LIFE INSURANCE TRUSTS: FAILED ASSUMPTIONS, FIDUCIARY LIABILITIES

FORT WORTH CHAPTER
TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
CPA TAX INSTITUTE 2010
FORT WORTH, TEXAS
August 6, 2010

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I. INTRODUCTION - THE SLEEPING DINOSAUR

The Irrevocable Life Insurance Trust ("ILIT") is a popular, now standard, estate planning tool that is implemented to accomplish many tax and non-tax objectives. Basically, the ILIT is an irrevocable trust that is established to own a life insurance policy or policies on the life of the Trustor. In establishing the ILIT, Trustors identify one or more of many important non-tax objectives to be accomplished, including:

- providing cash for the payment of federal estate taxes on Trustor's estate;
- providing financial security for the lifetime of the Trustor's spouse to the extent that such spouse survives the Trustor;
- creating wealth to provide an equalization gift to children of the Trustor to balance out the gift of a family-owned business, ranch, or like asset to other children of the Trustor;
- creating wealth to provide the inheritance for the Trustor's spouse, or children of the Trustor from a prior marriage, in a blended family situation; and,
- protecting the insurance proceeds from creditors, spendthrift mismanagement, and loss upon death or divorce of the Trustor's descendants by structuring the ILIT as a Dynasty Trust.

In addition, Trustors identify a number of federal transfer tax objectives to be accomplished through the ILIT, including:

- sheltering the insurance proceeds from the federal estate and generation-skipping transfer taxes; and,
- leveraging the Trustor's annual gift tax exclusion, gift tax exemption, and GST exemption.

The tax benefits of the ILIT are primarily dependent upon the Trust being structured and operated so that the Trustor has no "incidents of ownership" that would cause the proceeds to be subject to the federal estate tax in the Trustor's estate under Internal Revenue Code ("IRC") Section 2042. In addition, important components of the tax benefits include avoiding the "three-year rule" of IRC Section 2035, qualification of gifts to the Trust by the Trustor for the annual gift tax exclusion, and proper allocation of GST exemption to the Trust to fully exempt the Trust assets from the generation-skipping transfer tax.

Given the significant tax savings provided through ILITs, the IRS mounted a serious challenge to the tax benefits of the ILIT in several court cases litigated during the 1980's and 1990's, but after uniformly losing those challenges, the IRS acquiesced to the ILIT and it has become a staple of the estate planner's toolbox.

As such, a traditional model of the ILIT has evolved to include the following features: the Trust is formed to accomplish the specific objectives identified by the Trustor, including one or more of those mentioned in the first two paragraphs above; likewise, the specific life insurance policy or policies owned by the Trust are chosen by the Trustor in conjunction with a life insurance agent; the only asset owned by the Trust is the life insurance policy, and maybe a small amount of cash; the Trustee is someone that the Trustor feels that he or she can work with, such as a family member, family friend, or the Trustor's CPA, and that Trustee takes the job out of accommodation for the Trustor and without the expectation that he or she will actively manage the assets of the ILIT; the Trustee is paid no compensation; and, the Trustee carries out only administrative actions with respect to the Trust, including issuing gift notice letters and paying the insurance premiums. In some cases, the traditional operating model is modified in that the Trustee position is held by a bank Trust department, but that Trust department performs only the administrative duties carried out by the individual Trustee under the standard model, with no or minimal compensation, and only takes the position due to a long-standing relationship with the Trustor and the expectation of future business.

A. An Outdated Model. For many reasons, the traditional method of structuring and operating an ILIT needs to be reviewed and either abandoned or, at a minimum, substantially restructured. The weakness of the traditional model can be pinned primarily to one feature, and that is the lack of active management of Trust assets. The owner of a life insurance policy can shift the risk of policy performance to the insurance company by purchasing a fixed premium, guaranteed benefit policy. However, the vast majority of life insurance policies owned by ILITs involve an assumption of the policy performance risk by the ILIT because they own policies with variable premiums and non-guaranteed proceeds. A substantial number of ILITs existing today own life insurance policies that were structured with premiums and proceed payout amounts that were based upon interest rate and policy performance assumptions that were unrealistic at the time and unrecognized to date. These policies, to varying degrees depending upon the specific policy involved, can require frequent, sometimes annual, premium analysis and periodic premium adjustments to assure that the policy will perform and pay out according to expectations. In addition to monitoring the premiums being paid on an insurance policy, other steps including monitoring the performance of the underlying assets behind the policy and the financial health of the insurance company are required to assure that policy performance expectations are met.

However, as noted above, the traditional operating method for ILITs does not include active management of Trust assets, so the performance of the sole asset of the Trust (the insurance policy) and the continued suitability of that asset to accomplish the Trust's objectives goes effectively unchecked from the inception of the Trust. As a result, many ILITs today are holding life insurance policies that will lapse before the termination of the Trust or, at a minimum, substantially under-perform compared to the policy expectations and Trust objectives.

The bottom line is that the traditional method of operating an ILIT positions the Trustee as the captain over a sinking ship subject to lawsuits and fiduciary liability exposure. The reality of the risk faced by ILIT Trustees in today's environment is founded in beneficiary dissatisfaction with the under-performance of ILIT assets, the ramped-up statutory and judicial responsibilities imposed on Trustees in their management of Trust assets, and the increasing number of lawsuits against Trustees alleging breach of fiduciary duty.

B. <u>Trustee Liability Exposure</u>. At the present time, there is little guidance under the case law as to the specific standards that an ILIT Trustee will be held accountable to in his or her performance as Trustee. The current state of the law in this regard will be addressed in more detail in Articles II and III below. However, it is a legal fact that the responsibilities of Trustees are changing under the law and that such change is moving in the direction of a higher standard of fiduciary responsibility for Trustees. In addition, there are practical reasons that ILIT Trustees should be reviewing their operating standards and assessing their fiduciary risk exposure.

1. <u>General Reasons for Trustee Concern</u>. A recent trend has shown an increase in Trustee liability lawsuits, although there has not yet been a significant increase in the number of reported lawsuits involving ILIT Trustees. However, by its nature and results, the traditional ILIT opens the Trustee up to many avenues of risk exposure. As mentioned above, the Trustee's failure to actively manage the life insurance policies under his or her control can result in the lapse or poor performance of policies and, to the extent that the Trustee makes an unqualified attempt to rectify the problem, the typical result is still an under-performing policy. There are a number of opportunities for the results of the traditional model to cause beneficiary dissatisfaction:

a. the life insurance policy does not yield a sufficient amount of cash to pay the federal estate tax liability, which can result in a forced sale by the Trustor's estate to pay federal estate taxes;

b. the "equalization gift" delivered through the Trust to a child of the Trustor can be insufficient to meet the equalization objective;

c. in a blended family scenario, the Trust may fail to create the amount of wealth for the heirs of the Trustor that they were expecting (e.g., a Trustor's second spouse inherits the Trustor's $10M estate outright, but an ILIT owning a $10M life insurance policy at its inception delivers only $3.5M to the Trustor's children from a prior marriage after a replacement policy is acquired to salvage the initial policy from lapsing).

2. <u>Heightened Beneficiary Awareness and Dissatisfaction</u>. There are many other reasons that a traditional ILIT can lead to dissatisfaction on behalf of the beneficiaries and there is evidence that there is a growing trend amongst those beneficiaries to hold the Trustees accountable for the under-performance of the Trust assets. Though some states have enacted statutes (discussed below) that seek to protect the ILIT Trustee from this heightened level of fiduciary responsibility, dissatisfied beneficiaries do not have to recognize the traditional method (though it is the choice of the Trustor) and they have grounds to hold the Trustee accountable for policy under-performance.

As noted above, there is another factor that can lead to beneficiary dissatisfaction and the willingness of beneficiaries to sue the Trustee of a traditional ILIT, and that factor is the emergence of the "blended family". For this purpose, a blended family is one in which one or both of the spouses was previously married (one or more times) and one or both of the spouses has children from a prior marriage, in addition to the possibility of children from the current marriage. This family situation, which is becoming more and more common, offers additional opportunities for the use of an ILIT to provide an equalization gift and, worse yet for the Trustee, often positions the dissatisfied beneficiary outside of the Trustor's direct family line.

3. Trend in Texas. The long standing rule in Texas under *Barcelo v. Elliott* has been that an attorney owes no professional duty to the beneficiaries under a will or trust since the attorney did not represent the beneficiaries.[1] In *Barcelo*, the grandchildren of Frances Barcelo, the decedent, filed a malpractice action against Barcelo's attorney alleging that he negligently drafted their grandmother's trust (which had been declared invalid and unenforceable by the probate court). The sole issue in *Barcelo* was whether the attorney owed a duty to the grandchildren that could give rise to malpractice liability even though he represented only Ms. Barcelo, not her grandchildren, in preparing and implementing her estate plan.[2] The Texas Supreme Court held that the grandchildren/beneficiaries had no standing to sue the attorney and in so doing preserved the previously established bright-line privity rule which denies a cause of action to all beneficiaries whom the attorney did not represent, which the Court believes ensures the attorney's ability to zealously represent their clients without the threat from third parties compromising that representation.[3]

However, ten years later in *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.*, the Texas Supreme Court did not prevent an estate planning attorney from being sued for legal malpractice. In *Belt*, the Court addressed the issue of whether the *Barcelo* rule bars suits on behalf of the decedent client by his or her estate's personal representatives.[4] In *Belt*, the decedent's children, acting in their capacity as co-executors of his estate, sued his estate planning attorney for legal malpractice alleging that the attorney negligently drafted their father's will, which resulted in over $1,500,000 in tax liability that could have been avoided. In confronting the question for the first time, the Texas Supreme Court found that because the estate "stands in the shoes" of a decedent, it

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[1] *Barcelo v. Elliott*, 923 S.W.2d 575 (Tex. 1996).

[2] *Id.* at 577.

[3] *Id.* at 578-79.

[4] *Belt v. Opepnheimer, Blend, Harrison & Tate, Inc.*, 192 S.W.3d 780 (Tex. 2006).

is in privity with the decedent's estate planning attorney and, therefore, the estate's personal representative has the capacity to maintain the malpractice claim on the decedent's behalf.[5]

The Supreme Court went on to posit that precluding both beneficiaries and personal representatives from bringing suit for malpractice would essentially immunize estate planning attorneys from liability for breaching their duty to their clients and, further, that limiting estate planning malpractice suits to those brought by either the client or the client's personal representative strikes the appropriate balance between providing accountability for attorney negligence and protecting the sanctity of the attorney-client relationship.[6]

In a more recent case, *Smith v. O'Donnell*, the Texas Supreme Court considered whether a personal representative may bring suit against a decedent's attorney for malpractice committed outside the estate planning context.[7] In *Smith*, Mr. Denney served as the executor of his wife's estate and retained a law firm to advise him on the administration of that estate. During administration, the issue of whether to characterize certain shares of stock as separate or community property arose and, according to the law firm, they advised Mr. Denney that the stock was presumed to be community property and that he should pursue a declaratory judgment to properly characterize the stock, which he declined to do.

Mr. Denney, as executor, treated all of the stock as his separate property and titled all to his name and none to the trust established under his wife's will. Mr. Denney died twenty-nine years later and the bulk of his estate passed to charity. Within about one month of his death, his children, as beneficiaries of his wife's trust, sued Mr. Denney's estate alleging that he, as executor of his wife's estate, had mischaracterized the stock as his separate property and, as a result, underfunded their mother's trust. Thomas O'Donnell was the executor of Mr. Denney's estate and settled the children's claim for $12.9 million. Thereafter, O'Donnell brought suit against the law firm alleging that the attorneys failed to properly advise Mr. Denney about the serious consequences of mischaracterizing assets, thus causing damage to his estate. The law firm argued that the Court should adopt the rule that *Barcelo* bars all legal malpractice suits brought by non-clients, with the limited exception of estate-planning malpractice claims brought by executors, like that in *Belt*. However, the Court disagreed and held that to adopt this rule would place Texas alone among states, and would unnecessarily immunize attorneys who commit malpractice. Accordingly, the Court ruled that there was no reason to deprive an estate of any remedy for wrongdoing that caused it harm by prohibiting an estate from pursuing claims the decedent could have brought during his lifetime.[8] The Court allowed O'Donnell, as executor of the estate, to bring the legal malpractice claim on Mr. Denney's behalf against the law firm.[9]

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[5] *Id.* at 787.

[6] *Id.* at 789.

[7] *Smith v. O'Donnell*, 2009-TX-0629.585 (Tex. 2009).

[8] *Id.*

[9] *Id.*

These cases show that Texas beneficiaries are monitoring their inheritance and the action steps taken by fiduciaries and professionals that impact the amount they ultimately receive. In addition, those beneficiaries are willing to bring suit to collect damages if they perceive that an action of an executor, lawyer, etc. in the course of his/her duties led to a diminution in the value of their inheritance. ILIT Trustees have the same or more direct duty to Trust beneficiaries that the executor and lawyers had to the plaintiffs in these recent cases and that, along with other reasons, put ILIT Trustees in Texas on notice of the need to fully assess and guard against their liability exposure.

II. NATIONAL LEGAL ENVIRONMENT FOR THE ILIT TRUSTEE

According to an article by the New York Times, dissatisfaction with trustees has been growing with most complaints centering on investment performance as beneficiaries become more financially sophisticated and more types of investments become available.[10] As greater responsibilities are placed on trustees and beneficiaries become more likely to hold the trustees accountable as a fiduciary, individuals may be less agreeable to serving as trustee especially in the area of an ILIT, where such trusts are typically designed to hold only one asset - a life insurance policy - and fiduciary duties were once thought to be minimal. In hopes of clarifying the duties and liabilities of an ILIT Trustee based on national trends, the following is a brief overview of the Uniform Prudent Investor Act of 1994 ("UPIA"), various state statutes, and state case law impacting an ILIT Trustee.

A. Uniform Prudent Investor Act. The UPIA, as adopted by a majority of the states in various formats, provides fundamental statutory criteria for the investment management responsibilities of a trustee. The UPIA draws most extensively upon the revised standards for prudent trust investment as promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992).[11] The UPIA made fundamental changes to the former criteria for prudent investing, including incorporating the requirement that fiduciaries diversify their investments and permitting delegation of investment and management functions.

The prudent investor rule as set forth in the UPIA requires a trustee to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.[12] In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.[13] The prudent investor rule, however, is a default rule under the UPIA and may be expanded, restricted, eliminated or otherwise altered by the trust provisions.[14] Accordingly, a trustee may not be liable under the UPIA to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust that read to limit or

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[10] *Breaking Up Is Hard To Do*, The New York Times, Fran Hawthorne, March 18, 2008.

[11] Uniform Prudent Investor Act, drafted by the National Conference of Commissioners on Uniform State Laws, Annual Conference, Chicago, Illinois, July 29-August 5, 1994.

[12] UPIA, Section 2(a).

[13] *Id.*

[14] UPIA, Section 1(b).

otherwise modify the trustee's responsibilities[15], but it is not yet clear the extent to which the courts will apply those exculpatory provisions to protect the trustee and whether the courts will rely on other statutory duties, notwithstanding the exculpatory language, to find the trustee responsible for the prudent management of trust assets, including life insurance policies.

The UPIA integrates the diversification requirement into the concept of prudent investing by obligating a trustee to diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purpose of the trust are better served without diversifying.[16] The commentary within the UPIA goes on to explain that circumstances can overcome the duty to diversify and lists the goal of retaining a family business as an example of such a circumstance, which could override the conventional duty to diversify.[17] The UPIA does not speak specifically to the duty to diversify in the context of an ILIT, but arguably, the trust's purpose to only hold a single insurance policy could be a "special circumstance" overriding the trustee's conventional duty to diversify.

Section 5 of the UPIA sets forth a trustee's duty of loyalty and provides that a trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.[18] The commentary within the UPIA provides that a fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.[19]

Section 7 of the UPIA speaks to costs associated with the investment and management of a trust and 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.[20] Trustees are obligated to minimize costs associated with the investment and management of trust assets.[21] As mentioned above, an ILIT trustee may be able to argue that "special circumstances" exist so as to eliminate a trustee's duty to diversify, but an ILIT trustee will always have a duty under the UPIA to minimize costs associated with the trust's ownership of a life insurance policy.

In determining a trustee's compliance with the prudent investor rule, the trustee's actions will be reviewed under the UPIA in light of the facts and circumstances existing at the time of the trustee's decision or action and not by hindsight.[22] In the UPIA commentary, the Commissioners explain this rule by stating that not every investment or management decision will turn out in the

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[15] *Id.*

[16] UPIA, Section 3.

[17] *Id.*

[18] UPIA, Section 5.

[19] *Id.*

[20] UPIA, Section 7.

[21] *Id.*

[22] UPIA, Section 8.

light of hindsight to have been successful, even if that decision met the requisite standard of prudence at the time it was made.[23]

As mentioned briefly above, the UPIA permits a trustee to delegate investment and management functions to a third party. The UPIA provides that a trustee may delegate such functions that a prudent trustee of comparable skills could properly delegate under the circumstances, provided that the trustee exercises reasonable care, skill and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.[24] So long as a trustee complies with the preceding requirements, the trustee is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.[25] The UPIA Commissioners believe that the delegation provisions of the UPIA strike the appropriate balance between the advantages and the hazards of delegation.[26] The duty to minimize costs, as discussed above, applies to delegation as well as to other aspects of fiduciary investing, and in deciding whether to delegate, the trustee must balance the projected benefits against the likely costs.[27]

The UPIA makes no distinction between the investment management responsibilities of a trustee of a trust designed to hold numerous and varied assets and the trustee of a trust designed to hold only a life insurance policy, so arguably the same investment management standards apply to all trustees unless the trust provisions or a state statute provide otherwise.

B. State Statutes. Several states have recognized the heightened investment and management standards applicable to trustees under the UPIA, and in what could be seen as an acknowledgment of the application of those standards to an ILIT trustee, created an exception in the context of an ILIT. The following sections provide a brief overview of the different approaches taken by several states.

1. Delaware-type Statutes. The Delaware legislature has carved out a specific exception for the duties of an ILIT trustee. Under Delaware law, when a fiduciary is investing, reinvesting, purchasing, acquiring, exchanging, retaining, selling and managing property for another, he or she must act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account.[28] Notwithstanding the foregoing management and investment standard, a Delaware trustee may acquire a contract of life insurance upon the life of the trustor or

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[23] *Id.*

[24] UPIA, Section 9(a).

[25] UPIA, Section 9(c).

[26] *Id.*

[27] *Id.*

[28] Delaware Code, Title 12, Chapter 33, Section 3302(a).

the trustor's spouse, or both, without liability for a loss arising from the trustee's failure to: (1) determine whether the contract is or remains a proper investment; (2) investigate the financial strength or changes in the financial strength of the life insurance company; (3) make a determination of whether to exercise any policy option available under the contract; (4) make a determination of whether to diversify such contracts relative to one another or to other assets, if any, administered by the trustee; or (5) inquire about changes in the health or financial condition of the insured or insured relative to any such contract *so long as* the trustee discloses such limitation of the trustee's duties either in the governing instrument or in a separate writing delivered to each insured at the inception of the contract of life insurance or thereafter if prior to an event giving rise to a claim under such contract.[29]

While not as expansive as the Delaware statute, a Pennsylvania statute shields a trustee of an ILIT from certain liabilities by providing that a trustee may acquire or retain a contract of life insurance upon the life of the trustor or the trustor's spouse, or both, without liability for a loss arising from the trustee's failure to: (1) determine whether the contract is or remains a proper investment; (2) investigate the financial strength of the life insurance company; (3) exercise nonforfeiture provisions available under the contract; or (4) diversify the contract.[30] The Pennsylvania statute was passed to protect trustees of ILITs in accordance with the typical intent of the trustors.[31] South Carolina has adopted a very similar statute to that adopted by Pennsylvania in its adaptation of the UPIA, which protects trustees from certain liabilities with respect to acquiring and retaining a contract of life insurance.[32] Since the Delaware-type statutes negate most of the duties of a trustee of an ILIT, the risk of loss for inadequate or negligent investment and management of the trust shifts from the trustee to the beneficiaries of the trust.

Based on the protection for an ILIT trustee that the Delaware-type statutes provide, a trustee may wish to have the terms of the ILIT governed by a jurisdiction which has adopted a Delaware-type statute. Under the Uniform Trust Code, which has been adopted by 21 states to date but has not been adopted by Texas[33], the meaning and effect of the terms of a trust are determined by: (1) the law of the jurisdiction designated in the terms of the trust unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue; or (2) in the absence of a controlling designation in the terms of the trust, the law of the jurisdiction having the most significant relationship to the matter at issue.[34] Accordingly, under the Uniform Trust Code, the trustor may select the law that will govern the meaning and effect of the terms of the trust.

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[29] Delaware Code, Title 12, Chapter 33, Section 3302(d).

[30] Pennsylvania Consolidated Statutes, Title 20, Chapter 72, Section 7208.

[31] *Id.*

[32] South Carolina Code of Laws Section 62-7-933(J).

[33] Uniform Law Commissioners, The National Conference of Commissioners on Uniform State Laws, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utc2000.asp

[34] Uniform Trust Code, Section 107.

2. **Florida.** Under Florida law, a trustee of an ILIT may delegate certain investment functions with respect to the insurance policy to: (1) the beneficiaries of the trust; (2) the spouse or issue of anyone in (1); (3) any person or entity nominated by a majority of the beneficiaries; or (4) an investment agent if the fiduciary exercises reasonable care, judgment and caution in selecting the investment agent and in establishing the scope and specific terms of any delegation, *without any continuing obligation to review the agent's actions*, provided that the trustee has given written notice of its intention to delegate investment functions to all beneficiaries within thirty (30) days of the delegation.[35] As mentioned above, the UPIA allows a trustee to delegate its management and investment functions as long as the trustee periodically reviews the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. In contrast to the UPIA's delegation provisions, the Florida legislature has carved out a specific exception to the continuing obligation to review the agent's actions for an ILIT trustee who delegates investment functions.

3. **California.** California has adopted its own version of the Uniform Prudent Investor Act. However, in adopting the requirement of diversification, the California version of the UPIA provides that "[i]n making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."[36] Accordingly, a California ILIT trustee may have a so-called "prudence defense" under the California version of the UPIA. A California trustee may be able to defend his or her actions not to diversify the assets of the ILIT because it was prudent not to do so in light of the fact that the trustor established the ILIT to hold a single insurance policy. In light of the "prudence defense", however, the trustee of an ILIT may best be served if the trust reflects the trustor's intention to alter the UPIA's investment criteria and requirements. California recognizes the right of the trustor to expand or restrict the prudent investor rule by express provision in the trust instrument, and provides that a trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions.[37]

Note: As mentioned above, the effectiveness of exculpatory language in the trust document to protect the trustee is subject to court interpretation. In addition, it should be noted that federal and state legislation may restrict such clauses based on the belief that it is imprudent to expose beneficiaries to broad exculpation clauses, e.g. ERISA Section 404(a)(1)(D), 410(a), 29 U.S.C. Section 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law Section 11-1.7 (McKinney 1967).

C. Case Law.

1. **In re The Stuart Cochran Irrevocable Trust.** In one of the very few cases involving a claim of breach of fiduciary duty against an ILIT trustee, a decision from the Indiana Court of Appeals does provide some comfort to ILIT trustees. In *In re The Stuart Cochran Irrevocable Trust*, the beneficiaries of an ILIT, Chanell and Micaela Cochran, alleged that KeyBank,

[35] Florida Statutes, Title XXXIII, Chapter 518.112.

[36] California Uniform Prudent Investor Act, California Probate Code, Section 16048.

[37] California Uniform Prudent Investor Act, California Probate Code, Section 16046.

N.A. breached its obligations as trustee under Indiana's version of the UPIA.[38] The ILIT involved in this case was created by Stuart Cochran on December 28, 1997, for the benefit of his two daughters, Chanell and Micaela. Stuart funded the ILIT with life insurance policies insuring his life and named Elkhart National Bank as the initial trustee who was subsequently replaced by Pinnacle Bank as successor trustee. After Pinnacle no longer wished to serve as trustee of the ILIT, KeyBank was appointed successor trustee on February 3, 1999. In the spring of 2003, KeyBank retained Oswald & Company, an independent insurance consultant, to audit the policies held in the ILIT. At that time, Stuart was fifty-two (52) years old and the policies had a combined death benefit of approximately $8,000,000. The Oswald review of the policies at that time indicated that it was likely that the existing policies would lapse before Stuart reached his life expectancy of eighty-eight (88) years, and because Stuart's financial fortune had take a negative turn, he had no financial wherewithal to supplement the ILIT with additional resources or through the purchase of additional policies of life insurance. After an insurance agent proposed to KeyBank that a new policy, which offered a lump sum death benefit of approximately $2,700,000 guaranteed to age 100, be purchased to replace the existing policies, KeyBank requested Oswald to review this proposed policy. After reviewing the proposed policy, Oswald recommended that KeyBank purchase the new policy. After reviewing the Oswald analysis and recommendations, KeyBank decided to retire the old policies and purchase the new policy in their place.

In January 2004, Stuart died unexpectedly at the age of 53. The beneficiaries filed suit against KeyBank alleging, among other things, that KeyBank had breached its fiduciary duties as trustee. The trial court concluded that the conduct of the trustee was consistent with the standard established by the prudent investor rule under Indiana law and that KeyBank acted in good faith to protect the corpus of the trust given the downturn in the stock markets and the prospect that the existing policies would lapse before the expected life expectancy of the trustor. Accordingly, the trial court ruled that KeyBank did not breach its fiduciary responsibility to the trust or the beneficiaries. On appeal, the Indiana Court of Appeals upheld the trial court's ruling that KeyBank had not breached its fiduciary duties as trustee under Indiana's version of the UPIA. In reaching its decision, the Indiana Court of Appeals found that while KeyBank's decision-making process and communication was not perfect, it was sufficient, and although it is tempting to analyze these types of cases with the benefit of hindsight, the Court is not permitted to do so, nor should they. The Appeals Court noted that KeyBank chose between two viable, prudent options, and given the facts and circumstances it was faced with at that time, its actions were not imprudent and did not breach any of its relevant duties as trustee.

Under the Indiana version of the UPIA, a trustee is required to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust, and in satisfying this standard, must exercise reasonable care, skill and caution.[39] Instrumental to the decision of the Appeals Court that KeyBank had not breached its obligations under the Indiana UPIA was the fact that KeyBank relied on guidance from an outside, independent entity to review the policies and recommend a course of action for the trust. Interestingly, the Appeals Court in this case was satisfied with KeyBank considering only the old

[38] *In re: Matter of The Stuart Cochran Irrevocable Trust*, Cause No. 71C01-0404-MI-0059 (Ind. App. 2009).

[39] Indiana Code, Title 30, Article 4, Chapter 3.5, Section 2.

policies and one (1) new policy; however, other courts may require a higher standard resulting in the need to examine multiple policies.

2. Micale v. Bank One N.A. In one of the few other documented cases where an ILIT Trustee has been sued, claims were brought against a bank in a Colorado District Court.[40] This case never went to trial, but the plaintiffs were able to keep their suit in District Court for over two years before the case was dismissed. In *Micale v. Bank One N.A.*, Charles A. Micale, as trustor, for the benefit of his family brought suit against Bank One, as trustee, alleging, among other things, that Bank One had breached its statutory fiduciary duties and violated the Colorado Uniform Prudent Investor Act.[41]

In December 1991, Mr. Micale formed two ILITs and funded the two trusts by purchasing two life insurance policies - one for each trust. Bank One was not involved in the formation of the trusts or in the selection and purchase of the policies. The case against Bank One essentially rested on Mr. Micale's claim that if Bank One had not allowed the insured's previous policies to lapse, he would not have been required to pay premiums associated with the new policies that Bank One obtained after his old policies lapsed. The Colorado District Court first dismissed the claim that Bank One had violated the Colorado UPIA ruling that the Colorado UPIA provides a legal standard of care, not an independent cause of action.[42] However, in this ruling in August of 2005, the District Court did not dismiss Mr. Micale's claim against Bank One for breach of its fiduciary duties finding that he produced sufficient evidence of damages to survive summary judgment on this claim.

Subsequently, the District Court ruled on May 18, 2006, to dismiss Mr. Micale's claim of breach of fiduciary duties for lack of standing.[43] The District Court concluded that a trustee must administer a trust solely in the interest of the trust beneficiary, and only a beneficiary or one suing on his or her behalf can maintain suit against the trustee to enforce trust responsibilities or to enjoin or obtain redress for a breach of trust. The District Court went on to conclude that a trustor does not retain any interest in the trust property and, therefore, cannot maintain a suit to enforce the trustee's duties or responsibilities with respect to the trust. Accordingly, the District Court dismissed the breach of fiduciary duty claim as Mr. Micale did not have standing under Colorado law to maintain the action against Bank One. It is important to note that the District Court did not dismiss the breach of fiduciary duties claim for lack of cause.

3. Lack of Case Law. The lack of documented case law available does not mean that no cases have been filed against the trustees of ILITs. Many cases have been brought by the beneficiaries of ILITs based on alleged fiduciary breaches, including the trustee's failure to investigate other products from similarly rated insurance companies, which offered lower policy expenses and which could have provided greater death benefits; however, these cases have been

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[40] *Micale v. Bank One N.A.*, 382 F.Supp.2d 1207 (D. Colo. 2005).

[41] *Id.*

[42] *Id.*

[43] *Micale v. Bank One N.A.*, Civil Action No. 04-cv-00288-EWN-CBS, Order and Memorandum of Decision, May 18, 2006 (D. Colo.).

settled out of court.[44] According to *TheInsuranceAdvisor.com*, the fact that numerous cases have been settled out of court may show that there is simply no defense for an ILIT trustee who fails to meet the requirements of Section 7 of the UPIA.[45] Section 7 of the UPIA provides that the trustee may only incur costs that are appropriate and reasonable in relation to the assets and must minimize costs.[46] Accordingly, when an ILIT trustee pays costs of insurance charges, fixed administrative expenses, cash-value-based "wrap fees", and/or premium loads that cannot be justified, the trustee may have no defense to the cost minimization requirements of the UPIA.[47]

III. TEXAS

A. A History of Texas's Trustee Investment Rules.

1. A Brief History. Prior to 1940, Texas followed the "New York" Legal List Rule. The Legal List Rule was the majority approach among the states at the time, and each state's law listed the specific categories of approved fiduciary investments. This list guided the trustees to invest primarily in bonds, mortgages, and other fixed income securities.

The minority approach in the 1940's was the "Massachusetts" Prudent Man Rule. This rule allowed the trustee to use his or her discretion to invest as he or she sees fit, so long as the trustee "conducted himself faithfully and exercise[d] sound discretion."[48] As stocks began consistently yielding a higher rate of return than the listed investments provided by the states, the American Bankers Association developed a Model Prudent Man Statute which adopted a prudent man standard as a means to allow trustees to capture the higher yields available through equity investments.

Texas integrated the Prudent Man Standard based on the ABA's Model Statute into the Texas Trust Code in 1942, and later with the Restatement (2nd) of Trusts (1959). The Texas statute instructed trustees not to invest on speculation but with consideration to the permanent disposition of their funds, considering both the probable income from the investments as well as the probable safety of the invested capital. Risky and speculative investments were not allowed, and the law contained a portfolio-type provision which required that any determination of whether a trustee acted within the prudent standard was based on how all the assets of the trust were invested collectively, rather than by examining each investment individually.

2. Adoption of the UPIA. Texas replaced the Prudent Man Standard when the legislature adopted its version of the Uniform Prudent Investor Act, which became effective January 1, 2004. The Texas statute closely resembles the Uniform Act, with the major deviation surrounding the ability of trustees to delegate investment duties.

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44 *Complying with the "Prudent Trustee Rule"*, The Insurance Advisor.com, *available at* www.theinsuranceadvisor.com/?id=202.

45 *Id.*

46 UPIA, Section 7.

47 *Complying with the "Prudent Trustee Rule"*, The Insurance Advisor.com, *available at* www.theinsuranceadvisor.com/?id=202.

48 Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

The statute applies to trusts created after January 1, 2004, as well as applying to older trusts with respect to "an act or decision relating to the trust occurring after December 31, 2003."[49] If a trust refers to the Prudent Man Standard, as well as legal or authorized investments, etc., the standard of the Prudent Investor Act will be evoked.

B. <u>Texas's Prudent Investor Rule.</u> Below is an brief description of the principles integrated into Texas Trust Code Chapter 117 (the Texas Uniform Prudent Investor Act - TUPIA). While the TUPIA is the statutory standard for Texas, the rule is merely a default rule, and thus it may be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust.[50] Pursuant to the statute, a trustee will not be liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.[51]

1. <u>Standard of Care.</u> Under the TUPIA, trustees must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.[52] In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. 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. The following eight circumstances are listed for the trustee to consider when making investment and management decisions:

a. general economic conditions;
b. the possible effect of inflation or deflation;
c. the expected tax consequences of investment decisions or strategy;
d. the role that each investment plays within the overall trust portfolio;
e. the expected total return from income and the appreciation of capital;
f. other resources of the beneficiary;
g. needs for liquidity, income and preservation or appreciation of capital; and,
h. an asset's special relationship or special value, if any, to the purposes of the trust or to the beneficiary.

A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets. A trustee may invest in any kind of property or type of investment consistent with the standards of the TUPIA. If a trustee has special skills or expertise, he or she has a duty to use those special skills or expertise.

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49 H.B. 2240, Section 18, 78th Legislature (2003).

50 Texas Trust Code Section 117.003(b).

51 *Id.*

52 Texas Trust Code Section 117.004.

2. **Diversification and Duties at Inception of Trusteeship.** Under the prior law, there was no affirmative duty to diversify trust assets.[53] The TUPIA instructs a trustee to diversify the investments of the trust "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[54] This legislation codifies the trustee's duty to diversify to hedge the risk associated with the entire trust suffering if one investment goes bad. Some examples of possible special circumstances could include tax considerations, ownership of a family business, securities laws issues, or a trust owning heirloom or sentimental property.

Trustees also have an affirmative duty to review the trust assets within a reasonable time after accepting a trusteeship or receiving trust assets and to bring them in compliance with the prudent investor rule. This rule is a significant change from the prior Texas statute which permitted the trustee to retain the initial trust property without diversification and without liability for loss or depreciation of assets.[55]

3. **Loyalty and Impartiality.** Trustees are instructed to invest and manage the trust assets solely in the interest of the beneficiaries.[56] If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.[57] Trustees must take into account whether the interests of different beneficiaries are concurrent (multiple income interests) or successive (life and remainder interests) when considering the types of investments the trust should hold.

4. **Minimization of Costs.** When investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the trust assets, the purpose of the trust, and the skills of the trustee. The trustee is obliged to minimize costs.[58] If the trustee is going to hire a professional to manage the trust assets, fees and commissions are to be expected. Many professionals have not had success beating the market, plus they can whittle away trust assets by the transaction costs that they are collecting. It might also be reasonable for a trustee to adjust their compensation if they pay management fees to a third party investor so as to prevent the total fees from becoming unreasonable.

Because the standard of care required of trustees under the TUPIA is that of an ordinary prudent investor, not that of an ordinary prudent man, the skill required of the trustee is to be that of a specialist. This leads one to believe that an individual trustee, without the required informed-investor skill set, subjects themself to liability if they do not take reasonable methods to invest trust assets.

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[53] Texas Trust Code Section 113.003 (repealed); *see also Jewitt v. Capital Nat'l Bank of Austin,* 618 S.W.2d 109 (Tex. Civ. App.-Waco 1981).

[54] Texas Trust Code Section 117.005.

[55] Texas Trust Code Section 113.003 (repealed).

[56] Texas Trust Code Section 117.007.

[57] Texas Trust Code Section 117.008.

[58] Texas Trust Code Section 117.009.

C. Delegation of Investment and Management Functions. When a trustee lacks the sufficient skill to carry out his or her responsibilities under the Texas UPIA, there is a duty to obtain help, which can be accomplished by delegating these duties.

Under prior Texas law, a trustee was permitted to delegate investment and management functions, but the trustee continued to remain primarily responsible for the activities of the trust.[59] The trustee was required to send notice to the beneficiaries at least 30 days before entering into an agreement to delegate investment decisions to an agent.

1. Delegation Under the UPIA. Texas's prudent investor standard allows a trustee to delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.[60] To be relieved from liability for the performance of the agent, the trustee must carefully comply with all of the requirements of the TUPIA. To obtain that relief, the trustee must:

a. exercise reasonable care, skill, and caution in selecting an agent and establishing the scope and specific terms of the delegation; and
b. use due diligence in periodically reviewing the agent's action in order to monitor the agent's performance and compliance with the terms of the delegation.

Unlike the UPIA, the TUPIA places additional safeguards on the trust by making the trustee retain responsibility for the actions of the agent if:

a. the agent is an affiliate of the trustee;
b. the trustee or a beneficiary of the trust is required to arbitrate disputes with the agent under the terms of the delegation; or
c. the delegation agreement shortens the period for bringing an action by the trustee or the beneficiary of the trust with respect to the actions of the agent. Thus, when an agent accepts the delegation of a trust function from the trustee of a trust, the agent assumes the statutory obligations to the trust to exercise reasonable care to comply with the terms of the delegation and submits to the jurisdiction of Texas courts.[61]

While these safeguards help to protect the trust and the trust beneficiaries, the problem that arises is that many investment managers will not agree to manage money or make purchasing decisions without a contract containing a broad exculpatory clause, arbitration provisions, or both.

2. Elements to Consider Concerning Delegation. Although delegation is allowed under the TUPIA, the trustee is ultimately responsible for the proper administration of the

[59] Texas Trust Code Section 113.060 (repealed).

[60] Texas Trust Code Section 117.011(a).

[61] Texas Trust Code Section 117.0011(b & d).

trust. Thus, the delegation of functions to an advisor requires that the trustee ensure that the advisor is fully capable of performing the delegated functions and has sufficient information to do so on a continuing basis. The trustee must also take care to clearly define the terms and scope of the delegation which must be established in a manner that is consistent with the purposes and terms of the trust.

The following items should be considered for every delegation:

a. the actual terms and scope of the agent's duties;
b. the basis for the trustee's determination of whether, when, how often and what functions to delegate, based upon circumstances of the trust, the beneficiaries and the trustee's own abilities and limitations;
c. the expectations that a trustee has for the agent's performance of the delegated functions, and the trustee's and agent's rights and responsibilities with respect to one another;
d. the agent's compensation and any corresponding reduction in the trustee's compensation; and
e. the agent's responsibility for reporting/accounting to the trustee for the agent's activities in a timely manner.

3. **<u>Instances in Which the Trustee Should Consider Delegating.</u>** There is no set rule stating what functions a trustee can and cannot delegate. However, there is a general rule that provides that a trustee should not delegate acts that he or she can reasonably be required to personally perform. A trustee should delegate functions in areas in which the trustee does not have any expertise. Some of the assets that can require a special skill set to manage, develop, or make decisions concerning dispositions include:

a. real estate;
b. closely held business interests;
c. oil and gas interests or other mineral properties;
d. collections of antiques, art work and other collectibles;
e. intellectual property; and
f. life insurance policies.

Many trusts hold life insurance policies that vary in their level of complexity. The benefits of a trust owning life insurance policies are that it enables the trustor to provide for survivors, meet charitable objectives, cover estate tax liabilities, and balance inheritances among heirs. This asset may be overlooked by trustees when managing a trust portfolio because they may be viewed as a long term asset whose true purpose will not be needed for decades.

A trustee cannot be intimidated by the complexity of life insurance policies or incorrectly assume that a policy is a proper asset for the trust because the policy was not selected by the trustee. A trustee may need assistance from an agent concerning:

a. underperforming policies;

b. policies that are insufficient for current client needs- a different amount of death benefit may be needed due to changed circumstances;
c. newer policies that are more cost efficient;
d. new products and riders that may offer better options; and
e. policies scheduled for an increase in premium.

4. Steps to Protect the Trustee when Delegating. Even if the trustee has followed the statutory requirements of selecting an agent with due care and monitoring the acts of the agent, the trustee should consider the following steps to help protect himself or herself:

a. have adequate measures to monitor the agent;
b. require periodic accounting or reports from the agent on the agent's conduct and performance;
c. act promptly when any wrongdoing on the part of the agent is discovered;
d. do not act blindly on an agent's advice; and
e. exercise good faith and reasonable care in selecting an appropriate agent/successor agent and in establishing the scope of the agent's authority.

D. Diversification for ILITs.

1. Duty to Diversify Revisited. The affirmative duty to diversify can create problems for trusts with large concentrations of one investment, or one type of investment in the trust. This problem can arise with ILITs whose sole asset is an insurance policy, or a series of policies. This is similar to the problem that can arise with family farm and ranch trusts, trusts holding closely held business interests, and trusts holding large concentrations of the stock of the grantor's former employer.

Texas trustees may be able to avoid diversifying the trust portfolio under a couple of methods. First, the terms of the trust instrument can override the TUPIA's duty to diversify. Second, the trustee can argue that ILIT's fall into the "special circumstances" described in Section 117.005 permitting an undiversified portfolio.

2. Trust Terms Trump Duty to Diversify. As mentioned above, the prudent investor rule of the TUPIA is merely a default rule, and can be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust. Per the statute, the trustee will not be liable for reasonable reliance on the provisions of the trust.

All of the provisions of the Texas Trust Code may be overridden by the trust document, except for certain aspects of the trustee's duty to keep the beneficiaries informed of administration, and the trustee's duty to act in good faith, in accordance with the trust's purposes and for the beneficiaries' benefit.

For new trusts, the language can specifically state that the trustor's intent is for the trustee not to dispose of all or part of specific assets, or specific types of assets, in order to meet the diversification requirement. But what about trusts that were written without the specific reference to the waiver of the duty to diversify? How specific must the terms of the trust be to remove this duty to diversify? While this has not been directly addressed by Texas courts, other jurisdictions have addressed this issue with varying results.[62]

Some trusts are drafted with retention language that allows the trustee to retain assets the trustor placed in the trust. If the trustor transfers assets to a trust with a retention clause, the retention clause permits a trustee to keep the assets in the trust, even if in doing so the trustee would violate the duty to diversify, or even if it might be inappropriate for a trustee to retain such assets.

The Texas Trust Code prior to the current UPIA version of the Code specifically addressed the retention of assets in Section 113.003:

> A trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from the retention, any property that constitutes the initial trust corpus or that is added to the trust.

Trusts drafted prior to 2004 often mirrored this language in the trust provisions. However, with the new statutory duty to diversify in place and because the facts and circumstances vary from trust to trust, it is difficult to predict how a Texas court will rule on a particular matter concerning a duty to diversify being waived in the trust provisions. For now, if the objective is to waive the duty to diversify and protect an ILIT trustee from liability on that point, logic would dictate that the trust agreement should, at a minimum, identify specific assets (i.e., life insurance policies) that do not have to be sold to diversify a portfolio and state that the duty to diversify is being waived by the trustor.

3. Beneficiary Waiver and Release. If diversification is not possible and the trust instrument does not authorize a concentration of assets, the trustee should consider having all of the beneficiaries sign a waiver and release of liability.

The statute states that a beneficiary, who has the capacity to do so, my relieve a trustee from any duty, responsibility, restriction, or liability as to the beneficiary that would otherwise be imposed on the trustee.[63] The statute also provides that a written agreement between a trustee and a beneficiary, including a release, consent, or other agreement relating to a trustee's duty, power, responsibility, restriction, or liability, is final and binding on the beneficiary and any person represented by a beneficiary if the beneficiary which signs the document, has the capacity to do so, and has full knowledge of the circumstances surrounding the agreement.[64]

While the beneficiary release can provide a trustee with some protection, judicial modification, discussed below, provides the trustee with greater protection.

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[62] *Compare Will of Charles G. Dumont*, 791 N.Y.S.2d 868 (2004) and *Atwood v. Atwood*, 25 P.3d 936 (Oklahoma Civ. App. 2001), and *Wood v. U.S. Bank, N.A.*, 160 Ohio App. 3d 831, 828 N.E.2d 1072 (2005).

[63] Texas Trust Code Section 114.005(a). Part (b) of this Subsection mandates that this "release" must be signed by the beneficiary and delivered to the trustee.

[64] Texas Trust Code Section 114.032(a).

4. Trust Modification with Beneficiary Support. If a trustee is not confident that the trust terms specifically protect him from liability for retaining an undiversified portfolio, the trustee could seek the help of the beneficiaries and pursue a judicial modification of the trust terms to include language to waive the duty to diversify.

If all of the beneficiaries of the trust agree, the court can modify the trust terms in a manner that is not inconsistent with the material purposes of the trust.[65] This does require all of the beneficiaries to consent to the trust modification, but it allows the court the most discretion to change the provisions of the trust agreement. The trustee should consider doing this as soon as possible because if the trust assets decline in value, it might be more difficult to get the beneficiaries on board to proceed with the trust modification.

The Texas Trust Code allows a trustee or beneficiary to obtain a judicial modification of the terms of the trust if because of circumstances, not know or anticipated by the trustor, modification would further the purposes of the trust[66]. The trustee would need to be able to demonstrate that the trustee could not have anticipated the changes to the Trust Code requiring diversification and that it was the intent of the trustor for the trustee to retain the assets the trustee has maintained in the trust portfolio.

Another option is to persuade the court that trust modification is necessary to prevent waste or avoid impairment of the trust's administration, and this would allow the court to modify the administrative, nondispositive terms of the trust.[67] This is a harder argument to make than unanticipated circumstances, but it is an option to present to the court.

5. "Special Circumstances" to Not Diversify. The Texas UPIA requires a trustee to diversify "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[68] The examples of special circumstances that do not require diversification listed in the comments to the UPIA are (1) if a tax-sensitive trust is not diversified because of a large holding of low-basis securities, the tax costs of reorganizing the gain may outweigh the advantages of diversifying the holdings and (2) a trust that holds a large interest in a family owned business.

While not listed in the comments to the UPIA, there are several other holdings that would seem reasonable to include as a special circumstances holding. One example is a family farm, family ranch, or family vacation home. It is unreasonable for a trustee to sell part of an asset that is used primarily by the beneficiaries to an unrelated party in the name of diversification.

It can be argued that a reasonable undiversified holding is an insurance policy on the trustor's life. The purpose of the trust is to hold the insurance policy. While the trustee could buy a variety of insurance policies, or ensure that the company supplying the policy is a viable company,

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[65] Texas Trust Code Section 112.054(a)(4)(B).

[66] Texas Trust Code Section 112.054(a)(2).

[67] Texas Trust Code Section 112.054(a)(3).

[68] Texas Trust Code Section 117.005.

it could be argued that it is unreasonable to assume that the trustee should sell a policy for the mere purpose of diversification.

6. <u>What Makes a Trust Diversified?</u> The TUPIA does not say what percentage of a trust's assets may be invested in one investment and the trust still be considered diversified. This opens up a subjective determination of what is diversified. The comments from the National Council of Commissioners on Uniform State Laws concerning the duty to diversify from Section 117.003 states:

> There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries . . . . Broader diversification is usually to be preferred in trust investing, and pooled investment vehicles make thorough diversification practical for most trustees."[69]

The facts and circumstances of each trust must be taken into account when determining what is a diversified portfolio. Texas courts, even prior to 2004, have found that trustees have a duty to diversify their portfolios. In both *Jewitt v. Capital National Bank of Austin* and *Neuhaus v. Richards*, the Texas courts found that maintaining a highly concentrated portfolio was an act of negligence of the trustee.[70]

7. <u>Other Duties to Consider.</u> While a trustee might be able to avoid the duty to diversify through the terms of the trust or through a judicial modification, the trustee should not lose sight of the other duties of the TUPIA, such as loyalty and the standard of care. The trustee cannot rest on the idea that the duty to diversify has been waived so he or she is safe in retaining assets if they are compelled by other duties to sell the assets.

A trustee might also have a duty to seek relief from the court if the trust terms state that the trustee cannot sell a certain asset, if, due to a change in circumstances, it becomes imprudent to retain that asset. The trustee has a duty to the beneficiaries to maintain trust assets and should not rest blindly on ill-advised trust terms that run contrary to that duty.

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[69] The NCCUSL Commentary refers to Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, supra, at 23-24; Brealey, supra, at 111-13.

[70] *See Jewitt v. Capital Nat'l Bank of Austin,* 618 S.W.2d 109 (Tex. Civ. App.-Waco 1981) and *Neuhaus v. Richards*, 846 S.W.2d 70, (Tex. App.-Corpus Christi 1992).

IV. PRACTICAL CONSIDERATIONS FOR THE TEXAS ILIT

There are many compelling factors in place today that should motivate trustors, trustees, and beneficiaries of Texas ILITs to want to change the traditional method by which those ILITs have been structured and operated. The majority of insurance policies owned by ILITs operated under the traditional method are under-performing or, at worst, in a position where they will lapse before the death of the insured and/or termination of the Trust. The Texas Trust Code has been modified to include provisions calling for a more active management of trust assets by trustees and accountability for the trustee's failure to so manage those assets, and beneficiaries that held no more than an expectancy interest in an estate have filed, and won, lawsuits in which they alleged a breach of fiduciary duty by a professional that resulted in a diminution in the value of their inheritance. There are those trustors who want to maintain the status quo, but under the current circumstances they might not be able to find a corporate or individual who is willing to serve as trustee, so, in order to maintain their basic ILIT, they must modify their structure and operations. Alternatively, there may be some trustors who want to have their ILIT managed in the same fashion that an investment trust is managed, with an expectation of asset management and performance that is typically held for trusts owning stocks, bonds and other investments. In today's environment, the primary concern of ILIT trustees is liability exposure and how to avoid same. On the other hand, beneficiaries are beginning to take note of fiduciary responsibilities and are interested in holding trustees accountable for delivering to them, through the trust, properly managed assets that maximize the value of the assets ultimately distributed from the trust to the beneficiaries.

To sum it up is to repeat the statement that forces are in play today that should substantially change the way that ILITs are structured and operated in Texas. At a minimum, in an attempt to retain a status quo, trustors and trustees should pay close attention to the specific provisions added to the trust agreements to address the duties and standard of care imposed upon trustees under the Texas Trust Code. The more monumental response would be for trustors to expect, and trustees to deliver, based upon a cost benefit analysis, active management of ILIT trust assets so as to maximize the return on investment commensurate with the actions, policies and expectations of return imposed upon trustees of trusts holding traditional investment assets.

A. Steps to Limit Trustee Liability. If the objective is to maintain status quo, then the parties will need to work with the current statutory provisions under Texas law to attempt to fully insulate the trustee from liability exposure. As has been mentioned before, the steps required to accomplish this objective will evolve if and when Texas courts begin to issue opinions interpreting the statutes and outlining in more detail the parameters of trustee fiduciary duties and the impact of actions taken to restrict or eliminate those duties. As outlined in Article III above, steps available to trustors, trustees and/or beneficiaries to limit trustee liability exposure under Texas law include:

1. statutorily-based provisions added to the Trust Agreement;

2. beneficiary waiver and release;

3. modifications of the Trust Agreement through the courts.

B. Forum Shopping. To the extent that the parties do not achieve the requisite comfort in the protection afforded Trustees under current Texas law, they can choose to place the trusts in a state with statutes that provide a more definitive level of trustee protection. As noted in Article II.B. above, the Delaware statute provides the broadest level of protection for the trustee by basically removing the trustee's duty to monitor the performance of the insurance policy or the insurance company. There are two points to consider with respect to this Delaware statute. First, corporate trustees are apt to make this forum shopping decision for the trustor. For example, there is at least one corporate bank trustee operating in Texas that administers all of its ILITs through it's Delaware Trustee entity. Second, whereas the Delaware statute allows the trustor to accomplish the objective of retaining the status quo with respect to the administration of ILITs, it is worth the time for the trustor to ponder whether that is truly the direction that he or she wants the ILIT to move. More so, after consideration, it is possible that a Texas trustor might decide that it would be beneficial for the trustee to engage in active management of the assets owned by the ILIT, including the life insurance policies, and achieve a better return for the beneficiaries than the traditional method provides. If that is the case, then the provisions of C. and D. below would apply.

C. Modify the Traditional Operating Model Delegation. The trustor may be willing to accept the heightened trustee responsibilities and use those to expect more active management of trust assets from the trustee, but still want to name an individual or a local bank trust department to serve as trustee. However, in such a case, the individual or bank trustee may not have the skill level necessary to meet the standards imposed on trustees of ILITs under the new law. In this case, the parties can take advantage of the trustee delegation laws and allow the chosen trustee to delegate the management responsibilities to an agent who would carry out the active management of trust assets. As mentioned in III. above, Texas law allows a trustee to delegate trustee responsibilities to an agent with specific requirements for how that delegation may be effectively carried out and continuing liability for fiduciary responsibilities divided between the trustee and the agent. Again, as mentioned in B. above, if the parties are not comfortable with the Texas delegation rules they may seek another state in which to locate the trust and receive delegation rules that better meet their objectives. For example, as mentioned in II.B above, Florida law allows a trustee to delegate trust asset management functions to an agent without any continuing obligation to review the agents actions, assuming that specific steps are followed.

D. Modification of the Traditional Operating Model-Enter the New Century. More often than not the traditional operating model results in a trust return on investment that is below that which could be obtained if the assets of the trust were subject to active management. As mentioned in III.B.4 above, Texas Trust Code Section 117.009 puts the duty on the trustee to only incur those costs that are appropriate and reasonable in relation to the trust assets, the purposes of the trust, and the skills of the trustee. Thus, any steps taken by the trustee to more actively manage the assets of the ILIT must involve a cost/benefit assessment so the trustee can show that he or she has met the obligation to minimize costs. With that in mind, there are many steps the trustee can and should take in administering the assets of an ILIT, most importantly the insurance policies, to assure that the return on those investments meets the objectives set out for the trust as well as the reasonable expectations of the beneficiaries with respect to investment return. Those steps include -

1. Regularly monitor the premiums paid and policy performance of each policy owned by the Trust.

2. For underperforming policies, review multiple options available in the marketplace to correct that shortcoming, including:

a. sale of the policy;

b. restructuring the premiums and/or proceeds from the existing policy;

c. policy replacement, including those that can be accomplished without paying commissions.

3. At the outset, prepare an investment/policy management statement that identifies the objective(s) of the ILIT and regular maintenance steps to accomplish same.

4. Beware of the limitations of the life insurance agent, including the extent to which he or she offers no service with respect to monitoring the premiums and policy performance, and beware of marketing information that such agent might put forth as a means of analyzing the performance of the policy and seek out policy performance information from reliable third party providers as a means of assessing the relative performance of the policy.

5. Periodically review the financial stability of the insurance company.