The WRMarketplace is created exclusively for AALU members by experts at Baker Hostetler LLP and the AALU staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partner**. WR Marketplace #19-14 was written by **Edward J. Beckwith, Partner, and Jennifer M. Smith, Counsel, Baker Hostetler LLP**.

The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals**.**

Friday, August 2, 2019 **WRM#19-14**

TOPIC: Watch Your Step: Fiduciary Pitfalls for Trustees of Irrevocable Life Insurance Trusts.

MARKET TREND: Trustees must be mindful of their fiduciary duties to beneficiaries of trusts and should adopt procedures evidencing prudent administration to reduce their exposure.

SYNOPSIS: Sample cases targeting trustees vividly illustrate unique fiduciary challenges in terms of trust administration and asset management, including for irrevocable life insurance trusts ("ILITs"). The growing complexity of life insurance products and the potential for increased gifts in the next several years can make ILIT administration far more complicated than anticipated, particularly for non-professional trustees.

TAKE AWAYS: ILIT trustees have significant fiduciary duties that can result in serious liability if breached. To minimize exposure, they should act independently, conduct regular, independent evaluations of policy performance, seek professional advice with respect to investments as needed, document their deliberations and decisions, and disclose information to ILIT grantors and/or beneficiaries and obtain waivers or consents as appropriate. In these cases, insurance professionals can add value to their client relationships by offering monitoring and annual reviews of trust-owned life insurance to support ILIT trustees in executing their duties.

MAJOR REFERENCES: Paradee v. Paradee, Del. Ch. No. CIV.A. 4988-VCL, WL 3959604 (Oct. 5, 2010); Rafert v. Meyer, 859 N.W.2d 332 (Neb. 2015); Mennen v. Wilmington Trust Co., Del. Ch.

No. CIV.A 8432-ML, WL 1914599 (Apr. 24, 2015); In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Ind. Ct. App., Mar. 2, 2009).

A trustee's job in administering a trust can be unexpectedly treacherous, especially in the context of an ILIT and the management of its life insurance portfolio. Clients frequently turn to family and friends to fill this important role, since many financial institutions will not serve as trustees of an ILIT only funded with life insurance. Individual or non-professional trustees, however, are particularly vulnerable to beneficiary attacks, as they often are less knowledgeable about their duties and potential risks than institutional trustees and lack the protective shield of errors and omissions coverage. For these trustees, understanding their fundamental fiduciary duties and typical pitfalls in trust administration is crucial to avoiding unintended missteps.

ILIT TRUSTEES: TYPICAL RESPONSIBILITIES & DUTIES

Administration. An ILIT trustee is most often responsible for receiving targeted gifts from the grantor and applying those gifts to pay premiums on a life insurance policy that typically insures the trust creator (the "**grantor**") and possibly his or her spouse. Most ILITs require that the trustee give beneficiaries written notice of certain withdrawal (i.e., Crummey) rights upon the trust's receipt of any gift. Significant additional tasks include acquiring and managing the life insurance portfolio as a trust asset and coordinating with the grantor regarding income tax preparation if the trust produces income. Upon the grantor's death, the ILIT will receive the policy proceeds and possibly other assets depending on the details of the legacy plan, which will likely generate a shift in administrative focus to managing a broader investment portfolio and more frequent distributions to beneficiaries.

Fiduciary Duties. A trustee has many duties to the trust beneficiaries, chiefly the **duty of loyalty.** A trustee is charged with the duty to act solely in the interest of the beneficiaries regarding matters that directly and indirectly involve trust property. In this regard, the trustee also must avoid dealing with trust property for the trustee's own profit or engage in transactions in which the trustee has an interest adverse to a beneficiary.

Trustees also have a duty to manage and monitor trust investments in compliance with the trust agreement and any applicable prudent investor rule. Additional duties include investing, managing and distributing trust property impartially if the trust has multiple beneficiaries and keeping the beneficiaries reasonably informed of the trust and its administration. The trust agreement may modify or limit certain duties, depending on applicable state law, although the duty of loyalty generally cannot be waived.

NEW CHALLENGES

The lifetime gift and generation-skipping transfer tax exemptions increased dramatically under Tax Cuts and Jobs Act of 2017, more than doubling to $11,400,000 per grantor in 2019. Under current law, these changes will disappear in 2026. As the available planning window narrows, grantors may decide to use an existing ILIT to receive these larger gifts to use the increased exemption, requiring the trustee to manage an unexpected investment portfolio in addition to the policy. This outcome could significantly increase the trustee's responsibilities and, correspondingly, his or her potential fiduciary liability exposure.

COMMON PITFALLS FOR ILIT TRUSTEES

Prioritizing the Grantor's Interests. As noted, ILIT grantors often pick family members or close friends/associates to act as the trustee. As a result, the trustee may find it easy to lose focus on the beneficiaries' interests and simply default to taking recommendations or directions from the grantor (or even the grantor's spouse).

The case of *Paradee v. Paradee* provides a textbook example. In *Paradee*, Charles Paradee created an ILIT benefiting his grandson, Trey, which purchased a $1 million, second-to-die policy insuring Charles and his second wife, Eleanor (who did not get along with Trey). Charles appointed his insurance advisor, with whom he did substantial business, as trustee. At Eleanor's request, the trustee borrowed against the ILIT's policy to fund a loan from the ILIT to the family business. The business loan was unsecured and bore a rate of interest lower than that of the policy loan. Later, after the death of both Charles and the advisor, Eleanor appointed herself as trustee, never notifying Trey of the ILIT or his rights under the agreement (including to remove and replace trustees). Further, the family business defaulted on the business loan, yet Eleanor took no action as ILIT trustee to collect. The policy loan used to fund the business loan continued to accrue interest, finally causing the ILIT's policy to lapse. Trey ultimately discovered the ILIT's existence and brought suit for breach of fiduciary duties.

The *Paradee* court found that the insurance advisor, as initial trustee, breached his duty of loyalty in making the business loan from the ILIT because he placed the interests of his long-time clients above those of the ILIT beneficiary. Although the trust agreement authorized loans from the ILIT (with adequate interest and security), mere authorization did not make the trustee's action proper, as it was against the beneficiary's interests. Further, although the advisor consulted with legal counsel, counsel's advice only addressed the trustee's authority to make a trust loan and did not opine as to compliance with any fiduciary duties. The trustee also did not follow counsel's advice to secure the loan adequately.

Lessons for ILIT Trustees:

- <u>Just Because You Can Doesn't Mean You Should</u>. Possessing the necessary power to perform an act as trustee is different from electing to exercise that power. While a trustee must ensure there is legal authority to take an action ("can I?"), the trustee must also consider whether the action complies with his or her fiduciary duties ("should I"?).

- <u>Ensure Your Independence</u>. Significant conflicts of interest can arise when a trustee maintains too close a relationship with the grantor (typically the insured). ILITs are inherently more prone to this type of conflict, since: (1) by necessity, the trustee must work closely with the grantor to ensure timely contributions to the ILIT to pay premiums or to obtain personal information necessary to evaluate policy investments or changes; and (2) grantors often name friends or family as trustees who lack experience with trusts in general and life insurance in particular. Regardless of the relationship, a trustee must always make independent decisions based on what is in the best interests of the trust's beneficiaries.

- Consider Independent Co-Trustees. Appointing an unrelated or professional trustee can establish independence of administration and support inexperienced co-trustees who may find it challenging to maintain separation from the grantor. An independent trustee fortifies the legitimacy of the overall trust administration, as such trustees are less likely to permit undue control by the grantor.

Over-Reliance on ILIT's Exculpatory Provisions. Trust agreements can expand or restrict a trustee's duties and eliminate liability for the performance (or non-performance) of certain tasks. For example, many ILITs eliminate a trustee's duty (and associated liability) to diversify investments, to pay policy premiums if existing trust funds are insufficient, to evaluate a policy or monitor its performance, and to determine whether to change the policy or coverage.

Applicable state law, however, can limit the protections offered by these exculpatory provisions, as illustrated by a Nebraska case, *Rafert v. Meyer. Rafert* involved an ILIT agreement drafted by the grantor's attorney which also named the attorney as trustee. The trust agreement specifically provided that the trustee had no duty to pay the insurance premiums or notify the beneficiaries of nonpayment of such premiums and had no liability for any nonpayment. The ILIT acquired three policies insuring the grantor; however, the grantor's attorney, as trustee, provided a false/incorrect address to the issuing insurer. As all subsequent policy premium and lapse notices went to this address, the trustee never received them, and the policies eventually lapsed. When the ILIT grantor and beneficiaries sued the trustee for breach of trust, he argued for dismissal of the complaint in part because he did not cause the nonpayment of the premiums and had no notice from the insurers of nonpayment.

A lower court initially held for the trustee, finding that, based on the ILIT terms, the trustee did not have a duty to pay premiums or to notify anyone of the nonpayment and also had no responsibility for the failure to pay the premiums. On appeal, however, the appellate court found the trustee had breached his fiduciary duty despite the trust's exculpatory provisions. The appellate court stated that, as a general rule, a trustee's authority is governed not only by the trust agreement but also by statutes and common-law rules pertaining to trusts and trustees. Accordingly, a trust provision relieving a trustee of liability for breach of trust is unenforceable to the extent such breach was committed in bad faith or with reckless indifference to the purposes of the trust or the beneficiaries' interests.

Lessons for ILIT Trustees:

- *Trust Protections Have Limits*. Although a trust's terms generally prevail over statutory and common law, many states impose a minimum liability standard that cannot be waived, which may be based on "willful misconduct" and/or acts committed in "bad faith" or with "reckless indifference" or "gross negligence." Each of these legal standards has different implications for potential liability. Trustees should understand the minimum liability standard applicable to them and what it means in terms of their required duties and responsibilities (e.g., what constitutes reckless indifference in administering a trust under applicable state law?).

- *Know the Required Duties and Standards*. The ILIT's terms and applicable state law also will define the scope of the trustee's duties.[1] As with liability standards, states may have mandatory duties that cannot be modified or waived by the trust agreement, such as the duty to inform beneficiaries of material facts so that they can protect their interests if necessary. Trustees must fully understand these mandatory responsibilities and duties or face potentially serious liability for breach.

- *ILITs Are Special*. ILIT trustees face unique administrative requirements designed to preserve the ILIT's intended gift and estate tax planning benefits, for example, ensuring that an insurance policy properly designates the ILIT as owner and beneficiary or that *Crummey* notices are sent to beneficiaries when gifts are received. Failure to comply with these requirements may expose the ILIT's assets to unanticipated transfer taxes and the trustee to liability. Accordingly, a trustee may consider having outside compliance audits regularly performed (*e.g.*, every 2-5 years) to ensure satisfaction of these requirements.

Failure to Undertake (and Document) a Deliberative Decision-Making Process. The trustee should clearly document the reasoning and basis for the trustee's exercise of any discretionary power under a trust agreement, for example, in relation to distributions, investments, tax positions, etc. For ILITs specifically, this applies to any trustee actions related to the policy, such as changes in coverage type or amount, or whether to surrender or exchange a policy.

The case of *In re Stuart Cochran Irrevocable Trust* illustrates how a properly documented deliberative process can protect a trustee from claims of breach. In this case, the trustee (KeyBank) hired an outside insurance consultant to evaluate the ILIT's variable life policies and learned that they could potentially lapse within five years. Separately, the insurance producer who originally issued the policies conducted a review and suggested that the trustee execute a 1035 exchange for a fully paid-up policy with a guaranteed death benefit. The outside consultant reviewed this recommendation, noted the pros and cons, and indicated that the exchange was acceptable if the grantor was comfortable with the noted issues. Based on this analysis, the trustee made the exchange; however, the insured died unexpectedly less than a year later. Since the trust beneficiaries received far less from the guaranteed policy than they would have from the original policies, they challenged the trustee's decision to make the exchange.

Both the trial and appellate courts held in favor of the trustee. The appellate court specifically noted that the trustee hired an outside insurance consultant to conduct an independent review of the policies and the producer's recommendation for the exchange. The consultant was a disinterested person with no financial stake in the outcome. Further, the documentation showed that the trustee chose between two acceptable options presented by its independent consultant based on the circumstances as they existed at the time of the exchange, which complied with the prudent investor rule, despite the reduction in benefits.

Lessons for ILIT Trustees:

- *Protection is in the Process.* In fulfilling duties to the beneficiaries, a trustee is best advised to adopt a deliberate and reasoned approach that is regularly followed. Subject to the requirements of the trust agreement and applicable state law, a prudent ILIT trustee should regularly document the trust's insurance investments and their performance. If the trustee lacks sufficient expertise to evaluate and manage the policy, it should engage a qualified insurance specialist to assist. Based on *Cochran*, use of an independent or disinterested consultant may provide the trustee with the greatest level of protection. The ILIT trustee may want to obtain an independent analysis of any recommendations regarding policy or coverage changes that could benefit the producer making the initial suggestion.

- *Clearly Document Process and Actions*. An objective memorialization of the deliberations and reasoning underlying a trustee's exercise of its discretion can protect the trustee (as in *Cochran*). A trustee ideally should prepare a written memorandum or analysis of major decisions and maintain copies of notes and emails recording any discussions in the trust files. If during the course of this analysis the trustee is confronted with a situation where it may become difficult to objectively rationalize a proposed action in the beneficiaries' best interests, the trustee should not proceed.

- *Obtain Independent Analyses as Needed*. A documented, independent analysis of the advantages or disadvantages to the ILIT beneficiaries of various courses of action, and why selected or rejected, can provide evidence that the trustee acted prudently and in good faith. If the trust holds assets in addition to a policy, this concept also should be applied to the selection of an investment professional and the trust's investment objectives, considering the relative ages and anticipated needs of the respective beneficiaries.

- *Disclose, Disclose, Disclose*. Currently advising ILIT grantors or beneficiaries of trustee deliberations and actions (and documenting such disclosure) may avoid future challenges. The appropriate and permitted level of disclosure will depend on the particular circumstances, the trust agreement, and state law. Obtaining consents and waivers also may be a good practice, particularly if a potential conflict of interest exists (as discussed below) or the trust agreement offers limited protection. Upon any major shift in in a trust's insurance or investment holdings, the ILIT trustee may want to seek a full settlement agreement or a waiver of accounting and release for the period of administration.

Promoting the Trustee's Personal Interests. Conflicts of interest between trustees personally and the trust beneficiaries can be trouble spots for fiduciary liability, even if the trust agreement permits the trustee to engage in self-interested transactions. For example, in *Mennen v. Wilmington Trust Co.*, George Mennen created four trusts, one for each of his children. George's son, Jeff, served as a trustee of the trust for his sibling John. After a 1992 sale of stock in Mennen Company, John's trust held about $46 million and eventually reached a value of $115 million in 2000, but then fell to $25 million in 2014 due to several investments directed by Jeff, as a trustee, into two unsuccessful private companies. Even though Jeff claimed to have thoroughly vetted those companies, he maintained almost no records as a trustee. He also served on the board for one company and invested in both personally.

The trust agreement appeared to authorize Jeff's actions as a trustee by: (1) eliminating any duty to diversify; (2) permitting investments in ventures where a trustee is acting in an individual capacity (such as an officer, director, shareholder, partner) or where a trustee otherwise had a financial interest; and (3) exculpating the trustee from all actions except those made in bad faith and willful misconduct. The trust beneficiaries brought suit for breach of fiduciary duty, arguing that the trust's exculpation clause did not cover these breaches.

The *Mennen* court held for the trust beneficiaries, ruling that the majority of Jeff's conduct was motivated by pride. With his own fortune secured in his separate trust, Jeff aspired to make a name for himself at risk and expense of John's trust, which was a breach of the trustee's fiduciary duty of loyalty. Further, citing *Paradee*, the court noted that a trustee's actions are to be tested twice in the analysis of his or her fiduciary's duties: <u>first</u> as to whether the trustee is empowered to take the action, and <u>second</u> as to whether the trustee in the exercise of that power breached his or her duties. Finally, as Jeff's actions violated his duty of loyalty and were committed in bad faith, they could not be protected by the trust's exculpatory language.

Lessons for ILIT Trustees:

- *Proceed Cautiously with Conflicts.* Even if a trust agreement authorizes self-interested transactions, trustees should proceed cautiously when making trust investments in which they also have personal interest. Advisors serving as trustees should be particularly careful here. As noted, a deliberative process, documentation of the reasoning, and disclosure and consents/waivers can be key to protecting a trustee in such instances.[2] Also, as in *Mennen*, self-interest is not limited to financial interest. A trustee making risky trust investments to bolster his own personal reputation at the potential expense of the beneficiaries is just as disloyal, for fiduciary purposes, as one seeking personal financial benefit.

- *Investments After Asset Allocation Shift*. Many ILITs hold a life insurance policy as their sole asset. Yet, as noted, grantors may be motivated to make larger gifts to ILITs in the next few years to use the temporarily higher gift tax exemption. In addition, after the grantor/insured's passing, cash from the policy's death benefit will replace the policy as the ILIT's asset. In these cases, ILIT trustees must adjust their investment focus and determine how to invest these new assets in the beneficiaries' best interests. As shown in *Mennen*, risky ventures, even if potentially extremely profitable, may not adequately safeguard the trust's assets. An inexperienced trustee is advised to seek objective investment advice from a professional to fulfill this responsibility. Depending on state law, the trustee also may be able to delegate investment management responsibility and liability to a qualified investment advisor monitored by the trustee.

TAKE AWAYS

ILIT trustees have significant fiduciary duties that can result in serious liability if breached. To minimize exposure, they should act independently, conduct regular, independent evaluations of policy performance, seek professional advice, as needed, with respect to investments, document their deliberations and decisions and, as appropriate, disclose information to ILIT grantors and/or beneficiaries and obtain waivers or consents. In these cases, insurance professionals can add value to their client relationships, such as by offering monitoring and annual reviews of trust-owned life insurance to support ILIT trustees in executing their duties.

NOTES

[1] Most states have adopted Uniform Prudent Investor Act or similar statutes, which, among other duties, require a trustee to comply with the prudent investor rule, monitor and investigate trust investments (including for suitability), and invest and manage the trust solely in the interest of the beneficiaries. Some states, like Delaware and Florida, have passed statutes that minimize certain fiduciary duties with respect to life insurance policies.

[2] See e.g., see *French v. Wachovia Bank, N.A.*, 2011 U.S. Dist. LEXIS 72808 (E.D. Wisconsin 2011), involving a breach of fiduciary duty claim trigged by a 1035 exchange of ILIT policies. The *French* court found in favor of the ILIT trustee, even though the new policies acquired in the exchange were issued by an affiliate of the trustee, who received a commission. The trustee and affiliate repeatedly analyzed and discussed the exchange with the ILIT grantor and his counsel, who knew about the affiliate's commission and that the trustee required a conflict waiver. The grantor's counsel also provided an independent analysis of the proposed exchange, and the trust agreement specifically authorized the trustee to engage in a self-interested transaction.