



## **New Case Law for Trust-Owned Life Insurance: What Every Trustee Should Know About Managing TOLI (But Has Been Afraid To Ask)**

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## About the Speakers

**Barry D. Flagg** is founder of [THEInsuranceAdvisor.COM](http://THEInsuranceAdvisor.COM) with more than 25 years of experience in the life insurance business, the youngest CFP® in history, and the inventor of the only patented research tool for measuring pricing and Performance of insurance products. He holds CLU and ChFC designations, and is a frequent author and speaker on the subject of Trust-Owned Life Insurance (TOLI).

**Steven S. Zeiger** is a Senior Partner with Private Client Group, LLC - a financial services firm based in New York City - and founder of [XRayYourLifeInsurance.com](http://XRayYourLifeInsurance.com). Steven is an expert in Trust Owned Life Insurance (TOLI) and is a highly sought out lecturer to attorneys, CPAs and bank trust officers. Steven's TOLI service is endorsed by the New York Bankers Association (NYBSCO) and the New Jersey Bankers Association.

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## Objective:

To go beyond using authority to defend the old way of doing things, and instead use case law and other guidance to avoid litigation, and provide new services that produce happy clients and new fees/revenue.



## Important Disclosures:

This presentation is not intended as a complete review of all claims, decisions or opinions of the courts, nor of all aspects of the Uniform Prudent Investor Act (UPIA), and instead intends to focus on specific guidance most useful for avoiding Irrevocable Life Insurance Trust (ILIT) litigation and developing trust-owned life insurance (TOLI) management services.

Variable life insurance products are sold by prospectus, that describes the investment objectives, risk factors, expenses, fees, and surrender charges that may apply. Clients should read the prospectus carefully before purchasing a variable product. All guarantees are subject to the claims-paying ability of the issuing insurance company. Guarantees do not apply to the investment performance of any variable accounts, which are subject to market risk.



## Introduction:

“This case is a must read for any individual or corporate trustee”

LSI Estate Planning Newsletter #1486  
(6/29/2009) <http://www.leimbergservices.com>



## Introduction:

“This case is a must read for any individual or corporate trustee” given typical facts as to ...

... Agent/Broker made product recommendations but not liable for same.

... ILIT trustee involved after the “sale” made to the client.

... multiple replacements with various “flavor of the day” products.

... no premium payments -- dispels the “myth” that premiums are costs.



## Agenda:

1. Situation – Review New TOLI Case Law  
*In re Cochran Irrevocable Trust*
2. Best Practices – Review Other Guidance Authority  
for Best Practices
3. Results – Synthesizing Case Law and Best Practices  
into a Prudent Process to help:
  - Avoid ILIT Litigation,
  - Better Serve Clients &
  - Create New Fee/Revenue.



## Situation:

- ILIT trustee responsibilities used to involve sending Crummey notices & paying premiums.
- Most states have adopted the Uniform Prudent Investor Act (UPIA) prescribing new responsibilities for ILIT trustees.
- Many ILIT trustees have taken steps to comply but lacked guidance for how to apply UPIA to TOLI.
- *In re Cochran* provides guidance to avoid litigation (and develop new business).





## Situation: Background

- 1987 -Cochran ILIT created to own **\$4.75M** in “conservative” UL, WL & annuity policies.
- 1999 -Cochran’s agent/broker recommended replacing \$4.75M with **\$8.0M** VUL & ILIT trustee approved.
- 2001 -VUL cash values allocated to “aggressive” funds & declined by **\$37,000** (7% unrealized loss).
- 2003 -Cochran’s agent/broker recommended replacing \$8.0M with \$2.54M GUL at a cost of \$107,000+ (a 20%+ realized loss).

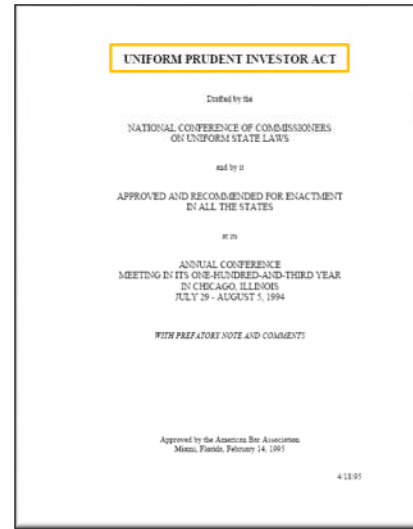


## Situation: Background

- 2003 -Proposed replacement “reviewed” by independent consultant who questioned then agreed.
- 7 months later, Cochran dies at age 54 & beneficiaries sue for breach of fiduciary duty.
- 2008 -Trial Court: “The ultimate question is whether prudent to move from policies with significant risk of lapse to a smaller guaranteed death benefit.”
- 2009 -Indiana Appeals Court affirms lower court decision in favor of ILIT trustee.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ...



## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ① monitor

**Duty to monitor.** Subsections (a) through (d) apply both to investing and managing trust assets. “Managing” embraces monitoring, that is, the trustee’s continuing responsibility for oversight of the suitability of investments already made as well as the trustee’s decisions respecting new investments.

**Duty to diversify.** Subsection (b) centers around the traditional responsibility of the fiduciary to exercise prudent judgment in the selection of investments. The Act does not require the trustee to diversify in order to avoid the risk of loss. *Estate of Cohn*, 72 Cal. App. 3d 953, 139 Cal. Rptr. 844 (1977), involves loss on a single security as unanticipated and seems, based on how loss appeared, not to require the trustee to diversify.

**Abrogating categorical restrictions.** Subsection 2(c) clarifies that no particular kind of property or type of investment is categorically restricted. Traditional trust law was encumbered with a variety of categorical exclusions, such as prohibitions on speculative investments or on investments in certain securities. In some cases, legislative enactments created so-called “safe harbors” of approved trust investments. The universe of investment products changes constantly. Investments that were at one time thought to be “safe” may, in the future, be more risky. Hence, the law must be able to adapt to changing circumstances. By contrast, the investment that was at one time thought to be “safe” may, in the future, be more risky. Hence, the law must be able to adapt to changing circumstances. By contrast, the investment that was at one time thought to be “safe” may, in the future, be more risky. Hence, the law must be able to adapt to changing circumstances.

The Act implicitly disavows the emphasis in older law on avoiding “speculative” or “risky” investments. Low levels of risk may be appropriate in

## Situation: Clear Guidance

☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ① monitor

- Obtaining TOLI Data
- Record-Keeping
- Updating Health Status
- Monitoring Default Risk & Lapse Risk

Insurer Strength  
& Claims-Paying  
ratings acceptable.

Existing \$8M  
death benefit risks  
lapsing before  
life expectancy.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ① monitor, ② investigate

**Duty to investigate.** Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

“An ongoing ‘ongoing’ investigation” – subsection (d) – carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses). The Act implicitly disallows the emphasis in older law on avoiding “speculative” or “risky” investments. Low levels of risk may be appropriate in



## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶ monitor, ❷ investigate

**SECTION 7. INVESTMENT COSTS:** “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.”

The language of Section 6 derives from Restatement of Trusts 26 § 163 (1951), see also id. § 212. Multiple beneficiaries may be beneficiaries as successors (such as life and remainder interests) or beneficiaries with simultaneous interests (in which the income interest in a trust is being divided among several beneficiaries).

The trustee's duty of impartiality causally affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly limited under specialized legislation, such as the Revised Uniform Principal and Income Act (1987) (which is presently under study by the Uniform Law Commission with a view toward further revision).

**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.

**Comment**

Working beneficiaries' interest is important. In deriving and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 26 § 168 (1951). The Restatement of Trusts 16 says: "Costs over compensation and

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate

### SECTION 7. INVESTMENT COSTS: “a

Consultant measured the \$107,000 surrender charge but failed to measure other, larger policy costs in both existing and proposed TOLI holdings.



## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ①monitor, ②investigate

### SECTION 2. RISK AND RETURN OBJECTIVES:

“a trustee shall [have] an overall investment strategy [with] risk and return objectives reasonably suited to the trust” and “consider ... the expected total return” therefrom.

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

(4) A trustee shall invest and manage trust assets as a prudent person 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.

(5) 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 a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(6) Among circumstances that a trustee shall consider in investing and managing trust assets are each of the following as are relevant to the trust or its beneficiaries:

(1) present economic conditions;

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate

### SECTION 2. RISK AND RETURN OBJECTIVES:

Consultant measured the risk of lapse for aggressive allocation of cash values but failed to measure the risk of lapse under a more conservative asset allocation or a lower death benefit.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium

Cochran unable or unwilling to make additional gifts for premium payments.

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## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium

2. Decreasing Death Benefit

New death benefit decreased but decreasing old death benefit not considered.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium
2. Decreasing Death Benefit
3. Changing Cash Value

New policy more conservative but changing old cash value allocations not considered.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ①monitor, ②investigate and ③manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium
2. Decreasing Death Benefit
3. Changing Cash Value
4. Exchanging/Trading

Old \$8M replaced with \$2.54M at a cost of at least \$107,000.

## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium
2. Decreasing Death Be
3. Changing Cash Value
4. Exchanging/Trading
5. “Wait-and-See”

“A ‘wait and see’ approach could also have been prudent.”



## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk by ...

1. Increasing Premium Funding
- 2. Decreasing Death Benefits**
- 3. Changing Cash Value Asset Allocations**
- 4. Exchanging/Trading TOLI Holdings**
5. “Wait-and-See”



## Situation: Clear Guidance

- ☒ Trustees not 2<sup>nd</sup>-guessed in hind-sight if following a “prudent process” to ❶monitor, ❷investigate and ❸manage TOLI to minimize/justify expenses and maximize return relative to risk.
- ☒ Reliance on information provided by an “independent entity with no policy to sell or any other financial stake in the outcome” was instrumental.



# Questions?



## Best Practices: FINRA Rule 2210

- Sole basis for Court's conclusion that replacement was more suitable than existing policies were illustrations of hypothetical policy values.
- Financial Industry Regulatory Authority (FINRA) considers such hypothetical comparisons “misleading” & “strictly prohibited”.
- FINRA compliance helps ensure independent research is “fair & balanced”, “does not omit any material fact” & is less likely to be challenged.



## Best Practices: Disclaimers

- Check the “fine print ... in policy [reviews that] advertise ... ‘complete’ [reviews but then] actually **disclaim** suitability determinations”

LISI Estate Planning Newsletter #1499 (August 5, 2009) at <http://www.leimbergservices.com/>



## Best Practices: Disclaimers

- Check the “fine print ... in policy [reviews that] advertise ... complete [reviews but then] actually **disclaim** suitability determinations”.
  - e.g., “This annual performance review is not designed ... to determine the suitability of specific insurance plans [or] the competitiveness of the existing policy.”
  - e.g., “this annual policy review is not designed ... to establish the suitability of a particular policy.”
  - e.g., “Policy Classification Codes ... are not intended to measure policy contract efficiency.”

## Best Practices: UPIA Section 7

- INVESTMENT COSTS: “a trustee may only incur costs that are appropriate & reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.”
- The purpose of an ILIT is to hold life insurance.
- Costs in trust-owned life insurance (TOLI) are:
  - ✓ Cost of Insurance Charges (COIs)
  - ✓ Fixed Administration Expenses (FAEs)
  - ✓ Cash-Value-Based “Wrap Fees” (e.g., M&Es)
  - ✓ Premium Loads
  - ✓ Surrender Charges



## Best Practices: UPIA Section 7

- TOLI costs of Cochran existing VUL likely between 12¢ - 19¢ per \$1 of death benefit.\*
- Costs of replacement GUL were 15¢ +/- per \$1 of death benefit before incurring the \$107,000 charge on the surrender the VUL holdings.\*
- Total costs of the VUL to GUL exchange were 25¢ per \$1 of death benefit (i.e., 30% to 50% more costly than maintaining existing holdings).\*

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\* LSI Estate Planning Newsletter #1499 (August 5, 2009) at <http://www.leimbergservices.com>



## Best Practices: UPIA Section 7

- Measuring and “only incur[ing those] costs that are appropriate and reasonable in relation to the assets” (instead of comparing hypothetical illustrations) could have ...
  - ...lead to reducing death benefits in existing VUL to between \$3.3M to \$5.0M (i.e., as much as 2X more than under GUL replacement).
  - ...saved the \$107,000+ expense involved in replacing “conservative” UL/WL with “aggressive” VUL only to go back to “conservative” GUL.





## Best Practices: UPIA Section 2

- RISK AND RETURN OBJECTIVES: “a trustee shall [have] an overall investment strategy [with] risk and return objectives reasonably suited to the trust” and “consider ... the expected total return” therefrom.
- In 2003, Cochran risk and return objectives changed from “aggressive” (i.e., VUL allocated primarily to equity accounts) to “conservative” (i.e., GUL invested in fixed-income and death benefits guaranteed)???



## Best Practices: UPIA Section 2

- Having “an overall investment strategy [with] risk and return objectives reasonably suited to the trust” (instead of comparing hypothetical illustrations) could have ...
  - ...lead to allocating existing VUL cash values to a “conservative” fixed-account also with interest rate & death benefit guarantees **free of charge**.
  - ...protected trust assets against “los[ing] progressively more money” in “a rapidly declining stock market”.



## Best Practices: UPIA Section 9

- DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS: “A trustee who complies with [delegation] requirements is not liable to the beneficiaries ... for decisions or actions of the agent.”
- Clearly establishes the roles & responsibilities to the client for both ILIT trustee and agent.
- Aligns ILIT trustee & agent interests (& liability).
- Reconciles conflicts-of-interest.
- Framework for “in-sourcing” life insurance product expertise that an ILIT trustee may lack.



## Best Practices: UPIA Section 9

- Delegating to “an agent [who] owes a duty to the trust to exercise reasonable care ...” could have ...
  - ...prompted the agent to disclose his role and responsibilities to the client.
  - ...encouraged the ILIT trustee & the agent to collaborate before the “sale” to the client.
  - ...discouraged multiple replacements with “flavor of the day” products unless in client best-interest.
  - ...left original \$4.75M UL/WL policies in-force & provided beneficiaries with +\$2M.



# Questions?



## Results:

- By definition, ½ of all TOLI holdings are poorly-priced and/or are poorly performing.
- TOLI expenses can be reduced by as much as 40%\* in poorly-priced holdings.
- Failure to justify TOLI expenses allows beneficiaries to claim they should have received greater death benefits.

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\* Tillinghast Towers Perrin study referenced in Trusts & Estates 5/2003 issue & CASCO third-party administrator (TPA) of trust-owned life insurance (TOLI) survey published in Trusts & Estates 4/1999 issue.





## Results: Prudent Process 1, 2, 3

- ① TPAs collect & compile TOLI info for online access & to **monitor** default risk & lapse risk.
- ② Independent Research used to **investigate** the five (5) major factors of TOLI suitability as to:
  - ★ Financial Strength & Claims-Paying Ability
  - ★ Cost Competitiveness
  - ★ Pricing Stability
  - ★ Cash Value Liquidity
  - ★ Historical Performance



## Results: Prudent Process 1, 2, 3

- ① TPAs collect & compile TOLI info for online access & to **monitor** default risk & lapse risk.
- ② Independent Research used to **investigate** the five (5) major factors of TOLI suitability as to:
- ③ For suitable, adequately-funded holdings, file TPA and research reports in trust file.





## Results: Prudent Process 1, 2, 3

- ① TPAs collect & compile TOLI info for online access & to **monitor** default risk & lapse risk.
- ② Independent Research used to **investigate** the five (5) major factors of TOLI suitability as to:
- ③ **Manage** unsuitable/under-funded TOLI holdings using Grantor/Beneficiary Consent Form to ...
  - ☐ Increase Gifts/Premiums
  - ☐ Decrease Death Benefits
  - ☐ Change Asset Allocations
  - ☐ Reduce TOLI Expenses
  - ☐ Wait-and-See



## Results: Prudent Process 1, 2, 3

- ① TPAs collect & compile TOLI info for online access & to **monitor** default risk & lapse risk.
- ② Independent Research used to **investigate** the five (5) major factors of TOLI suitability as to:
- ③ **Manage** unsuitable/under-funded TOLI holdings using Grantor/Beneficiary Consent Form to ...
  - ✓ If Grantor declines to participate in TOLI Management process, then file in trust file to “estop” future claims of breach of fiduciary.

## Results: Prudent Process 1, 2, 3

- ① TPAs collect & compile TOLI info for online access & to **monitor** default risk & lapse risk.
- ② Independent Research used to **investigate** the five (5) major factors of TOLI suitability as to:
- ③ **Manage** unsuitable/under-funded TOLI holdings **with Grantor/Beneficiary Consent** then
  - ✓ Collect Health Profile Questionnaire (HPQ)
  - ✓ Collect Risk Profile Questionnaire (RPQ)
  - ✓ Confirm expected coverage duration
  - ✓ Search for best-available rates & terms (BART)
  - ✓ Implement BART & go back to step #1



## Results: Conclusions

- ILIT trustees following a “prudent process” will not be second-guessed in hind-sight.
- Reliance on independent research is instrumental.
- FINRA compliant research provides more useful information & is less likely to be challenged.
- Only by measuring actual TOLI expenses (UPIA Sec. 7) & actual performance (UPIA Sec. 2) can expenses be reduced & performance improved.
- Delegating (UPIA Sec. 9) can reduce liability, identify prudent TOLI trades/exchanges & better serve clients.



# Questions?