PRACTICE TIPS

Statutory Exemption From Fiduciary Liability for Trustees of Life Insurance Trusts

Many law firms offer trustee services to their clients. A common estate-planning device is the design and implementation of an irrevocable life insurance trust (or, "Crummey" trust) which is the owner and beneficiary of a life insurance contract. Although Annotated Code §15-116 provides a limited statutory exemption from certain duties for trustees of life insurance trusts, the recent adoption of §15-114's Prudent Investor standards may make it difficult for the trustee to claim broad-scope liability protection in the event that a life insurance contract fails.

This essay helps the practitioner to situate the life insurance trustee's statutory exemption between the "legal-list" standards of §15-106 and the Prudent Investor standards of §15-114. Additionally, it details, when the decision to purchase insurance has a bad outcome, how difficult it is to establish that trustee action (or inaction) falls under the statute's limited protections. Finally, we present a series of fact patterns in order to highlight how the new Prudent Investor standards may, in fact, increase trustee liability for trust owned life insurance contracts. A pervasive theme is the benefit of developing a written policy to establish procedurally prudent guidelines for insurance policy selection, implementation and surveillance. The practitioner will find that reliance on written procedures, communicated to and agreed upon by the grantor and beneficiaries, provides a greater measure of protection than reliance on the limited statutory exemptions.

Prudent Investor Standards and Title 15 of the Maryland Annotated Code: Estates and Trusts

Title 15 of the Annotated Code sets forth general provisions governing the definition of, powers granted to and the duties of fiduciaries with respect to their administration of trust assets. Section 15-106 enumerates the investments that are "lawful investments for any person." Although "this section shall not be construed to make unlawful any investment not listed in this section;" and, although "this section shall not be construed as relieving any person from any duty of exercising reasonable care in selecting securities," a strict adherence to the §15-106 "legal list" provides a measure of safety for the fiduciary in the event that future investment results are poor. It is doubtful that §15-106 constitutes a safe harbor. The fiduciary still retains the duty to deploy assets in accordance with the terms of the trust instrument and in accordance with the needs, purposes and distribution requirements of the beneficiaries.

However, restricting investment selection to the fixed-income instruments that constitute §15-106's "legal list" subjects the trust estate to a variety of risks. These risks include:

1) Concentration Risk (i.e. the failure to diversity into other asset classes);
2) Interest Rate Risk (i.e. decline in capital value through adverse moves in required yield); and,
3) Purchasing Power Risk (i.e. the failure to keep pace with the general level of inflation).

Additionally, there has been pressure on fiduciaries charged with money management responsibilities to select from a more broad range of investment opportunities. This pressure comes, in part, from:

1) An historical awareness that in most investment periods a diversified portfolio of stocks has outperformed a "legal-list" fixed-income portfolio; and,
2) A reference bias towards U.S. stock investments because of the recent multi-year domestic bull market.

Fortunately, §15-114 provides the fiduciary with new and important liability protections if the portfolio extends beyond the "legal list" menu. The trustee now has the ability to file an election with the Commissioner of Financial Regulation with respect to "all fiduciary assets controlled by the person." [It is not clear that the election means that all assets within the specific trust become subject to the Prudent Investor standards or that all assets within trusts managed for every client become subject to the standards. If the latter interpretation holds, electing Prudent Investor standards for one trust will result in a universal election for every trust].

Such election, referred to as an election to manage the trust estate under the "Prudent Investor Standards," absolves the trustee from the onerous task of assuring each investment's profitability. Rather, the investment success of trusteeship is to be judged by the performance of the portfolio as a whole rather than by the outcomes of each investment in isolation. Additionally, although the "success" of the investment performance may be judged by portfolio results, fiduciary liability becomes a function of the integrity of the decision making and portfolio monitoring process rather than the random variable of future security returns.

Wandering from the "legal list" on a piecemeal basis, ignoring the fact that election of "Prudent Investor Standards" applies to "all fiduciary assets," is probably the worst of all possible worlds. On the one hand, if the election is not made, deviations from the "legal list" expose the fiduciary to liability for each underperforming investment. On the other hand, making the election for the purpose of adding some "blue-chip" U.S. companies to the portfolio without documenting "...an overall investment strategy that incorporates risk and return objectives..." also courts the risk fiduciary liability surcharges. It may be argued that the trustee failed "...to competently administer the fiduciary estate" [§15-112] because of a lack of a written Investment Policy outlining:

1) The rationale for portfolio design according to the risk/reward objectives of the trust;
2) The criteria for investment selection and retention; and,
3) The protocol for future portfolio monitoring and surveillance.

Annotated Code §15-116. Contract of Insurance on Life of Grantor

A limited "exemption" from some of the "Prudent Investor" standards is granted in §15-116:

Notwithstanding any other provision

of law, and except as otherwise provided in the governing instrument, the duties of a trustee regarding the acquisition, retention, or ownership of a contract of insurance on the life of the grantor of the trust, or on the lives of the grantor and the grantor's spouse, children, or grandchildren, include a duty of loyalty and fair dealing, but do not include a duty to:

(1) Determine whether any contract of life insurance in the trust is or remains a proper instrument;
(2) Diversify the investment; or,
(3) Exercise any policy options, right, or privileges available under any contract of life insurance in the trust, including any right to borrow the cash value or reserve of the policy, acquire a paid-up policy, or convert to a different policy.

Two preliminary observations are appropriate. First, the adoption of the statutory exemption eliminates the definitional argument that fiduciary liability for insurance policy selection and retention does not exist simply because an insurance policy is not an investment. The fact that §15-116 brings the insurance program into the purview of the prudent investor rule with the idea of mitigating trustee liability may, ironically, create increased liability with respect to the non-exempt duties of the trustee of the irrevocable insurance trust.

Following this line of argument a bit further, the fact that §15-116 provides only a limited three-part exemption may tend to weaken the argument that the grantor rather than the trustee bears primary responsibility for insurance related decisions. The statute affirms the trustee's duty of loyalty. The duty of loyalty extends beyond mere fair-dealing and conflict of interest issues. Indeed, it extends to *any* action or inaction that affects trust beneficiaries. It is therefore important to gain a clear understanding of the nature and scope of the "exemption" because, presumably, non-exempt actions may become liability triggers.

Secondly, we observe that Title [§15-114] affirms the long-standing common law principle that, at the end of the day, "the terms of the governing instrument shall control." If, as time unfolds, local standards of practice shaped by legislative and judicial actions suggest that §15-116 in combination with exculpatory language offer a broad-brush exemption for the trustee, then what is the purpose of the trust? Other than providing administrative services, what role is played by the trustee? Beyond the practical question of justification of fees paid to the trustee, there may loom a larger issue. We know that trust-owned insurance is a tempting target for the Revenue Service because, for many years, is argued unsuccessfully that active decision-making by the grantor results in the inclusion of insurance proceeds within the taxable estate. Given a liberal interpretation of §15-116 the Service may not have grounds to attack the trust as little more than an estate tax avoidance scheme. If many of the traditional reasons for creation of a trust (professional management, investment expertise and so forth) cease to exist, will the trust remain a legitimate estate-planning tool in the eyes of the IRS? Who is protecting unsophisticated trust beneficiaries against, in William Hoisington's words at the Heckerling Institute, the damages from "third-party importuning?" Does the trustee rely on a strategy of passive acquiescence to the recommendations of the insurance salesperson? Who is minding the store?

Guidelines and Standards for Investment: the Three "Exemptions"

Presumably, because insurance policies are not a "legal list" asset, they fall under the purview of the guidelines that constitute the general standards of prudence under §15-114. This code section closely follows the "Principles of prudence" enumerated in the reporter's commentary to the Third Restatement. The "Principles of prudence," in the reporter's words, are intended:

> "...to preserve the law's adaptability by confining its mandates to those that seem essential to prudence (based on traditional duties of care, skill and caution), to the protection of fiduciary goals, and to supplying helpful guidance to courts and trustees."

It is instructive to review §15-114 because it provides the backdrop necessary to understand the nature of the §15-116 exemptions; and, perhaps more importantly, suggests that the conduct of the fiduciary must be evaluated in light of the several critical components of the "Principles of prudence." If the decision to commit assets towards insurance policy funding has a bad outcome, it may be difficult to establish that the trustee is without liability because trustee inaction falls under the heading of an "exempted duty." In many cases, it is equally likely that liability for breach of trust may exist because of trustee negligence or trustee failure to uphold the duty of loyalty with respect to a "non-exempted" duty.

Specifically, §15-114 states:

A fiduciary shall:

(1) Invest and manage fiduciary assets as a prudent investor would, considering the purposes, terms, distribution requirements, and other circumstances of the governing instrument and the nature of the fiduciary appointment;
(2) Exercise reasonable care, skill and caution regarding the anticipated effect on the fiduciary assets as a whole under the facts and circumstances prevailing at the time of any action by the fiduciary;
(3) Invest and manage not in isolation but in the context of the fiduciary assets as a whole and as part of an overall investment strategy that incorporates risk and return objectives reasonable suitable under the terms of the governing instrument and the nature of the fiduciary appointment;
(4) Diversify investments unless, under the circumstances, the fiduciary reasonable believes it is in the best interests of the beneficiaries or furthers the purposes for which the fiduciary was appointed not to diversify;
(5) Review fiduciary assets within a reasonable time after acceptance of the fiduciary appointment and make and implement decisions concerning the retention or disposition of investments existing prior to the appointment in order to conform with this section;
(6) Pursue an investment strategy that considers both the reasonable production of income and safety of capital, consistent with the fiduciary's duty of loyalty and impartiality and the purposes for which the fiduciary was appointed;
(7) Act with prudence in deciding

whether and how to delegate authority and in the selection and supervision of agents; and

(8) Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the fiduciary appointment.

Given the §15-114 backdrop, we can now examine critically the nature and scope of the §15-116 exemptions. In order to motivate the discussion, we will often refer to specific fact patterns that the trustee of an irrevocable life insurance trust may encounter in the course of trust administration. Often, as the fact patterns develop, ambiguities will also develop that, ultimately, throw into doubt the ability to segregate the "Principles of Prudence" into neat boxes that can be labeled "exempted – no liability" or "breach."

The First Exemption: Is an Insurance Contract a "Proper Investment?"

The first exemption states that the trustee has no duty to "determine whether any contract of life insurance in the trust is or remains a proper investment." The use of the term "proper investment" is somewhat strange in light of the fact that §15-114 specifies, in its review of investment decisions paragraph, that "No specific investment or course of action is, taken alone, prudent or imprudent." We are, consequently, left to speculate on the definition of a "proper investment," and, given the general guidelines and standards of §15-114 outlined above, it is probably reasonable to refer to them. Therefore, let us assume that an insurance policy owned by a trust has significantly underperformed relative to the original projections illustrated by the insurance agent. Perhaps it has lapsed with a loss of all cash values. Perhaps the carrier has issued a premium notice for many times the originally scheduled premium cost. Perhaps the policy is part of a split-dollar arrangement and the level of policy equity indicates that the terms of the collateral assignment cannot be fulfilled. Does the first exemption give the trustee a broad-scope immunity from liability? Or, asking a slightly different question, *should* the first exemption give the trustee a broad-scope immunity from liability?

Among the key terms of the §15-114 general guidelines and standards is the duty to consider the "purposes, terms, distribution requirements and other circumstances" of the trust. Assume, for example, that the insurance policy was issued in 1980 on a rated premium basis because of adverse pre-existing health conditions. Further, assume that the premium surcharge equals 200 percent of standard rates (some carriers issue policies with table ratings up to ten times standard). Finally, assume either that the health of the insured improved substantially over the time period, or advances in medical technology diffused the mortality risk of the health condition. If the policy fails, is it because it is not a "proper investment?" Or, assuming that the trustee never reviewed the "circumstances" of the trust (or never documented a periodic review of the trust with interested parties), does the policy fail because of trustee negligence? Alternately, it may be argued that the contract failed because the trustee incurred costs that were not reasonable and appropriate. Finally, if the contract fails because the prospect of insurance company failure creates a "run-on-the-bank" phenomenon, does the statutory exemption to determine whether any contract in the trust is a proper investment extend to an exemption from verification of the financial health of the insurance carrier?

The second guideline and standard for prudent asset management in §15-114 specifies that the trustee must "exercise reasonable care, skill, and caution regarding the anticipated effect on the fiduciary assets as a whole under the facts and circumstances prevailing at the time of any action by the fiduciary." Consider the following fact pattern: a grantor's estate consists mainly of an interest in a closely held business. The grantor establishes an irrevocable trust; and the trust subsequently acquires a life insurance contract in order to hedge against an anticipated decrease on the value of the business if it is subject to a forced liquidation upon the death of the owner. After a period of time, the owner sells the business and the estate becomes liquid. Should the trustee pay future premiums on the policy or should the trustee reallocate existing cash values and future cash flows to non-insurance investments? The economic issue is whether the trustee should continue to pay for the cost of a hedge instrument when the hedge is no longer required. This comes under the heading of breach due to negligent retention of assets. One reading of the §15-116 exemption suggests that the trustee can ignore questions of contract *viability* (is it likely to underperform its original projections) and contract *suitability* (is it appropriate to the purposes, terms, distribution requirements and other circumstances). Once again, the use of the term "proper investment" creates ambiguity. The duty of loyalty to the beneficiaries suggests that the trustee should at least inform interested parties of the likely future effects of a decision to retain or surrender existing insurance coverage. Absent such a review, it is difficult to see how the fiduciary can claim that he exercised reasonable care, skill and caution.

Many irrevocable life insurance trusts are created to pre-fund estate taxes or to pass wealth to children and grandchildren. Insurance applicants are usually older and, not surprisingly, may find it difficult to qualify for preferred premium rates. Absent a transfer of existing coverage to a trust, it is the trustee that applies for the insurance coverage. The §15-114 guidelines state that the trustee has a duty to "act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents." If the trustee requires the services of a life insurance agent, does the statutory exemption of §15-116 absolve the trustee from using the requisite care, skill and caution in selecting, directing and monitoring the agent? If the agent is an employee of an insurance carrier, does the trustee have the duty to set reasonable parameters for the delegation in order to assure that the agent does not "force" the coverage into his primary company at the sacrifice of a preferred premium rate? If an unsupervised agent's attempt to place business with a particular company "locks" the reinsurance market with the result that the application on the life of the grantor can no longer receive a fair and open-market consideration, is the grantor barred from seeking legal recourse? Agents owe a duty of loyalty to their employers and, provided they follow the "fair-trade" standards embodied in the state insurance code, their primary responsibility is to place business with their company. The duties of the insurance agent and the risks with which the agent must be concerned (i.e. lack of production) differ from the duties of the trustee and the risks against which the trustee must guard. Does the §15-116 exemption alleviate the responsibility to disclose referral or other quid pro quo arrangements between the agent and other members of the estate planning team; and does it alleviate the necessity of ascertaining whether the agent's business history includes complaints from consumers or actions by regulatory agencies? Is an exemption from insurance policy due diligence also an exemption from insurance agent due diligence?

Finally, the §15-116 exemption to determine whether an insurance contract is a proper investment may not provide the trustee with an iron clad protection against liability for a contract that fails or that substantially underperforms it original projections. Most insurance contracts self-destruct not because the carrier fails to achieve its line-of-business profit objectives. They blow up because the carrier credits to the policy an amount insufficient to support ongoing administrative and actuarial costs that the policy (not the carrier) must bear. The Restatement Third of the Law of Trusts suggest that the presence of large commissions may be relevant to the insurance policy evaluation process: "...the duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule." This is especially the case when payments of sales commissions have the effect of substantially reducing the cash values of the policy. Although the non-guaranteed projections of high commission policies may sometimes exceed the projections of "no-load" policies, the relevant issue is whether a trustee can defend successfully the voluntary election to pay a substantial sales load for product acquisition.

Additionally, by selecting a financial instrument that offers little or no cash value to the policyholder for a lengthy period of time, the trustee assumes a significant liquidity risk. If the trustee determines that the extra risk is appropriate, then he must also be prepared to demonstrate the likelihood that trust beneficiaries will be sufficiently rewarded. If a high commission policy underperforms, and if the trustee paid a high level of acquisition costs when a comparable "no-load" product was available, can the trustee defend the reasonableness and appropriateness of the transaction costs? Many consumers complained when they discovered that failed real estate tax shelters had a commission load of 20 percent or more. It is common, however, to find a commission load of from 50 to 100 percent of the initial premium on a life insurance contract. A drain on policy values of this magnitude makes acquisition of high commission insurance products a risky proposition. This is especially the case when the planning objective is to keep premium inputs low either because of cash-flow reasons or because of present interest gift limitations. It is not simply a matter of a one-time loss of initial value. Rather, each dollar initially removed in commissions means that the compound future earnings on that dollar are also forever lost. Use of the §15-116 exemption offers a problematic defense against liability. Documentation of commissions payable over the life of the policy and disclosure of such commissions to all interested parties prior to the acquisition of the policy is the preferred method.

The Second Exemption: No Duty to Diversity the Investment

Presumably, the life insurance trust reflects one element of a diversified and integrated plan of family wealth management. As such, it does not seem unreasonable for the trustee to limit the asset within the trust portfolio to the class of financial instruments that can best achieve the objectives of the grantor. However, §15-116 leaves some ambiguity for the trustee. Is the exemption from the duty of diversification applicable to the portfolio level (i.e. only invest in life insurance assets), to the carrier level (it is permissible to concentrate all funds in the policy of a single insurance company), to the policy level (if a policy offers a separate account investment selection is there a need for diversification, monitoring and review within the allowable options), or some combination of the above?

In recognition that one of the primary benefits of diversification is to protect against the shock of an insurance carrier's insolvency, prudent asset management should ordinarily take some steps to immunize a reasonable portion of the trust portfolio against the adverse effects of creditor claims on the general assets of insurance companies. Unless pricing and coverage availability factors outweigh the potential advantages of diversification there should be little justification for not diversifying. Usually, the impetus for concentrating all coverage with one insurance company comes from the agent who designs his presentation to suggest that his company has superlative past performance and offers "the best" policy for the future. As events unfold, even if this claim proves true (a somewhat heroic assumption), modern portfolio theory indicates that the nominal return must be risk-adjusted (in this case, adjusted for unique risk or concentration risk) in order to measure performance accurately. In the absence of pricing and availability concerns, the trustee should not ever need this exemption from liability simply because, as the reporter for the Third Restatement notes: "Diversification is fundamental to the management of risk and is therefore a pervasive consideration in prudent investment management."

The Third Exemption: No Duty to Exercise Any Policy Options, Rights, or Privileges

It is difficult to imagine that one could maintain the pretense of investing and managing fiduciary assets as a prudent investor would when, in fact, one has no duty to exercise any options, rights, or privileges with respect to the financial assets within the portfolio. The duty of loyalty to the beneficiaries would seem to be exceedingly difficult to fulfill under such conditions. Consider the following fact pattern. A trustee discovers that the grantor is terminally ill with a life expectancy of from six months to two years. The trust owns a Universal Life policy purchased 16 years ago with a face amount of $1,500,000 and a cash value of $900,000 with a tax basis of $500,000. A check with the carrier reveals that no more than $100,000 in cash value is necessary to cover the cost of keeping the policy in force for a two-year period. Even if the trustee did not wish to exercise the option to borrow against the contract, a letter requesting withdrawal of funds up to tax basis would leave the trust beneficiaries with a total benefit of $2,000,000. Failure to exercise policy rights by sending such a request for withdrawal letter is a $500,000 mistake and represents clear negligence on the part of the trustee.

Exempting the trustee from the duties that are fundamental to sound asset management may provide the revenue service with the wherewithal to argue that the trust arrangement is not valid. Thus the beneficiaries may not realize one of the primary advantages of the insurance trust planning vehicle – namely exclusion of insurance proceeds from the decedent's estate.

Trustee Elections and Written Trust Investment Policy

Life insurance policies are not "legal list" investments. Therefore, trustees of irrevocable life insurance trusts may wish to file the election with the Commissioner of Financial Regulation in order to achieve the status of "Prudent Investor with exemption for certain duties." Absent such a filing, the trustee may be judged on an asset by asset basis. Furthermore, it is questionable whether the exemption from trustee duties would apply to a trustee operating under the "legal list" standards of §15-106: "No general, local, or special law which is inconsistent with this section shall have any effect." In the absence of such an election, it is not entirely clear that the trustee is without liability if an insurance policy blows up with a loss of all investment capital.

Making the Prudent Investor election, even with the limited exemptions from duties of prudent asset management, places the trustee under the portfolio management guidelines and standards of §15-114. It is clear, from the language of the Third Restatement and from the legal commentary thereon, that the Prudent Investor Rule places the emphasis for liability protection on the establishment, documentation and implementation of sound decision making policy. A written investment policy statement outlining a framework for the prudent implementation and ongoing administration of the trust portfolio may become a valuable tool for liability mitigation. Furthermore, given the degree of ambiguity in §15-116, a written statement of investment policy should be helpful to the grantor who wishes to have competent services at a reasonable cost; and should be helpful to the estate planning attorney who wishes to make the strongest possible case against inclusion of assets in the taxable estate.

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