

A Duty to Advise

Estate trustees are being held to a higher standard of performance for assets under their direction, including life insurance.

by Anthony Steuer

Life insurance is commonly used as an asset held inside a trust for both estate planning and executive-compensation planning. But while life insurance has typically been treated as an entirely separate and unique piece of property within those trusts, new investment-performance standards are creating the need for trustees to monitor life insurance policies. This additional monitoring requirement comes at a time when life insurance policies are increasingly complex and imbued with more flexibility and features.

In 1994, the Uniform Prudent Investor Act was approved by the National Conference of Commissioners on Uniform State Laws. Under this act, a trustee must make investment decisions in the context of the trust portfolio as a whole and as part of an overall strategy of having risk and return objectives reasonably suited to the trust. One purpose of the prudent-investor rule is to permit the trustee to apply modern portfolio theory by investing for total return and to minimize risk by diversifying.

The issue then is how this applies to life insurance trusts. Trustees and other fiduciaries have a duty to act in the best interests of beneficiaries. A fiduciary is a person who occupies a position of special trust and confidence in handling the affairs or funds of another person.

In addition, the courts are holding life insurers and their agents to a higher standard of care. Increasingly, courts are suggesting that when an unsophisticated insured relies on the advice and knowledge of an agent, the agent has a greater duty to advise. This fact, combined with the rules of the Uniform Prudent Investor Act, suggests that the traditional standard of due care for fiduciaries involved with the sale and maintenance of life insurance policies and trusts funded with life insurance will not be sufficient; a higher standard is likely to apply. That higher standard is based on modern portfolio theory and the principles of prudent investing.

Principles of Prudent Investing

Applying the principles of prudent investing, trustees should consider the following in managing and investing trust assets:

- general economic conditions;
- the possible effects of inflation or deflation;
- expected tax consequences of investment decisions or strategies;
- the role of each investment within the overall trust portfolio;
- expected total return from income and capital appreciation;
- other resources of beneficiaries known to the trustee;
- needs for liquidity, regularity of income and preservation or appreciation of capital; and
- an asset's special relationship or value to the purposes of the trust or to one or more of the beneficiaries.

While those factors apply to various assets within the trust, they do not all apply to life insurance. When examining life insurance within the trust, the first concern is whether the policy information is correct. Issues to consider include the following:

- Are the policy type, face amount, planned premium, riders, underwriting class, insured, ownership and beneficiary designations correct?
- Is the policy performing according to the original illustrations, sales letters and materials?
- Are there any surprises—such as unexpected loans, required premiums or change in modified endowment contract status?
- Do you have a current in-force illustration? This is the only way to evaluate the policy, so it is important to examine the carrier's illustration questionnaire.

It is also necessary to determine whether the case design meets the desired financial objective through planned premium, death benefit and future death benefits. Consider, for example, a



trust that owns \$2 million of second-to-die life insurance on a 72-year-old couple with a planned annual premium of \$50,000 for life. The goal is to use life insurance to increase the future wealth of the beneficiaries. The rate of return at age 100 on death is only 2.4% (free of estate and income tax), which is low, considering that there is a 20% chance that at least one person will live that long. An option for the trust is to consider an increasing death benefit.

Then, the question is whether the policy is providing good value or should be replaced. With a term insurance policy, consider pricing, re-entry options and product guarantees. With cash-value policies, consider in-force illustrations, rate-of-return calculations and the replacement questionnaire offered by the Society of Financial Service Professionals. For either type of policy, consider financial strength and certain contractual stipulations—such as incontestable and suicide provisions.

Improving Policy Performance

If the policy can be modified to provide better value, there are several ways a trustee may be able to retroactively improve the performance of an existing policy. Glenn Daily, a New York-based life insurance analyst, in an article titled, "Danger: Fiduciary Liability Ahead," offers the following suggestions:

- Retroactively blend the policy.
- Use dividends to buy paid-up additions.
- Pay premiums annually to avoid an interest rate on some products of up to 27.1% for semiannual payments and 18.9% for monthly payments;
- Determine the true cost of a policy loan. Pretax cost is the policy loan interest rate plus the reduction in interest rate or dividends caused by borrowing. If an in-force whole-life policy has a fixed loan rate, update it to a variable rate in exchange for higher dividends.
- Cancel riders that are no longer needed.
- Stop paying premiums on flexible premium policies if the insured is in poor health. They can always be restarted later.
- On flexible-premium policies, take advantage of weaknesses and strengths of the design.
- Instead of dropping an existing whole-life policy, consider reduced paid-up status.
- If the policy has a rated premium, determine if it can be reduced or removed.

The client and fiduciary also should consider whether additional benefits can be obtained through litigation. For example, the

policyowner may already be eligible for benefits as part of a class-action settlement. If the policyowner is not part of a class action, the insurance company may agree to a quiet settlement on a case-by-case basis, to avoid bad publicity and extended litigation.

And if a company is planning to demutualize, the policyowner may be entitled to a valuable distribution of stock or cash in the future.

Also consider whether the planned premiums are adequate to support the desired case design using prudent assumptions. Since interest rates are significantly lower on most cash-value policies than when they were originally issued and other pricing factors are being increased, it is prudent to determine if the policyowner has the coverage originally expected.

For example, under the assumptions at the time of issue, a 51-year-old man who purchased a \$750,000 universal-life insurance policy 10 years earlier was projected to pay a premium of \$5,661 annually, which would endow the policy when he turned 95. But this year, an examination of the policy has determined that, based on current assumptions, he would need to nearly double his annual premium to \$10,800 for it to endow at age 95.

The carrier did not give the policyholder any indication that the policy was so far off the original marks. This is not unusual. Only a few carriers have added a line to their annual reports stating the client age at which policies will lapse, making it important for policyholders to monitor policy performance regularly. Often, the agent who sold the policy has no further contact with the insured after the original sale, so the policy is not re-viewed.

Policy loans present a similar issue. A policy with a large loan and loan interest can eventually crash, creating an issue of no coverage and a significant phantom income-tax gain. This is because the IRS considers any policy value over basis to be taxable income.

For example, a 35-year-old man owned a policy that his father had purchased for him when he was 4 years old for a single premium of \$10,000. The policy contract was designed to default to an automatic premium loan, which means the son was borrowing his annual premium payments against the value of the policy. He, therefore, has never made a premium payment out of his own pocket. Recently, however, the automatic loan program reached its limit—that is, the total value of the policy had been borrowed against. As a result, the insurer notified the insured man that annual

Life Insurance Terms

- **Automatic premium loan:** A provision in a life policy authorizing the insurer to use the loan value to pay any premiums still due at the end of the grace period.
- **Endow:** When a life policy matures, the cash value will equal the death benefit.
- **In-force illustration:** A measure of how a in-force policy is performing, which can be compared with the assumptions made at the time of purchase. The illustration uses the current values of a policy (basis, cash value and death benefit) and calculates them for the future based on current assumptions (interest, mortality and expense) and guaranteed assumptions.
- **Modified endowment contract:** A life insurance policy in which the amount payable at the end of the contract period is greater than the face amount and the amount payable to a beneficiary upon the insured's death is greater of the policy's face amount of its cash value. These contracts are subject to

payments of \$4,000 would be required to keep the policy in force. If he let the policy lapse, he would have had a phantom taxable gain of more than \$70,000—the value of the policy, less the \$10,000 initial payment. This was a significant problem for the man, since his annual income was about \$45,000. He decided to keep the policy in force until a better solution could be found.

Unanswered Questions

It is not yet known how many of these issues will be applied to life insurance that is held within a trust. But given the higher standard that the courts have placed on trustees, it is important to analyze life insurance from the same perspective as any other financial product.

Prudent Investor Law Spotlights Needs-Based Planning

As the prudent investor rule becomes law in many states, financial planners, life insurers and life agents have vast opportunities for new business, said Alan J. Mittelman, president of the Greater Philadelphia Chapter of the Society of Financial Service Professionals.

Pennsylvania became the most recent state to adopt the rule with legislation that goes into effect this month.

Under the prudent investor rule, trustees are allowed to invest trust assets using modern portfolio analysis, which means, in part, that they can invest in a manner that generates long-term growth.

"Historically, trusts have been drafted in a way that requires trustees to maximize income, which is defined as interest and dividends," said Mittelman, a partner with the law firm of Spector Gadon & Rosen. "This results in extremely conservative investing that is not in the best interests of the trust's beneficiaries."

Previous trust-investment laws required trustees to minimize risk and discouraged diversification. They penalized trustees with surcharges for portfolio losses, Mittelman said. "And investing in something like Microsoft or Berkshire Hathaway was totally off limits," he added.

The ideas of modern portfolio theory have been around for some time. Its developers were awarded the Nobel Prize for economics in 1990, but it's taken the states years to make it available to trusts.

Trustees must be careful, however, to balance the trust so it benefits the beneficiaries and those who inherit it later, Mittelman said. Under the new laws, trusts can be structured so that the beneficiaries receive a percentage of the principal instead of the income. In that way, the beneficiaries receive more money than they would have and the investments are growing at a faster rate for the next generation of beneficiaries, he said. A side benefit is that taxes on distributions to the beneficiaries won't be as high because they are taxed as capital gains rather than as income, he said.

The opportunities the new laws offer to insurance companies involve new trusts and old trusts. Existing trusts will have to be rewritten to take advantage of the prudent investor rule. It's a case of "the person who knows the answers gets the

business," Mittelman said. The people who review estate-planning and trust documents are going to be the first to see defective documents.

"If they point that out to their prospective clients, they're going to get future business," he said. "Knowledge is always power."

Insurance companies should realize that everybody who walks through their door probably has an old trust of some kind, he said.

The change in the law also promotes needs-based selling because it forces advisers to refocus on how much capital a person has, because the principal will be the basis of how much cash flow there will be, Mittelman said. Many planners have focused on tax-based planning and have lost sight of needs-based planning, he said.

"Now that people are focusing on how much capital they need, they'll be able to back into how much insurance they need," he said.

Also, modern portfolio analysis teaches that people who are setting up trusts need to have competent investment managers, he said.

"It's a gold mine waiting to be mined by the people who can figure it out," he said.

—SallyWhitney

