Fiduciary Responsibility of a Trustee of a Life Insurance Trust

Using life insurance inside of an irrevocable life insurance trust is a very common estate planning strategy to help create the liquidity to pay estate taxes upon a person's death, or to replace the value of the assets that were lost due to taxes and estate administration expenses. The trustee is the person or institution that is designated to manage and operate the trust. Often, the trustee is a family member or friend of the person creating the trust (the "grantor") with little or no experience in being a trustee. Once the life insurance trust has been created and funded with money, the trustee uses that money to buy a life insurance policy on the individual and/or the spouse. Is that the end of the process? What happens next?

The management and operation of a trust does not end with the purchase of the life insurance, nor is the duty of the trustee simply to pay the premiums and to manage and disburse trust assets according to the terms of the trust. The trustee is a fiduciary and is held to a fairly high standard of care to properly manage and operate the trust. Let's look at a common example.

John is the trustee of an irrevocable life insurance trust (ILIT) created by his best friend, Bill. The trust holds a $7 million universal life insurance policy issued on the life of Bill. The primary purpose of the insurance is to help pay estate taxes when Bill dies. Bill is currently 50 years old and in reasonably good health. Since policy inception, Bill has been making gifts to the trust so that the trust would have the cash to pay the premiums. John, as the trustee, has been using the cash to pay the minimum premiums on the policy. Since the policy is a universal life contract, the policy owner can vary the premium payments and need not pay the recommended premium, known as the target premium.

John finally agrees to meet with an insurance agent to review the policy in the trust. John is informed that if Bill lives to life expectancy, the insurance policy will lapse or become too expensive to maintain. On the advice of the insurance agent, John decides to replace the existing policy with a $3 million permanent policy that Bill could not outlive. Bill agrees to the replacement and willingly signs the application as the insured. John goes one step further by discussing the situation with the trust beneficiaries who have no objection to the replacement.

Two years later Bill dies unexpectedly. Did John, as the trustee, breach his fiduciary responsibility to the trust beneficiaries? If John retained the original policy the trust would have been paid the original $7 million death benefit because the policy would have not lapsed in such a short period of time.

A court case with a fact pattern similar to the one described above, was decided by the Court of Appeals in Indiana*. Fortunately, in that case, the court decided that the trustee did not breach his fiduciary obligation to the trust beneficiaries. However, as a result of this case, and common sense planning, trustees and their advisors should realize the following:

*(*In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009))

1. Trustees have a fiduciary responsibility to trust beneficiaries, not the grantor of the trust. Based upon state law, trustees have the obligation to manage and invest trust property in a prudent manner. Most states have adopted a law commonly known as the Uniform Prudent Investor Act that will provide guidelines to trustees regarding trust investments. Trustees should review their respective state law regarding fiduciary responsibility.

2. Unfortunately, there is little guidance with respect to life insurance. Life insurance is a complicated financial product that may not be understood by trustees. It is prudent for a trustee to retain an independent insurance consultant to review a trust owned policy in the context of the long term goals of the trust, the nature of the policy, the financial stability of the issuing company, the type of policy owned by the trust, and explore various options with respect to the policy.
3. To the extent practical, trustees should perform their due diligence before accepting the policy.
4. When an existing trust policy is replaced, effective communication with trust beneficiaries is important.
5. Based on this case, trustees should not be held liable for unforeseen events such as the premature death of the insured grantor. In other words, while hindsight may be a great virtue, the court looked at the actions of the trustee at the time of its actions based on the assumption that the existing policy would eventually lapse. However, many underfunded policies may provide coverage to or close to life expectancy, which makes a replacement decision that much harder.
6. An insured may want to consider naming a financial institution as a trustee to protect friends and family members from liability. Alternatively, a special trustee can be named to make all investment decisions regarding trust property.
7. Even in close families, relationships between parties may change after a parent dies.

What would have happened if the facts of this case were reversed? What if the trustee kept the policy and it lapsed before the insured died? Also, would the trustee have violated his fiduciary responsibility if he did not try to replace the policy with one that was guaranteed against lapse?

There are times when insurance recommendations do not make sense in the context of expected life expectancy by advocating term insurance or underfunded universal life policies. These policies are generally designed to only provide benefits if the insured dies prior to a certain period of time. However, life expectancy is an average. Some will live well beyond life expectancy, and others may be well short. If the goal of a life insurance policy is to pay a death benefit when the insured dies, regardless of when, it makes sense to own a policy that will not lapse prior to death.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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