with some usually arbitrary and often unreliable assumption as to the rate of return on invested assets underlying policy cash values. While comparing illustrations of hypothetical policy performance is a common practice in the life insurance industry, it is a practice unique to the life insurance industry, and is actually prohibited by the Financial Industry Regulatory Authority (FINRA).

We have discussed how such comparisons of illustrations of hypothetical policy performance could leave the trustee vulnerable to accusation of breach of fiduciary duty for failure to investigate, justify trust expenses and failure to set and manage to reasonable rates of return. In addition, because these comparisons of illustrations of hypothetical policy performance were the sole basis for the court's understanding of the attributes of the various life insurance policies involved here, it is relevant that FINRA considers such life insurance policy comparisons misleading.

While FINRA does not have jurisdiction over the ILIT trustee, their rules are intended to ensure that "communications … shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service" and may not "omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading."

While these rules only apply to the sale of variable life (VL) products, and while a trustee could argue that the FINRA standard does not apply to comparisons of illustrations of hypothetical policy performance for their purposes, a plaintiff attorney could conversely argue that accepting a lower standard of care for certain products just because current (and soon to be changed) regulations allow for the omission of underlying cost and performance disclosures, and do not require that communications be fair and balanced, is not consistent with the standard applicable to fiduciaries.

While the use of comparison illustrations of hypothetical policy values happened to produce a good result for the trustee in this case, this is the first case involving a breach of fiduciary claim in an ILIT that has actually been adjudicated, and it remains to be seen whether other courts will make the same determinations. As such, the conservative trustee (or its "prudent delegatee") should take only limited comfort from the precedential value of this case, and should as a matter of "best-practices" examine the standard of care prescribed by the more evolved FINRA rules governing such comparisons of illustrations of hypothetical policy values, namely: FINRA Rule 2210 Communications with the Public[16], Section (d)(2)(B), which states that:

> "any comparison … between investments … must disclose all material differences between them, including (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features."

Simply comparing hypothetical illustrations of projected premiums, policy cash values or death benefits does not disclose any differences as to cost of insurance (COI) charges (accounting for as much as 85% of total trust expenses), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and/or premium loads. As discussed above, such cost disclosures are also essential to compliance with Section 7 of the Uniform Prudent Investor Act (UPIA) as adopted by the respective States[17].

FINRA Rule IM-2210-1 (Guidelines to Ensure That Communications With the Public Are Not Misleading[18]) requires that "statements are not misleading within the context in which they are made" and instead must provide "balanced treatment of risks and potential benefits" and "be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments." Of course, the context of the comparative analysis in this case was (supposedly) to evaluate and establish for the trustee the suitability (or lack thereof) of existing and replacement policy holdings.

However, simply comparing hypothetical illustrations of projected premiums, cash values and/or death benefits fails to consider "the risks of fluctuating prices [or lack thereof] and the uncertainty of dividends, rates of return and yield inherent to investments" and therefore also fails to provide a "balanced treatment of risks and potential benefits". As such, policy comparisons that use hypothetical illustrations for the purpose (i.e., within the context) of determining the suitability of a given policy are "misleading" under FINRA rules.

Establishing the reasonableness of the rate of return expected on invested assets underlying policy cash values, as it relates to either actual historical performance and/or the historical performance for the asset classes corresponding to the asset allocation appropriate to the trust, is also essential to compliance with Section 2 of UPIA as adopted by the respective states.

For these reasons, FINRA Rule IM-2210-2 Communications with the Public About Variable Life Insurance[19] concludes in Section (b)(5)(C) that:

> 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."

In support of this conclusion, Section (b)(5)(A)(i) states that "illustrations may not be used to project or predict [future] results as such forecasts are strictly prohibited by the Rules." Inherent in any comparison of illustrated premiums, cash values or death benefits is inherently the presumption that projections are accurate predictions of future results, which is "strictly prohibited by the Rules."

While policy comparisons are common practice in the life insurance industry, they are beyond the allowable "singular purpose," "inappropriate" and "misleading" by FINRA standards. As such, to the extent that FINRA standards provide guidance as to the fiduciary standard to which ILIT trustees may be held, cautious ILIT trustees should consider alternative means of determining and documenting suitability.

CONCLUSION:

Cochran is the first case involving a claim of breach of fiduciary duty against an ILIT trustee that has worked its way through the courts. As such, this case marks the beginning of a new understanding for how to apply Prudent Investor Act principals to TOLI.

While *Cochran* provides ILIT trustees with some guidance and comfort, it appears that this case could easily have gone the other way on the issue of "prudent process" giving only cursory treatment to certain elements of the breach of fiduciary duty claim that could well form the main elements of a similar future challenge. As such, ILIT trustees intent on preventing similar such future challenges before they are ever brought should also consider:

1) Taking steps to demonstrate they investigated and justified TOLI expenses. For instance, most illustrations of hypothetical policy values can include upon request the actual year-by-year detail for the cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and premium loads they expect to charge.

   As such, cautious trustees should simply ensure these detailed expense pages are included in their routine requests for in-force illustrations and so as to then be able justify such TOLI expenses by measuring against corresponding representative benchmark averages (e.g., available for free at www.PolicyPricingCalculator.com).

2) Ascertaining the appropriate asset allocation and corresponding expected rate of return as it relates to the overall investment strategy and corresponding risk and return objectives reasonably suited to the trust. Performing this function for a life insurance trust is at least similar to, if not the same as, that which trustees routinely perform in investment trusts.

   For instance, the more conservative the asset allocation in an investment trust, the lower the risk and the lower the benefit in the form of income and/or growth, and vice-versa.

   Likewise, in a life insurance trust, where the more aggressive the asset allocation, the greater the expected rate of return that can pay for more cost of insurance charges and policy expenses, and thus pay for a higher death benefit, but with a greater the risk of a "premium call" or lapse, and vice versa (as we saw in this case here). As such, cautious trustees should set and manage to reasonable expectations as to the rate of return on invested assets underlying policy cash values in the same way they would in an investment trust.

3) Adopting alternative means of determining and documenting suitability, either in addition to or in lieu of policy comparisons using illustrations of hypothetical policy values. For instance, while certain policy comparison services "advertise" their policy review reports to be "complete", many of these policy analysis reports actually disclaim suitability determinations in the proverbial fine print. Having a report in the trust file that purports to ascertain the suitability/competitiveness of a particular policy is an acknowledgement by the trustee of their duty to investigate suitability.

    However, a report that acknowledges this duty to investigate, but then does not actually demonstrate the exercise of this duty, and instead actually disclaims the performance of this duty, may prove indefensible in future such breach of fiduciary duty cases. As such, cautious trustees should "check the fine print" of their policy review reports and seek out independent research to determine and document suitability by 1) justifying TOLI expenses ,2) setting and managing to reasonable performance expectations, and 3) documenting the delegation of responsibility to the independent researcher in accordance with the Uniform Prudent Investor Act.

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

Barry Flagg

Patti Spencer

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] LISI Estate Planning Newsletter #1486, Patrick J. Lannon

[2] Page 8 of the UNIFORM PRUDENT INVESTOR ACT drafted by the NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS and by it APPROVED AND RECOMMENDED FOR ENACTMENT IN ALL THE STATES at its ANNUAL CONFERENCE MEETING IN ITS ONE-HUNDRED-AND-THIRD YEAR IN CHICAGO, ILLINOIS JULY 29 - AUGUST 5, 1994 (*www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf*).

[3] See part 3 of 3 of "The Prudent Investor and TOLI" published in the May/June 2007 issue of the ABA Trusts & Investments magazine.

[4] Fiduciary Pitfalls with Trust-Owned Life Insurance, ABA Tele-Briefing, 2006, Christopher P. Cline and Barry D. Flagg, CFP®, CLU, ChFC.

[5] The court concluded that another previous exchange of policies in 1999 that resulted in the $8,000,000 death benefit was consistent with the Settlor's intent and observed "the transaction nearly double the total death benefit available to the trust" as support for its conclusion.

[6] See http://www.ebix.com/vss_signs_carrier.aspx

[7] See www.PolicyPricingCalculator.com

[8] See http://www.theinsuranceadvisor.com/Confidential-Policy-Evaluator/How-CPE-Works.

[9] LISI Estate Planning Newsletter #1342, Patrick J. Lannon.

[10] Source: Life Insurance and Market Research Association (LIMRA)

[11] See part 3 of 3 of "The Prudent Investor and TOLI" published in the May/June 2007 issue of the ABA Trusts & Investments magazine.

[12] Tillinghast Towers Perrin study referenced in the May 2003 issue of Trusts and Estates.

[13] CASCO survey reported in the April 1999 issue of Trusts & Estates magazine both indicate that trust-owned life insurance (TOLI) death benefits can be increased by 40% or more, or that premiums can be reduced by 40% or more in 65% to 85% of single-life and survivorship trust-owned policies respectively.

[14] Source: Ibbotson® SBBI® 2009 Classic Yearbook, Summary of Annual Returns, Data from 1926 to 2008.

[15] While the amount of cash values in existing VUL holdings was not mentioned in the record evidence, such cash values likely totaled approximately $550,000 based the findings of the outside consultant that were included in the record evidence and given product pricing and performance data in THEInsuranceAdvisor.COM database.

[16] See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3617.

[17] For a list of States which have adopted the Uniform Prudent Investor Act in some form or fashion, see the Table of Uniform Laws in the Legal Information Institute section of the Cornell University Law School web site (http://www.law.cornell.edu/uniform/vol7.html#pruin).
[18] See http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3618.
[19] See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3619.