ILIT Asset Management: The Written Investment Policy Statement
(Part 4 of 4)

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This article is the fourth of a four-part series on the administration of life insurance as an asset of a trust. The first part discussed the duties of trustees under different models for administering an irrevocable life insurance trust. The second part examined the impact of the Prudent Investor Rule on holding life insurance in a trust. The third part described one approach that trustees may take in evaluating the appropriateness of insurance as an asset in a particular trust. This final part deals with how best to develop and communicate policy management guidelines for the decisions that a trustee will face.

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PART 4: THE WRITTEN INVESTMENT POLICY STATEMENT

§4.1 THE WRITTEN IPS: AN ALTERNATE PATH TO PRUDENCE

A written investment policy statement (“IPS”) establishes and communicates to all interested parties the guidelines for management of a trust’s insurance portfolio. For trustees seeking to delegate investment management functions prudently, in other words to set the terms of the delegation and to monitor the performance of the agent, a written IPS may be an indispensable tool. The following discussion focuses exclusively on trust administration during the lifetime of the grantor-insured.

For the unsophisticated family trustee, a written IPS acts as a roadmap to assist in the decision making process. Although the absence of compensation does not mitigate the duty of prudence, it is unlikely that friends or relatives of the grantor possess the skill sets required to assess the financial condition of insurance carriers or the credibility of their product illustrations. Furthermore, the unskilled and uncompensated trustee managing a trust with little in the way of cash resources may not have sufficient funds to retain independent expertise. The result is often a suboptimal process that finds the grantor seeking to exonerate the trustee from the duty to manage assets prudently or forcing the trustee to rely uncritically on the recom-

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mendations of salespeople who themselves are unconstrained with respect to asset management standards suitable to the purposes, terms, distribution requirements and other circumstances of the trust.

If the unskilled trustee has access to a written IPS, however, the management of the insurance portfolio may be put on a more firm footing. The unskilled trustee can use the IPS:

1. As a guide to the "architecture" of the insurance portfolio—types of policies, standards for carrier and policy selection and retention;
2. As a guide to the exercise of various rights and policy options—loans, dividend applications, non-forfeiture elections, policy abandonment or replacement options, etc.; and
3. As a tool for delegation to qualified agents—agents cannot only be provided with guidelines within which their recommendations must fall, but also with clear indication of expected periodic reporting obligations.

Likewise, professional co-trustees such as attorneys and accountants may also find that the written IPS is an important tool to evidence prudent asset management. The American College of Trust and Estate Counsel (ACTEC), for example, publishes a "Guide for ACTEC Fellows Serving as Trustees."[1] The Fiduciary Matters Subcommittee advises that the guide is "not in any sense, a 'restatement of the law' dealing with trusteeships" and acknowledges "it is addressed only to Fellows of the American College…and not to the legal community generally." Nevertheless, the ACTEC report defines standards of reasonableness for fiduciary administration of trust assets. Of particular interest are the Guide's recommendations regarding prudent procedures for investment of trust assets:

- The lawyer-trustee should "adopt an investment plan that is suitable to the purposes of the trust." The plan should provide for the selection of appropriate investments, monitoring of performance on a continuing basis and management of investment risks in order to minimize exposure to losses.
- The plan, although based on the provisions of the trust document with respect to investment matters, including the status of beneficiaries and the relative importance of income and growth of principal, should be separate from the governing trust instrument.
- The plan should be in writing.

Once a written IPS is in place, the lawyer-trustee can determine how best to discharge the administration of the trust estate. Although many professional trustees will wish to delegate the asset management function, they must employ a requisite level of care, skill and caution in selecting an agent for the purposes of such a delegation. Under the ACTEC standards, the lawyer-trustee cannot delegate responsibilities for establishing the scope and terms of the delegation, such as written investment policy guidelines, and for "monitoring the agent's performance."

Additionally, one can look to the American Law Institute—American Bar Association's (ALI-ABA) Fiduciary Accounting Guide for guidance on developing and implementing best practice standards for asset administration. Section 9.5.5 recapitulates the principles of prudence and in its "set of unofficial guidelines" suggests that:

> "The fiduciary's investment strategy should be reviewed in order to determine whether the fiduciary has preserved the value of account assets, while also seeking to obtain a reasonable rate or return on income-earning assets. Unless there are special circumstances, the fiduciary accounting should reflect both asset diversification and a prudently balanced investment strategy."[2]

In general, the ALI-ABA fiduciary guidelines parallel those promulgated by the CFA Institute: "…in the context of trust administration, corporate fiduciaries now have access to commonly accepted ethical standards and principles."[3] Therefore, it is not surprising to find that the CFA Institute, in the seventh edition (1996) of its Standards of Practice Handbook, also recommends creation of a written investment policy statement for each client, and directly incorporates the Prudent Investor Rule into the eighth edition (1999) of the Handbook.[4]

For commercial trustees advertising experience and expertise in asset management, a written IPS may be a critical document with which to evidence a requisite degree of care, skill and caution. Commercial trustees must often operate in a more heavily regulated environment. For example, as of January 29, 1997, the Office of the Comptroller of the Currency (the "OCC") revised Regulation 9 ("Reg. 9") governing the

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[1] *ACTEC Notes* Vol. 26 (2001), pp. 313-327

[2] Whitman, Robert, *Fiduciary Accounting Guide, ALI-ABA* (Second Edition, 1998) p. 52.

[3] *Id.,* §G-2.

[4] *Standards of Practice Handbook* Association for Investment Management and Research (Seventh Edition, 1996), p. 102; and *Standards of Practice Handbook* Association for Investment Management and Research (Eighth Edition, 1999), pp. 210-211.

fiduciary activities of national banks serving in fiduciary capacities such as trustee or executor. The revised Reg. 9 requires a national bank "to establish written policies and procedures to ensure that its fiduciary practices comply with applicable law."[5] National banks must conduct an initial asset review upon accepting the trusteeship and conduct a yearly review of each trust for which the bank has investment discretion to "evaluate whether the assets are appropriate, individually and collectively, for the account."[6] Although Restatement (Third) of Trusts (Prudent Investor Rule), §171 ("Restatement Third") repeals the common law prohibitions against delegation of certain non-administrative trustee functions, Reg. 9 provides that banks delegating such functions retain "investment discretion."[7] A 1999 Towers Perrin survey of bank executives indicates that OCC concern with ILIT administration procedures is growing. Approximately 28% of survey respondents indicated that the OCC reviewed or commented on ILIT asset management during the last review of their trust department operations. Towers Perrin estimates that more than $1 trillion of policy death benefits are managed via trust-owned life insurance policies.[8]

Moreover, the OCC issues guidelines for national banks considering purchase of life insurance.[9] Although the OCC guidelines emphasize the insurance purchase decision in the context of acceptable banking practices, nevertheless the guidelines provide a useful list of topics that banks should address in a "pre-purchase analysis." Of particular interest is its recommendation that the pre-purchase analysis consider certain risks of acquiring and maintaining a life insurance policy. According to the OCC, insurance policies manifest the following risks for national banks: (1) transaction risk; (2) credit risk; (3) interest rate risk; (4) liquidity risk; (5) compliance risk; and (6) price risk. Although some OCC-recommended criteria are closer to the standards of reasonable business judgment as well as to standards of sound banking practice, they are of interest in terms of "minimum" standards for skilled trustees bound by fiduciary standards.[10]

The Office of Thrift Supervision, which regulates savings associations and state trust companies, requires examiners to verify that the institution conducts a "…review of the life insurance policy(ies) to confirm that the policies held by the trust continue to be a prudent investment, taking into consideration any relevant language in the trust document or under applicable state law."[11] Furthermore, as state legislatures evaluate and enact the Uniform Trust Code (the "UTC"), there will be additional modifications of existing standards for prudent asset management. For example, under UTC §803, trustees advertising special skills or expertise have a duty to use them on behalf of the beneficiaries.[12] Therefore, it is important to develop sound and workable approaches to trust-owned life insurance policy management lest the trustee incur liability for fiduciary breach. To date, however, we are unaware of any published draft of a written Investment Policy Statement (IPS) for management of trust owned life insurance policies.[13]

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[5] 12 C.F.R. §9.5.

[6] 12 C.F.R. §9.6(c).

[7] 12 C.F.R. §9.2(i). *See also* Goodwin, Iris J. & McDowell, Pierce, "Delegating Responsibility: Trustees Explore the Once Taboo," *Trusts & Estates* (March, 1999), pp. 8-14.

[8] *Best's Review* (February, 1999), p. 68. *See also* "Warning on neglecting Life Policies in Trust Accounts," *American Banker* (November 10, 1998), p. 12.

[9] "Bank Purchases of Life Insurance: Guidelines for National Banks," *Bulletin 96-51* (September 20, 1996).

[10] *The Insurance Activities Comptroller's Handbook* (June, 2002) published by the Comptroller of the Currency details "the OCC's process for assessing risks to the national bank from insurance activities."

[11] *OTS Trust and Asset Management Handbook, supra* at §870.1: "This review should be conducted on an annual basis and the savings association should document its decision making as to the continued retention of the policies in light of any premium payment option changes or conversion provisions of the policy that might be triggered by some event. The savings association should also document its reviews of the solvency and financial health of the insurance companies issuing the policies. In its review, the savings association should take into consideration certain assumptions that were made when the policy was originally purchased or the ILIT created, about the insured's financial situation, life expectancy, health condition, number of dependents and other factors. Those factors can change while the insured is still alive, possibly rendering a life insurance policy inadequate, obsolete or no longer appropriate. Savings associations should be reviewing the policies to make sure that the trust does not continue to hold policies that have become inadequate or inappropriate."

The language of the OTS regulations suggests that the institutions under its jurisdiction may have responsibility for determining the ongoing adequacy of insurance coverage in addition to the prudence of the policy and carrier selection process. For example, §870P.6 (Level III Examination) requires supervisory reviews to "ensure that management purchases enough life insurance for the premiums paid."

[12] Professional trustees may be held to a higher standard of care than an average individual. *See, e.g., Estate of Collins* (1977) 72 Cal. App. 3d 663, 139 Cal. Rptr. 644.

[13] *See, however,* Collins, Patrick J. & Lawson, Kristor J., "Managing Attorney and Trustee Liability for Life Insurance Contracts," *Journal of Asset Protection* (September/October, 1996), pp. 47-57. Rybka, Lawrence J. "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustees and Advisors," *Trusts & Estates* (February, 2002), pp. 44-50 also has a brief discussion of an IPS for an ILIT. The Rybka article, however, is largely an advocacy piece for variable life insurance and contains many insupportable assertions, and for these reasons, should be used with caution.

§4.2 RATIONALE FOR THE IPS

One of the central themes of the Restatement Third is that trustees following a prudent decision making process will not be held liable for the outcomes of such a process. Trustees making *ad hoc* decisions may, however, be judged according to future outcomes. The investment community generally advocates the use of a written IPS by investment fiduciaries.[14] This recommendation flows primarily from a consideration of two factors: (1) a good decision making process sometimes generates poor results, while bad decision making sometimes generates lucky results; and (2) future investment return is a random variable the value of which cannot be precisely known or controlled. Written policy evidences the fact that the trustee:

- Developed an overall investment strategy;
- Made conscious decisions regarding risk and return objectives reasonably suitable to the trust; and
- Administered trust assets with the requisite degree of care, skill and caution.

A written IPS mitigates trustee liability for unfortunate outcomes to the extent that the written IPS changes disputes into matters of fact and circumstance rather than matters of mere opinion. Ultimately, the fiduciary has a choice. He or she can rely on his or her ability to identify and select insurance programs that generate favorable outcomes. In this case, the fiduciary must rely on the future results of current decisions to demonstrate the prudence of their stewardship. Alternately, the fiduciary can document the prudence of the decision making process. In this case, there is reduced likelihood that the fiduciary will be found to be in breach of the duties inherent in the fiduciary's office. A fiduciary cannot always be right. A fiduciary, however, can always be prudent.

Academic research, some of which is cited throughout this article, forms a body of work that is sufficiently substantial and credible to be given at least normative emphasis by ILIT trustees. In translating academic findings to the practical business of trust-owned asset management, establishment of a written statement of objectives, policies and procedures is a preferred method for designing and implementing a prudent administrative process. Sound written policy offers the trustee:

- A legally defensible position that documents the procedural prudence of financial decisions;
- An academically reasonable position that enables interested parties to make informed judgments regarding the risks and rewards of financial decisions; and
- An administratively convenient system through which a myriad of apparently contradictory vendor claims can be intelligently evaluated.

An institutional investor such as a pension plan, profit sharing plan and endowment, often develops a written IPS as the cornerstone document of its decision making and asset administration process. Although much has been written regarding the need for written investment policy for trust-owned assets, most commentary focuses on investment-oriented as opposed to insurance-oriented trusteeships. Likewise, although the Uniform Prudent Investor Act in no way exempts life insurance from its provisions, there is an absence of drafting suggestions that focus on the particular needs and characteristics of the irrevocable life insurance trust that must be administered during the lifetime of the insured. Trustees of ILITs and their legal advisors may be relying on exculpatory trust language, drafting for "special relation" status for the insurance assets, "directed investment" instructions or a more ambiguous standards-of-practice defense.[15] However, special relation asset status and exculpatory language may not alleviate the trustee from the duty to make trust assets productive. If economic circumstances change, the duty of loyalty may demand that the trustee seek to modify trust provisions when the failure to seek such a modification would itself be imprudent.[16]

A written IPS sets realistic risk and return expectations and communicates them to interested parties. With respect to ILIT administration, a written IPS is especially important because:

1. Under many discounting assumptions, the expected return on an insurance policy is negative; and

[14] *See, for example,* Bodie, Kane & Marcus, *supra* at 263-287; and Reilly, Frank K. & Brown Keith C., *Investment Analysis and Portfolio Management 5th Edition* (The Dryden Press, 1997), pp. 41-55. In at least one ERISA case, *Liss v. Smith,* 991 F. Supp. 278 (S.D.N.Y. 1998), a fiduciary was surcharged, in part, because the absence of a written investment policy was found to be a breach: "…there are no genuine issues of material fact with respect to the allegations that the trustees had no investment policy and that the absence of such a policy, coupled with the other acts and omissions by the trustees of these Funds, constituted a breach of fiduciary duty."

[15] *See* §1.4.2 for a more complete exposition of legal issues facing trustees.

[16] *See, for example,* Raskin, John D., "Some Observations on Compliance With the California Prudent Investor Act," *Estate Planning & California Probate Reporter* (Vol. 18, No. 3), October, 1996, p. 34; and Lipton, Paul R., & Kornspan, Susan F., "Expansion of Trustee's Authority May Not Relax the Standard of Care," at the website of the Greenberg Traurig law firm (www.gtlaw.com/pub/articles/2002/lipton02a.pdf). California Probate Code §16007 imposes a duty on the trustee to make the trust property productive under the circumstances and in furtherance of the purposes of the trust.

2. The ILIT portfolio is a "completion portfolio," as opposed to a balanced, globally invested portfolio diversified over a broad range of asset classes.

Only if the insured suffers an early demise will the beneficiaries realize a death benefit the present value of which is greater than the present value of the aggregate premiums paid into the policy. As Moshe Milevsky, York University Professor of Finance, states: "…no product is sold at cost, or zero profit. In fact, your premiums are much higher than what the company is expected to payout, since they are obviously in the business of generating returns for their shareholders."[17] The fact that the expected value of an insurance contract is negative has important consequences for asset management. The trustee retains the duty to determine the suitability of the assets within the trust corpus in light of the objectives of the grantor and the purposes and economic circumstances of the trust. Therefore, it is particularly important to situate the insurance program as part of a larger and fully diversified estate planning strategy.[18] This is one reason why the trust's insurance portfolio may be deemed to be a completion portfolio—that is, assets either fill in gaps in an existing investment portfolio or supplement other assets, such as farms, business interests and real property, that exist outside of the trust.[19]

If the estate planning strategy calls for a risk-hedging instrument to avoid forced sale of non-liquid assets, the fact that the completion portfolio's expected value is negative may be economically justified.[20] Likewise, life insurance contracts originally acquired as hedges against loss of human capital may merit retention as part of an ILIT portfolio oriented towards estate transfer planning objectives provided that the trustee executes and documents an appropriate analysis. This is important because the decision to retain the life insurance is also a decision not to invest in an alternative investment vehicle. Acquisition of a trust-owned insurance program for estates with readily marketable assets, however, may be more difficult to justify. Although "Discounted Dollar" sales pitches are endemic within the life insurance industry, the trustee faces the difficult task of justifying implementation of a state-contingent "sinking fund" to discharge future debts. Unlike corporations that establish sinking funds to redeem callable bond issues, it is more difficult to justify prepayment of future liabilities with an asset (insurance policy) that has negative expected present value.

§4.3 DIVERSIFICATION AND INVESTMENT POLICY

One of the central principles of the Restatement Third is that no investment is risk free. It follows that trustees are rarely directed to either ignore risk (maximize returns) or avoid risk (maximize safety of the principal's nominal value). Rather, they have the obligation to understand risk and to manage it for the best advantage of trust beneficiaries.[21] Investors often view risk as either the possibility of economic loss or as the possibility of failing to achieve desired economic objectives. According to academic studies, fiduciaries face two types of investment risk:

1. Systematic risk (often called "market risk"); and
2. Unsystematic risk (often called "unique risk").

Systematic risk is that portion of risk that cannot be eliminated through asset diversification. Systematic risk is "...due to common factors facing *all firms* in the economy and/or industry: the business cycle, interest rates, inflation, and so on."[22] Unsystematic risk is the portion of risk that remains after accounting for all systematic risk. It is the risk that is unique to the firm,

[17] Milevsky, Moshe A., "Insurance: When and Why," http://www.yorku.ca/milevsky/papers/essay12.htm., p. 2. *See also* Milevsky, Moshe A. & Gottesman, Aron A., *Insurance Logic* (Stoddart Publishing, 2002), p. 26. *See also* Atkinson & Dallas, *supra* at 254: "Life insurance starts with a simple concept: In return for a series of premium payments, the insurance company agrees to pay a death benefit if the insured dies. At a minimum, the pricing actuary's job is to ensure that the present value of expected premium payments is more than the present value of expected death benefits."

[18] The unique nature of the ILIT is recognized in the following discussion regarding drafting considerations for California trusts: "The trustee might counter with the argument that the trust provision—although couched in the language of a power—was actually intended to override the Prob C §16048 duty to diversify investments. A settlor might desire such a provision, wisely or otherwise, if the main trust asset was the family business. A settlor might also desire such a provision in a trust, perhaps a life insurance trust, that is intended to hold a specific asset that constitutes a relatively small portion of total family wealth." Dennis-Strathmeyer, Jeffrey A., "Trustee Administration Powers: Drafting Considerations," *Estate Planning & California Probate Reporter* (December, 2003), p. 69.

[19] Condon, Kathleen A., "Equity Portfolio Management," *Managing Investment Portfolios: A Dynamic Process,* 2nd Edition (Warren, Gorham & Lamont 1990), p. 9-12.

[20] In at least two respects, life insurance policies share characteristics with put options. First, each financial instrument can be a valuable portfolio risk management tool. Second, insurance policies derive, at least in part, their values by reference to the performance underlying financial instruments such as a separate account or an insurer's general account portfolio.

[21] Collins, Patrick J., "A Risk Primer for Investment Fiduciaries: With Special Attention to the Management of Endowment Funds," *California Trusts and Estates Quarterly* (Fall, 2002), pp. 4-24.

[22] White, Gerald, Sondhi, Ashwinpaul, and Fried, Dov, *The Analysis and Use of Financial Statements,* John Wiley & Sons, New York (1994), p. 294.

such as the possibility of labor strife, product obsolescence, litigation and management ineptitude. Most importantly, unique risk can be mitigated by a policy of portfolio diversification.

Given the fact that effectively diversified portfolios mitigate unsystematic risk, classical economic theory posits that the pricing of a firm's stock does not take this type of risk into account. The market assumes that all investors will want to achieve returns at the lowest possible level of risk and, therefore, will diversify. Only the firm's non-diversifiable risk—*i.e.,* its systematic risk—is relevant in the determination of its stock price because, in a well-diversified portfolio, only systematic risk remains. Systematic risk becomes the measure of how a stock must be priced to compensate an investor for holding it within the portfolio. Unique, firm-specific risk is ignored in market pricing; and, therefore, investors cannot expect to be rewarded for bearing it. Unsystematic risk may, therefore, be ultimately defined as uncompensated risk.

This flies in the face of conventional wisdom that expects that the trustee will deliberately give up market diversification in order to select a limited number of companies that are "safe" or "above average." Indeed, if we desire a conservative, low-risk portfolio, common sense tells us that, instead of buying stocks willy-nilly, we would want to carefully review a list of blue-chip candidates to select the few firms that are most "solid."[23] Such an approach, however, may be judged imprudent under the prudent investor standards: "Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill.... Diversification is fundamental to the management of risk and is therefore a pervasive consideration in prudent investment management. So far as practical, the duty to diversify ordinarily applies even within a portion of a trust portfolio."[24]

The augmentation of the duty to diversify both across and within capital markets makes a decision to place all insurance coverage with a single carrier problematic. Absent pricing difficulties flowing from personal health, habits, hobbies or occupational considerations, it is hard to see how extreme asset concentration risk can be justified by excluding all but one carrier from the insurance portfolio. Indeed, given the recent financial outlook for the U.S. life insurance industry at the start of the 21st century, it is increasingly difficult to justify use of cash value insurance programs to provide long-term death benefits for trust beneficiaries.[25] The extent and magnitude of tax, regulatory, financial and competitive risks faced by each life insurance company make both future carrier solvency and insurance policy performance uncertain. Such conditions enhance the need for clearly articulated policy with respect to the acquisition and management of life insurance policy assets.

Although the black letter language of the Restatement (Third) of Trusts §227 emphasizes the trustee's duty to diversify trust investments, there is scant commentary on the practical effect of this duty on the administration of ILITs.[26] Indeed, because most policies are purchased with the assistance of a salesperson, it is often the case that all insurance coverage is placed with a single insurance carrier. If the demise of Executive Life and Confederation Life were not sufficient to alert the trustee to the perils of asset concentration risk, the more recent default at General American Life

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[23] Careful evaluation of investments "in isolation" was a rationale for the creation of legal lists by many state legislatures prior to Restatement Third. However, academic studies conducted over several decades demonstrate that investment selection based on criteria such as intrinsic value calculations (cash flow discount models), safety measures (quality of earnings / free cash flow analysis), track record (dividend payment history) does not lead to the formation of coherent portfolios that lie on the "efficient frontier" (offer the greatest expected return for a given level of risk; or the lowest level of risk for a given expected return). *See, for example,* Schaengold, David, "Decade of Change: Revising Trust Investment Law to Coordinate with Modern Portfolio Theory," *Tax Management Estates, Gifts and Trusts Journal* (November, 2001), pp. 258-266.

[24] Restatement (Third) of Trusts: *supra* at comment e.

[25] *See, for example,* Schott, F. H. *supra* at 85: "The best the industry can do in the rating game is 'stable' in the near term" (Moody's, February, 2000); "neutral to modestly negative" (A.M. Best, July, 2000); "negative yet sound" (Standard & Poor's, December, 1999 and June, 2000); "negative—although with high financial strength" (Duff & Phelps, January, 2000). The single most important factor in these appraisals is that the industry is behind other financial services provider groups in its rate of return on capital and assets." As noted, in September, 2002, Moody's downgraded the U.S. life insurance industry to "negative" from "stable" in recognition of the exogenous shocks caused by bond defaults, litigation against major insurance writers of COLI policies, possible adverse changes in tax law, and so forth. Moody's, Fitch and other rating services have more recently upgraded their outlook for the life insurance industry from negative to stable: "The stable rating outlook reflects Fitch's expectation that favorable operating performance that has existed in recent years will continue in 2005, and recent improvements in balance sheet fundamentals are expected to be sustained." (*Review & Outlook,* 2004/2005)

[26] Restatement (Third) of Trusts, §227 *supra* at comment (g): "diminishing uncompensated risk through diversification should be a pervasive consideration in prudent investment management and ordinarily applies even within specialized programs." For a discussion of trustee duty to diversify even a portion of a trust corpus, *see,* Aalberts, Robert J. & Poon, Percy S., "The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries," *American Business Law Journal* (Fall, 1996), p. 66.

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serves as a powerful reminder. The Missouri Insurance Department's placement of General American under its supervision is especially noteworthy because of the company's excellent long-term track record and high ranking by independent rating services.

Insurance vendors often point to past policy performance as a primary reason to select a particular insurance company. Although rational consumers might hesitate to commit their entire retirement nest egg to a single stock or even a single mutual fund despite evidence of superior past performance, it is nevertheless common practice for a trustee to eschew diversification within the insurance portfolio.[27]

Trustees embrace concentration risk (and salespersons, perhaps, encourage it) despite convincing empirical evidence that historical track record has little or no predictive value with respect to future insurance policy performance. This issue is a subset of the larger issue of whether current carrier financial strength ratings have predictive value with respect to future company solvency. It may not be an exaggeration to state that most ILIT trustees acquire an insurance policy based on a consideration of:

- The carrier's financial rating at the time of purchase;
- The historical performance of the carrier's policies up to the time of purchase; and
- The projected cost of the insurance benefits.

It is ironic that a trustee would voluntarily assume concentration risk based on three decision variables that have been repeatedly shown to have little predictive value.[28] When faced with the task of making a decision under conditions of uncertainty, the natural human reaction is to seek "solid" information. Historical track record seems like ideal information upon which to base a decision. Consumers may believe that it is purely quantitative, not subject to revision or manipulation, easily understandable, and dispositive in nature. Skilled trustees, however, must exercise a level of care, skill and caution that rises above the unsophisticated consumer. Such a process probably envisions something different than placement of all coverage with a single company based on a salesperson's representations of historical performance or company financial strength.

A decision to assume concentration risk may be particularly difficult to defend.[29] Even if the trust contains language permitting the trustee to eschew diversification, the trustee may find it imprudent to do so. Granting a trustee the latitude to deviate from the principles of prudence does not mean that the trustee must exercise such latitude. Indeed, The Insurance Counselor cautions:

> "We would no sooner have all our investments in one company than we should consider having all our life insurance in one insurance carrier. Diversification should be both by carrier and by product (*e.g.,* general account products and variable separate account products)."[30]

Comment (*g*) to §227 of the Restatement (Third) of Trusts recognizes two circumstances under which the duty to diversify may not apply:

> 1) Unless, under the circumstances, the objectives of both prudent risk management and impartiality can be satisfied without doing so, or
> 2) Unless special considerations make it prudent not to diversify in the particular trust situation.

The first point brings home the critical importance of the written IPS. On a macro-planning level, it is arguable whether an irrevocable trust should limit its holdings to the single asset class of life insurance policies. However, the written IPS can document the fact that the ILIT itself is a part of an integrated and diversi-

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[27] Investment fiduciaries sponsoring pension programs are subject to ERISA §404(a) prudence standards that establish diversification as the default funding standard for a plan unless the trustee determines that it is not prudent to do so.

[28] *See, for example,* Collins, Patrick J., "Myths and Realities Regarding Life Insurance Advice," *California Trusts and Estates Quarterly* (Fall, 1998), pp. 5-10.

[29] Collins, Patrick J., "Diversification, Due Care and Duties of an ILIT Trustee," *supra* at 8-15. *See also* Nowotny, Gerald, R., "Important Questions and Considerations for the Lawyer and CPA Regarding Life Insurance in the Estate Plan," *Tax Management Estates, Gifts and Trusts Journal* (September, 1995), pp. 192-196.

[30] *The Insurance Counselor, supra* at 8. *See, also, U.S. Trust supra* at 3589: "If the insurance amount is substantial, consideration should be given to whether diversification—using policies of two or more companies—is desirable." Admonitions regarding ILIT diversification appear in several recent articles. *See, for example,* Rybka, Lawrence J., & Jones, R. Marshall, "Guesses, Projections, Promises, and Guarantees," *Journal of Financial Service Professionals,* (July, 2005) p. 59: "The financial risk of a single issuer and the failure to diversify or consider long-term equity premiums are all prima facie grounds for an action by the policy's beneficiaries against the trustee for breach of fiduciary duty;" and Malarkey, Timothy P., & Leimberg, Stephan R., "Innovative Planning With 'No Lapse Guarantee' Life Insurance," *Estate Planning Journal* (2005), p. 17, at www.logos4me/Life: "At the 'end of the day,' the tried-and-true principle of diversification—not one but two or three different life insurance contracts, across more than one carrier—may provide the best answer to the question of product selection."

fied plan of estate management and conservation. However, on the trust portfolio level it may be difficult to justify a voluntary assumption of unsystematic carrier solvency risk by placing all coverage with one company.

Thus, without a written IPS, the trustee is left with the "special considerations" defense to justify a lack of diversification. This type of defense is appropriate where the trust instrument directs the retention of specific assets such as closely held businesses or family farms. Clearly, the lack of diversification is defensible on the grounds that it furthers the intent of the grantor. Cases where pre-existing medical conditions or hazardous activities or occupations make it difficult to obtain more than one or two well priced offers for coverage probably fall into the special considerations category. In most cases, it should be underwriting considerations that provide the trustee with the rationale for assuming concentration risk. It is, however, ironic that many trustees devote time and resources to scrutinize life insurance track records and financial statement data in order to select the single best company. This is tantamount to documenting a possible fiduciary breach due to improper diversification rather than exhibiting care, skill and caution.

Finally, the trustee may be able to advance a defense based on the fact that other insurance carriers reinsure the contract. The viability of this defense rests, in part, on how well the trustee can document a critical inquiry into how the issuing carrier re-insured the risk, the length of its reinsurance treaties, the financial soundness of the reinsurers and so forth. When a carrier has a low risk retention limit, investigation into reinsurance arrangements may be as important as any other aspect of procedural prudence. However, little has been written about this important subject from the fiduciary duty viewpoint.[31]

There is a lengthy and well-chronicled list of recent court decisions imposing surcharges on fiduciaries who fail to diversify adequately. For example, in *Baker Boyer Nat. Bank v. Garver,*[32] a corporate fiduciary was surcharged for failing to diversify into stocks, being faulted for concentrating too much of the portfolio in bonds and farmland. The trial court had found that the trustee breached its investment duties in part because "the trustee did not at any time make any considered conscious balancing of risk and advantages weighing the amount invested in farmland equity against the amount invested in fixed-income securities."[33]

The court in *Trusteeship of Williams*[34] also dealt with a failure to diversify question. The trust held stock in a local dairy that was acquired by Borden. After the acquisition, Borden stock represented 39.3% of the trust corpus. There were two individual trustees and one corporate trustee. One individual trustee voted to diversify but the other trustees "apparently felt that it would be prudent to hold Borden stock until the price of the stock rose in value."[35] Unfortunately, the value dropped from $36.375 a share to $14.25. The plaintiff's expert opined that a prudent trustee would hold no more than 10% of the trust in Borden. The court on appeal concluded that this raised the issue of possible negligence and remanded the case for trial.

The court held that an exculpatory clause limiting liability to "misfeasance or nonfeasance" did not absolve a diversification breach: "Norwest concedes that it is a professional trustee and has greater skills in the area of trusts than does a person of ordinary prudence. Therefore, Norwest was under a duty to use those skills.... Further, failure of a professional to meet a minimum standard of care is not a mere error in judgment."[36]

[31] *See, however,* the discussion on reinsurance in Collins & Lawson, "Managing Attorney and Trustee Liability for Life Insurance Contracts," *supra* at 47-57. Results from the 1996 Wharton Financial Institutions Center survey of the life insurance industry indicate that larger, more well-capitalized firms retain more risk while smaller firms tend to cede risk to reinsurance companies. The median amount of risk retained is $500,000 while the mean is between $2.75 and $3.5 million. These numbers suggest a substantial difference between insurance carriers with respect to retention of underwriting risk. Moore & Santomero, "The Industry Speaks: Results of the WFIC Insurance Survey," *Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management, supra,* at 55. Changes in reinsurance practices may profoundly change the face of the U.S. insurance industry. Many direct underwriters are "securitizing" their actuarial risks and ceding them to a small group of reinsurance syndicates. Selling risk provides working capital to insurance carriers wishing to compete with other financial products and services firms for retirement and investment dollars. This is a radical departure from the traditional business model followed by the industry for most of the 20th century and provides further evidence for the uncertainty of basing future projections on historical performance data. *See,* Panko, Ron, "Checking in the Risk," *Best's Review* (August, 2001), pp. 77-85. Indeed, under assumption reinsurance, a company can rid itself of the entire liability for a block of business. Following execution of an assumption reinsurance treaty, the carrier simply notifies policyholders that a new company will be responsible for payment of all future claims. Reinsurance due care analysis promises to be a difficult task and requires a deep understanding of strategies to mitigate various forms of counterparty risk. Atkinson & Dallas, *supra* at 902-903.

[32] 719 P.2d 583, 591 (Wash. App. 1986).

[33] 719 P.2d at 589.

[34] 591 N.W.2d 743 (Minn. App. 1999).

[35] 591 N.W.2d at 746.

[36] 591 N.W.2d at 748.

The case was remanded for trial on the issue of negligence.[37] A written IPS is a tool that may be especially valuable in helping trustees offload liability for breach of fiduciary duty.

It is a good idea to acknowledge in the written IPS that the trust's diversification strategy is suitable for a completion portfolio. Modern portfolio theory indicates that well diversified portfolios are built from assets exhibiting low, or negative, return covariance. Zero covariance (termed "orthogonality" by financial economists) is a necessary (but not sufficient) proof that one investment's return is statistically independent from another's. It is highly unlikely, however, that a diversified portfolio of insurance contracts issued through several carriers will exhibit statistical independence because of the clustering of product manufacturers within the U.S. insurance industry. Diversification, in terms of a completion portfolio, seeks to mitigate the systematic risk characteristic of the industry group (rather than the systematic risk of the market) by spreading the risk across a reasonable number of carriers. A second reason for articulating that trust assets form a completion portfolio designed to hedge selected perils is to mitigate trustee liability for investing in financial instruments with an expected negative net present value. Without a clearly defined rationale for portfolio construction, the trustee may have to defend, *ex post facto,* the decision to use life insurance, versus alternative strategies. However, the written IPS's explicit communication of the asset management objectives and strategies allows grantors and beneficiaries to review and ratify the risk and reward expectations of trustee decisions.

§4.4 DEVELOPMENT OF A WRITTEN IPS FOR THE ILIT

The following section discusses topics that should be addressed in the written IPS. Opinions on written IPS construction can, legitimately, vary widely. Therefore, the approach sketched herein is not meant to be prescriptive. Although the written IPS presented in this article draws from and builds on the concept of a benchmark model, a written IPS drafted for trustees lacking this type of analytical resource would, of course, differ. The purpose of a written IPS is to help trustees of all levels of skill and expertise discharge the duties of the office in a manner that promotes the legitimate expectations of trust settlors and the interests of beneficiaries. Generally, the goals of written IPS are threefold:

1. To establish asset management policies including asset selection and retention criteria;
2. To provide for regular monitoring and evaluation of the portfolio; and
3. To provide a prudent methodology for dealing with adverse changes or unanticipated events.

When setting the terms of delegation of investment responsibilities to a qualified agent, a written IPS may be a critical management control document for the trustee.

§4.4.1 General Composition of the Written IPS

A sound written IPS for an ILIT will incorporate a clear statement regarding the purposes, terms, distribution requirements, and other circumstances of the trust. The draftsperson may wish to insert a profile of the grantor or insured; a statement of trust objectives and constraints (time horizon, income needs, liquidity concerns, special legal and tax issues); information on health status; decision making procedures for acquisition of new insurance or replacement of existing policies; and procedures for exercising policy rights and options. The following subsections outline some general issues that pertain to formulating and drafting a written IPS.

§4.4.2 Allocation of Duties and Responsibilities

A written IPS provides an opportunity to allocate responsibility for defining and implementing trust policy and for trust administration and operations. Specifically, a written IPS will define the relationship between the members of the estate planning team (attorney, trustee, investment advisor, life insurance agent) and, cognizant of the standards of practice and codes of professional responsibilities, outlines what will or will not be done by each team member in his or her professional capacity. Clear understanding of the roles of the client, the advisors and the insurance agent both with respect to policy acquisition and future policy surveillance can facilitate the planning process and can serve as a powerful liability management tool in the event of dissatisfaction for poor future policy performance relative to other insurance plans or to other types of financial investments.

For a trustee who lacks the sufficient skills or resources, the delegation of investment management duties is a preferred method for documenting use of care, skill and caution in ILIT administration. The written IPS can facilitate this objective while, simultaneously, providing guidance to the life insurance sales agent. There are several schools of thought regarding agent responsibilities for trust owned insurance. Although it is doubtful that the employment contracts

[37] Collins, Patrick J. & Campisi, Dominic J., "Index Returns as a Measure of Damages in Fiduciary Surcharge Cases," *Trusts & Estates* (June, 2001), pp. 18-41; and Campisi, Dominic J., "The Perils of Prosperity: What Goes Up Will Likely Result in Surcharge," *The Thirty Fifth Annual Philip E. Heckerling Institute on Estate Planning* (Univ. of Miami School of Law 2001), pp. 12-1 to 12-23.

of many career agents permit them either to assume trustee or co-fiduciary responsibilities,[38] nevertheless, some commentators advocate implementation of a "service contract" between agent and trustee.[39] Contract provisions may include, among other things, minimum standards regarding agent experience and education, various disclosure provisions ranging from litigation and consumer complaints against the agent to detailed information on commissions payable for insurance transactions, ongoing responsibilities for timely reporting of specified policy values as well as calculation of designated performance measures and availability for periodic reviews. Some trustees may prefer to "outsource" service and policy monitoring functions either by relying on carrier home offices to provide critical policy data in an annual in-force policy report or by engaging the services of a third party administrator. Some commercial trustees can retain fiduciary monitoring and surveillance tasks in house provided that they establish rational investment policy and defensible administrative procedures. A written IPS gives trustees the opportunity to provide interested parties with reports focusing on the trustee's stewardship of a policy rather than on the trustee's prowess either at understanding insurance ledger illustrations or at finding the best deal in the marketplace. Lawyers acting as ILIT trustees may find themselves in a conflict of interest situation if the lawyer or the lawyer's firm also acts as estate planning counsel or if the client was secured by insurance agent referral. It may be especially important in such circumstances for the lawyer-trustee to provide interested parties with thorough disclosure.[40]

§4.4.3 The Statement of Trust Circumstances and Objectives

The Statement of Trust Circumstances and Objectives evidences the careful consideration given by both the grantor and the trustee to the formulation and implementation of asset management strategies appropriate to the needs and circumstances of trust beneficiaries and to the grantor-established purposes of the trust. As such, it provides a context for planning decisions that can be periodically revisited, both to account for changes in the trust beneficiaries' situation or in the insurance marketplace and to remind grantors and other interested parties of their original purposes and thinking. Furthermore, it provides an objective, written rationale for the fiduciary's exercise of the requisite care and skill in ongoing portfolio asset management.

The Statement of Trust Circumstances and Objectives also serves as an important risk management tool by setting forth the trust policy regarding diversification, in order to mitigate carrier-specific risk, as well as a number of other important risk management and investment strategies. Given the direct integration of diversification into the task of prudent investment management, the draftsperson may wish to specify that the ILIT is itself only one part of a larger diversified and integrated plan of family wealth management. In achieving the goals of the larger wealth management program, trust investment policy may be drafted to limit the assets within its portfolio to the class of financial instruments (insurance or investment products) that can best accomplish the grantor's intent. This view of ILIT asset management strategy corresponds to the establishment of "completion portfolios" with the mainstream investment community. Within the specified classes of financial instruments, however, the trustee should adhere to the practice of diversification "unless, under the circumstances, it is prudent not to do so."[41]

To this end, the draftsperson may wish to limit the face value of any one life insurance policy backed by the general portfolio of the carrier to that percentage of the aggregate face amount of coverage from all trust-owned policies that the trustee deems reasonable and appropriate. As stated previously, if there are significant pre-existing health conditions, avocational concerns or other underwriting difficulties, with the result that only one or two carriers offer well-priced insurance programs, then the trustee may determine, properly, to eschew diversification in favor of premium cost savings. Likewise, where an insurance contract's value is linked to investment funds that are separate from the general asset portfolio of the insurance carrier and, therefore, would not be likely to be subject to general creditor claims, as is the case for variable contracts, the trustee may elect to place a larger percentage

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[38] Agents accepting a delegation of responsibility may be subject to the jurisdiction of the courts in the state of trust *situs*. *See, for example,* California Probate Code §16052(d).

[39] An example of an "Insurance Service Contract" can be found on Glenn Daily's website at www.glenndaily.com/service.htm. The merits of an agent service contract are further outlined by Gerald Nowotny, "Important Questions and Considerations for the Lawyer and CPA Regarding Life Insurance in the Estate Plan," *supra* at 192-196. Using the sales agent as a source of objective and independent advice, however, may create insurmountable conflict of interest issues. For a comprehensive discussion of delegation agreements *see* Ballsun, *supra*.

[40] *See, for example,* the sample disclosure statement for insurance transactions, Collins & Lawson *supra* at 47-57. For a general discussion of mitigating attorney liability for insurance-related transactions, *see* Collins, Patrick J. & Curran, Robert F., "Ethical Considerations and Malpractice Claims," *Trust & Estates* (November, 1995).

[41] California Probate Code §16048.

of coverage with a single insurance carrier, provided that that carrier offers separate accounts that can, in their own right, be well diversified.[42]

In recognition that one of the primary benefits of diversification is to protect against the shock of an insurance carrier's insolvency, the trustee may want to immunize a reasonable portion of the trust portfolio against the adverse effects of creditor claims on the general assets of insurance companies. To this end, the trust's investment policy might want to enumerate specific "allocation targets" detailing the percentage of insurance coverage that will be tied to the general portfolio of any insurance carrier and the percentage of the coverage that will be backed by separate accounts not subject to creditor claims.[43]

§4.4.4 Risk and Return Analysis

One of the most valuable aspects of a written IPS is that it sets forth procedures for identifying and managing risk. Initially, it may seem inappropriate to speak of risk in the context of life insurance because policies act as hedge instruments designed to shift actuarial risks with undesirable or unacceptable personal economic consequences to insurance companies willing and able to pool many such personal risks. Unlike traditional life insurance policies, newer contracts contain various degrees of risk sharing between the insured and the insurance company. Additionally, the risk of insurance company insolvency, whether ending in seizure by regulators or in a merger or acquisition by a successor company, remains an important factor in asset management. The following is list of risk management issues that the draftsperson may wish to address in a written IPS.

Going Concern Risk (Risk of Insurance Company Insolvency)

Academic evidence suggests that there does not yet exist a model that, with a high degree of accuracy, can predict insurance company insolvency. Furthermore, although the past decade has seen a great improvement in solvency monitoring systems on the part of both regulators and independent rating agencies, the nature and scope of such activities are, for all practical purposes, beyond the skill set of most ILIT trustees. Solvency monitoring is no longer a spreadsheet exercise drawing data from accounting and actuarial performance results. Rather, it is a sophisticated process that entails the necessity to develop and test intricate stochastic valuation models as well as to make insightful predictions regarding the likely future consequences of current business strategies in an increasingly competitive marketplace. Bankruptcy prediction for insurance carriers is difficult because of constant changes in the economic, tax and regulatory environments under which carriers operate. Much of traditional credit-risk analysis opines on the quality of assets owned by the carrier. However, when the carrier's general asset portfolio contains a significant amount of private placement securities and surplus note financing, opinion shades quickly towards mere guess. It is no longer adequate to assume that carriers owning risky investments, such as "junk bonds," pose a higher insolvency risk than carriers with portfolios of "safe" assets. High quality private placement bonds that lack marketability because they are not registered for sale in public markets can turn from blue-chip assets into accounting nightmares, as insurance companies holding Enron bonds discovered to their great dismay.

Asset-based solvency analysis may overlook the greater risk exposure that flows from interest-rate risk. Interest rate risk arises from carrier decisions about how to match (or mismatch) the duration and convexity characteristics of assets to liabilities, how to define its fixed-income investment management objectives (spread management vs. total-return management), how to utilize derivatives, how to employ hedging strategies (interest rate swaps, surplus-note & commercial paper transactions) and, to a lesser extent, how to employ non-U.S.-dollar denominated fixed-income assets.[44] These complexities call into question any determination of financial strength based primarily on

[42] Unfortunately, however, much of the advice literature that focuses on variable life policies repeats the same nostrums, myths, platitudes and sales pitches that are endemic to life insurance marketing.

[43] A trustee electing to purchase policies underwritten by several carriers from a commission-based agent should understand the relationship between target premiums, which are the amount of premium upon which the agent receives the highest rates of commissions, and policy acquisition costs. Clearly, it would be difficult to defend a diversification strategy based on purchase of several load mutual funds manufactured by differing fund families if each fund purchase falls just below a commission break point. Diversification and the duty to avoid unreasonable or unwarranted costs are obligations that should receive simultaneous evaluation. The insurance marketplace does not make the trustee's job particularly easy, and there does not appear to be interest in developing a bundled or multi-carrier insurance product comparable to a mutual fund or unit trust. The authors believe that there may well be an opportunity for bank or insurance affiliates to develop low-load, multi-carrier or multi-reinsured specialty products for ILITs. The approach to product development might proceed along the lines of ERISA's self-dealing exemption for placement of employer products in employer-sponsored pension plans which specifies that products offered to employee benefit trusts should meet certain standards regarding prudent selection criteria and expense requirements.

[44] Maginn, John L., "Investment Policies and Practices of U.S. Life Insurance Companies," *Investment Policy* (The Association for Investment Management and Research, 1994), pp. 18-22.

formula-driven systems of financial ratio analysis that use unadjusted data derived from public sources. Evaluation based on published financial statements without adjustment either for consistency and comparability, on the one hand, or for qualitative evaluation of the business and marketing strategies that generate the ratios, on the other, may lead to incorrect conclusions.[45]

Therefore, although the conventional wisdom of the ILIT advice literature encourages the trustee to look beyond the letter and number grades assigned by rating firms, the draftsperson of the ILIT's written IPS may wish to rely primarily on the summary conclusions and grades of independent ratings and company evaluation services that conduct both a qualitative as well as a quantitative examination of insurance carrier assets, liabilities and management policies. That is to say, the draftsperson may wish to keep it simple and not commit the trustee to a promise of independent due diligence and carrier solvency evaluation.

Independent ratings services that are not purely quantitative in nature include:

- Standard & Poor's;
- Moody's;
- A.M. Best Co.; and
- Fitch Rating Company.

A written IPS might, for example, include a provision that the trustee will systematically monitor the ratings of two or more of these firms. Usually there are several "layers" of ratings within each general category.[46] Ratings vary over time; but either a significant and sudden downgrade or a series of sequentially smaller downgrades may presage financial distress.

Conventional advice literature usually states that, in the event of a downgrade, the trustee should determine what portfolio modifications, if any, are warranted. Without written policy, however, the trustee is left with the task of making *ad hoc* decisions in reaction to unanticipated events. Prior to selecting an insurance contract, the trustee is told to look beyond ratings to "try to glean from the reports a sense for whether the carrier is well positioned…." This implies that the trustee can and should generate judgments regarding future carrier solvency. However, the trustee is then told to react, in some unspecified manner, to ratings downgrades that, in all probability, result from exogenous factors that were never tractable to predictive models. This type of advice puts the trustee between a rock and a hard place. To be blunt, no trustee can manage such a task by following conventional wisdom any more than a trustee could be held liable for *ex ante* predictions regarding the value of the Dow Jones industrial average five, ten or twenty years hence.

The best way to manage such risks is through the techniques of:

1. Diversification; and
2. Cost control.[47]

The financial stability of the trust's portfolio should not be held hostage to the future financial condition of a single insurance company. From the prospective of beneficiaries who rely on trust values for funding economic objectives, an asset management strategy that calls for investing the entire corpus in securities issued by one company is imprudent absent direct instructions in the trust instrument or absent other mitigating factors such as low tax basis or designation as a special relation asset. Even then, however, it is not clear that a trustee can rely on mandates or broad discretionary boilerplate language to avoid diversification if such mandates conflict with the duty to invest prudently.

The trustee's goal is to act as an honest and effective steward of policy. The goal of the trust portfolio is not to maximize the death benefit or the ratio of death benefit per premium dollar eventually received by beneficiaries. Despite the fact that maximization of return is the mantra of policy sales and replacement activities, this is a form of treasure hunting that is achievable only by concentrating assets in an insurance policy issued by a single carrier. Only one carrier will have the top performing policy 20 or 30 years from today, but the odds of the trustee correctly identifying the future win-

[45] Even if financial statement information was adjusted for comparability and consistency, ratios or other bits of accounting data in and of themselves are of marginal value when considered in isolation. Their informative value emerges only when used as part of a larger analytical model of a firm's operations. What can be concluded from a leverage ratio when corresponding asset turnover, sales activity, and profit (tax) ratios are missing? The explanatory (predictive) value of a ratio is best judged in the context of the larger model in which it is used rather than as an isolated datum. The reader may note that this evaluative process is strikingly similar to the Third Restatement's recommendation to view each investment from the portfolio context rather than in isolation. Insurance agents, for example, may tout the fact that their company is a leader in insurance in force. This bit of isolated datum, however, cannot be helpful because insurance in force is a liability! Likewise, another agent might point to the quality of assets. This factoid cannot be helpful because it provides no information regarding the nature and scope of company liabilities. Neither can snapshot measures of, for example, the ratio of surplus to reserves be an objective indication of financial safety because it is the variability of company surplus, its value of assets less than the value of its liabilities, that is critical for carrier solvency.

[46] This is comparable to bond ratings. Bonds rated BBB and above are considered "investment grade," while those carrying lower ratings are "non-investment grade."

[47] This observation echoes Glenn Daily's advice. Daily recommends two strategies for consumer protection purposes: (1) Focus on Distribution Costs; and (2) Diversify. Daily, Glenn S., "How To Choose a Life Insurance Policy," *Journal of Financial Planning* (April, 1994), p. 75.

ner are remote. Today's frontrunner may become tomorrow's Executive Life, and as we have seen, academic evidence suggests that, at critical points in the history of the insurance industry, the difference between survivorship and receivership may be little more than an effective public relations campaign. Furthermore, the fact that any insurance carrier can demonstrate a superlative track record may be merely a form of statistical bias. The track record reflects a single sample of economic history during which the insurance firm has not yet encountered a unique pattern of risks that puts its survival into question. Such a statistical bias, however, does not guarantee the absence of risks. Rather, such a statistical bias indicates that such risks have not yet manifested themselves.

The goal of ILIT portfolios is, usually, to implement and manage successfully an insured, state-contingent hedge strategy. The hedged peril may be termination of an income stream, forced sale of illiquid assets, protection against loss of control for business interests and so forth. Vague strategies that are a mixture of greed (finding the best deal) and conservatism (diverting investment dollars to implement an insured hedge strategy) might suffice in the general marketplace of insurance buyers but may not constitute a coherent asset management strategy appropriate for the purposes, terms, distribution requirements and other circumstances of the trust.

It is critical to note that insurance policies that carry high commission and acquisition costs destroy asset management flexibility. If the trustee cannot replace unsuitable policies because of an excessive surrender charge or inadequate cash value accumulation, effective risk management becomes unfeasible. Failure to pay rigorous attention to acquisition costs and ongoing policy expenses undermines the duty to monitor and review the trust portfolio because the illiquidity penalties may hinder the trustee from taking timely and appropriate action. A well designed written IPS substitutes rational asset selection and portfolio diversification for the difficult burden of predicting carrier solvency and substitutes reasonable cost control and policy monitoring strategies for the impossible task of successfully identifying the top performing contracts of the future. The strategies of diversification and cost control are not new. These strategies are, however, central to the Restatement Third's standards of prudence, and it is time that they become central to ILIT asset management.

Risk of Contract Underperformance

Contrary to conventional wisdom, evaluation of insurance products and carriers should not place undue weight on the long-term track record of a specific policy form or on the market presence or prestige of the carrier.[48] Given the rate of introduction of new policy forms into the marketplace, usually under the influence of competitive pressures, it is unlikely that even policy forms launched in the recent past would have the same profit objectives, expense assumptions, compensation structures and so forth that are embedded in the new products available for sale today. Segmentation of the carrier's investment portfolio is also the primary reason why the past performance of a carrier's overall general account is not a valid predictor of how any specific policy form can be expected to perform. The general portfolio is merely an aggregation of segmented portfolios, each of which may have substantially different actuarial characteristics and competitive objectives.

Given the fact that illustrations may not accurately project future contract values, one of the most challenging tasks faced by an ILIT trustee is to determine the suitability of proposed or existing insurance contracts. The comparative benchmark model approach can facilitate an objective evaluation of a contract's vulnerability to mispricing and the likelihood that future premiums will be needed to fund projected benefits. Additionally, a benchmark model approach can assist the trustee to compare policies from different carriers in terms of a variety of critical factors including expected value, liquidity risks and so forth. A valid benchmark approach examines the timing, risk, magnitude and probability of all cash flows according to generally accepted standards of statistical and quantitative financial analysis. Although it is difficult to argue that uncritical reliance on vendor-supplied information constitutes "reasonable care, skill, and caution," a benchmark model that, over the appropriate planning horizon, adjusts cash flows for the time value of money, for the probability of policy lapse or surrender and for the statistically expected pattern of death claims offers a credible method of demonstrating that the trustee made "conscious decisions concerning the levels of risk" appropriate to the trust. If a trustee employs a benchmark approach to the management of trust-owned insurance, the trustee can document and communicate to interested parties an unbiased picture of the risk-reward tradeoffs. Depending on the model's functionality, the trustee can estimate:

- The statistically expected value of the insurance contract;
- The probability that the insurance contract will subtract rather than add value to the estate of the grantor;

[48] Mehr & Gustavson, *Life Insurance Theory and Practice, supra* at 133: "The insurer's prominence often is considered important in the selection decision. As prominence indicates only a well-advertised and well-represented insurer, it should not be a consideration."

- The expected average overfunding or underfunding of a contract given its schedules of costs and benefits; and
- The merits and liabilities of life insurance policies when compared to alternative financial instruments.

The specific findings of the analysis can be incorporated directly into the written IPS or can either be attached in an addendum section or kept in a separate file and thereby become a permanent record that the trustee adequately discharged fiduciary responsibilities.

From time-to-time it is suggested that the purchase of a contract with a "no-lapse" guarantee obviates the need for in-depth critical analysis. No-lapse guarantees shift risk back to the insurance firm issuing these types of contracts.[49] Although such contracts are relatively new in the U.S. market, they have a troubled history in European and Asian life insurance markets: "Over the years, more than a few life insurance companies have become insolvent when interest rates fell and they were no longer able to earn interest rates high enough to support long-term guarantees."[50] Many European no-lapse contract issuers fell into severe financial difficulty as adverse market conditions forced them to honor provisions for which they did not adequately charge. Ironclad guarantees evaporated as insurance carriers disappeared from the marketplace.[51]

In certain respects a premium sufficiency guarantee is a grant of an option to the policyowner. Specifically, the option to pay a premium to continue the policy death benefit despite insufficient cash value is akin to a put option. The correct pricing of options, however, may be elusive: "…the cost of most options is never quantified and never explicitly reflected in pricing."[52] In the United States, some underwriters have longer-term experience with guaranteed minimum death benefits ("GMDBs") on variable life and annuity products. These products must be priced using stochastic modeling or option pricing methods. However, "theoretical costs have usually been higher than the costs assumed by most companies offering variable annuities with GMDBs."[53] Just as a corporate bond indenture "guarantees" timely repayment of principal and interest, the guarantee is only as good as the ability of its maker to discharge its financial obligations. Nevertheless, there is strong anecdotal evidence suggesting that agents use no-lapse guarantees as a lever to replace policies without this "attractive" policy provision. Trustees should exercise caution when faced with this type of policy replacement decision especially if the agent recommends concentrating all coverage in a no-lapse policy.[54]

Liquidity Risk

ILIT portfolios are usually completion portfolios designed to implement state contingent hedge strategies. It is a good idea to state this explicitly in the written IPS lest the trustee be subject to a fiduciary surcharge action for not implementing either a return

[49] However, most no-lapse-guarantee products require premium payments on a fixed and inflexible schedule. If a payment is missed, the guarantee may be voided and the policy may suddenly become grossly underfunded. *See, for example,* Bannen, "No Lapse Guarantee Life Insurance Policies," *supra* at 246-247.

[50] Atkinson & Dallas, *supra* at 172. *See also,* Giraldi, Claudio; Susinno, Gabriele; Berti, Giacomo; Brunello, John; Buttarazzi, Silvia; Cenciareeli, Gianluca; Daroda, Carlo; and Stamegna, Giuseppe, "Insurance Optional," *Risk* (April, 2000), pp. 87-90.

[51] Many no-lapse guarantees may not be adequately reserved and it may be difficult to identify assets backing them. This has prompted some commentators to draw comparisons between no-lapse guarantees currently offered by some U.S. life insurance companies and the lapse-supported term-to-age 100 policies once offered to Canadian consumers. Canadian insurers withdrew from this market when they determined that continued policy sales would create untenable financial obligations. *See, for example,* Belth, Joseph M., "Secondary Guarantees, Marketers, Actuaries, Regulators, and a Potential Financial Disaster for the Life Insurance Business," *The Insurance Forum* (March/April, 2004), pp. 21-30.

[52] Atkinson & Dallas, *supra* at 911. The complex pricing for guaranteed contracts is outlined, in detail, in Ziemba, William T., *The Stochastic Programming Approach to Asset, Liability, and Wealth Management,* The Research Foundation of AIMR (2003), p. 85: "Selling guarantees is like smoking Cuban cigars while driving a dynamite truck; you better do it carefully. These products are interesting and popular, but they are dangerous if the guarantees are set too high. Many insurance companies in Japan, the United States, Europe, and elsewhere write insurance policies in which a certain investment return is guaranteed over time. This practice is risky and dangerous and frequently leads to disaster."

[53] Atkinson & Dallas, *supra* at 790.

[54] The July 21, 2004 edition of *The Wall Street Journal* (online) reports: "A competitive frenzy led insurers to offer generous guarantees on some business lines, but insurers may well have underestimated the costs of those guarantees…. Often called 'no-lapse guarantee' policies, or sometimes 'term for life,' the guaranteed universal-life policies provide both a death benefit and a savings account…. Such policies are all the rage among life-insurance agents. Agents say they are busy replacing existing policies—particularly among older policyholders—with the new, guaranteed ones. But concerns are mounting that insurers' current reserves are based on unrealistic assumptions about investment returns or about 'lapses'—policies that expire unpaid, usually because holders stopped paying premiums…. Moody's Investors Service warns that the implications of any pricing problems or erroneous lapse-rate assumptions 'will become apparent sometime during the next five to 10 years' without changes by insurers. Even a one percentage-point error in assumed lapse rates, Moody's notes, 'can have a material impact on product profitability.'" ("Life Insurers Face a Profit Squeeze," http://online.wsj.com/article_print). The authors wish to thank John E. Mayer (Fiduciary Review Services www.fiduciaryreview.com) for information on the topic of secondary life insurance guarantees.

maximization strategy or a diversified mix of tradable financial assets. The phrase "state contingent" is important because, at some point, the hedged peril may diminish or cease to exist. Loss of earned income may no longer be of importance to a retiree; sale or public offering of a closely held business eliminates a possible loss of value through forced liquidation or estate transfer liabilities might disappear under new tax law regimes. Under one legal and economic environment, an insurance policy might be a suitable vehicle to further the terms and purposes of the trust. Under a new environment, the policy might defeat the objectives of the trust. The duty of loyalty generally requires the trustee to review periodically both mandated assets and assets that may be retained or sold at the trustee's discretion. A failure to determine ongoing suitability with respect to grantor objectives, trust terms and beneficiary needs may result in a fiduciary breach action, especially if the asset's value decreases or there is a significant opportunity cost relative to investment alternatives.

It may be prudent for the written IPS to include a consideration of liquidity risk as part of the policy selection criteria for acquisition of new trust-owned insurance contracts.[55] Asset selection criteria, in this case, direct the trustee to evaluate both "load" policies, which generates commissions payable to the selling agent and "no-load" policies, no commission compensation payable to an agent.[56] The rationale for including a liquidity risk analysis is found in the commentary to the Restatement Third which, referring to the decision to purchase a load or no-load mutual fund investment, states:

A distinction should be drawn between an insurance guarantee and a financial guarantee. The insurance policy offers the former, while a no-lapse rider (a secondary guarantee) is an example of the latter. The guarantee is, of course, only as strong as the company that sells it. But insurance guarantees are priced much differently than financial guarantees. Pricing of insurance guarantees assumes (1) a large number of individual insured events; (2) independence of events both within a single period and across all periods; and (3) predictable risk measurement. Insurance guarantees have measurable risks (the face amount of the policy) and predictable claims (independence of trials assures that the actuary can apply the central limit theorem). In the case of a financial guarantee, at the limit, either all of the policyholders within a certain cohort will present a valid claim against the resources of the insurance carrier, or none will present such a claim. This undermines pricing assumptions based on the independence of claims events. Furthermore, the distribution of variables leading to a claim may not be close to multivariate normal. For example, claims for continued coverage when cash values are depleted may become more probable in a prolonged regime of low interest rates or in the face of certain lapse rate assumptions. If these two variables (among many possible variables) are correlated, the resulting distribution is co-monotonic. This means that the magnitude of claims presented to the insurance carrier may be more severe than allowed for through normal reserving. It is as if the insurance company sells a put option against the value of underlying assets and hopes that it can invest the put option premium so that it has sufficient funds to pay potential future claims. However, if all claims appear at once, the likelihood that the financial guarantee (*i.e.,* put option) is "deep in the money" is also the measure of the bankruptcy risk for the carrier because the claims reserves are calculated on the insurance guarantee pricing model rather than on the financial guarantee pricing model. For a more in-depth discussion of this topic *see* Wendt, Richard Q, "An Actuary Looks at Financial Insurance," *Financial Engineering News* (November/December, 2003), pp. 7 & 12; Dhaene, J., Denuit, M., Goovaerts, M.J., Kaas, R. & Vyncke, D., "The Concept of Comonotonicity in Actuarial Science and Finance: Applications," *Insurance: Mathematics & Economics* (April, 2002), pp. 1-44; and "Beware of What You Price For: Credit Implications of UL Secondary Guarantees for U.S. Life Insurers," *Moody's Investors Service Report* #87150 (July, 2004). Moody's is especially concerned that certain companies are using unrealistic, aggressive and insupportable pricing assumptions and that these carriers may not have efficient risk measurement and control systems in place. The report concludes: "Moody's believes that the focus at many companies has been more on meeting market demand for products that sell than appropriately managing the risks from these products." Trustees seeking the comfort of no-lapse guarantees may inadvertently be increasing the idiosyncratic (carrier solvency) risk of the insurance portfolio. A no-lapse guarantee is a poor substitute for prudent portfolio diversification: Malarkey & Leimberg, *supra* at 17: "…because of NLG's illiquidity and consequent lack of flexibility, in most cases clients will be best served by using NLG as a relatively modest portion of an insurance portfolio that is carefully diversified across carriers, products, and cash value/death benefit performance projections." A general discussion of different approaches to pricing financial and actuarial risks is Embrechts, Paul, "Actuarial versus Financial Pricing of Insurance," *Conference on Risk Management of Insurance Firms,* The Wharton School of the University of Pennsylvania (May 15-17, 1996).

[55] A 1995 survey by the Consumer Federation of America estimated that cancellation of existing insurance policies costs consumers more than $6 billion annually. The American Council of Life Insurers [ACLI] reports that in 2000 the life insurance industry paid death benefits from individual life insurance contracts amounting to $27.267 billion. However, $27.173 billion was paid for surrender of life insurance contracts and an additional $213.989 billion was paid under annuity surrender options. This means that, as of 2000, only approximately 11% of all realized benefits were paid because of the death of the insured. *Life Insurers Fact Book 2001,* American Council of Life Insurers (Washington, D.C.), pp. 74-75. Sales pitches or replacement rationales based on maximizing death benefit rate of return ignore the fact that most insurance benefits flow from policy surrenders and annuity settlement options.

[56] Glenn Daily correctly asserts, "Distribution costs are a primary determinate of performance." He estimates that: "for a typical block of agent-sold policies, the expected present value of all distribution costs is 15 to 30 percent of the expected present value of all premiums, versus 3 to 8 percent for low-load products." Daily, *supra* "How to Choose a Life Insurance Policy," at 74.

> Concerns over sales charges, compensation, and other costs are not an obstacle to a reasonable course of action…but they do require special attention by a trustee. Because the differences in the totality of the costs … can be significant, it is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.[57]

In order to document investigation into this area, it is helpful to require commission disclosure statements, in writing, from insurance agents and to retain them in the trustee's records. The decision to purchase a traditional, commission-paying insurance product may result in the acquisition of a financial instrument that offers little or no cash surrender value for a lengthy period of time.[58] Among the issues for the trustee are:

- Is the illiquidity risk appropriate to the purposes of the trust; and
- Is there a reasonable probability that trust beneficiaries will be sufficiently rewarded for assuming the extra risk?[59]

The written IPS sets forth the guidelines under which the trustee will conduct the analysis and documents the asset management decisions.

Underwriting Risk

An essential element of effective cost control involves a determination that the pricing offered to the insured is reasonable. The premium differences between a preferred and standard risk classification, or between a standard and substandard risk classification, can be substantial.[60] Therefore, sound investment policy also incorporates procedures to assure that the pricing of any insurance coverage reflects a technically proficient underwriting process that is unconstrained by an agent's contractual duties to place coverage with specific companies or by an agent's objectives to qualify for awards and bonuses by steering business to his or her "preferred" carriers. The written IPS can document that the trustee endeavored to assure that trust-owned insurance contracts "…incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."[61]

The pricing of insurance contracts is usually determined by the interaction of: (1) underwriters at the retail insurance carrier; and (2) underwriters at the reinsurance companies that provide the risk-sharing and surplus relief mechanisms required for an operationally efficient market. Often, prudence may best be assured by instructing the insurance agent to avoid making application for life insurance coverage in such a manner that the reinsurance risk-ceding options are unnecessarily constrained or encumbered. This means that formal applications used by an insurance company to execute automatic and exclusive reinsurance agreements, thus preventing the reinsurer from negotiating with other retail carriers offering more favorable pricing, should be avoided. Rather, the written IPS should instruct the agent to use pricing inquiry forms, also know as informal or preliminary applications.

When a carrier offers coverage on a rated basis, or declines to offer coverage at any price, the written IPS should direct the trustee to ascertain whether a sufficient number of inquiries were made to insurance underwriting departments so that a fair and reasonable market evaluation was possible.[62] In the event that ratings or surcharges appear likely, the trustee may, if it is prudent under the circumstances, solicit pricing offers from carriers who do not meet the selection and retention criteria outlined in the written IPS. Of equal importance, the written IPS should direct that all continuing ratings or price surcharges be reviewed periodically in light of improvements in the health of the insured or in light of breakthroughs in medical treatments.

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[57] Restatement (Third) of Trusts, §227, *supra* at comment m.

[58] Prager, Michael & Miliano, Christopher, "Survivor: Which Companies to Vote Off the Island?" *California Broker* (January, 2005), p. 53: "If you do not question the high commissions or incredible policyholder features, you may put your client and yourself at risk."

[59] For a review of the literature on the liquidity risk premium, *see* Browne, S., Milevsky, M.A., & Salisbury, T.S., "Asset Allocation and The Liquidity Premium for Illiquid Annuities," *The Journal of Risk and Insurance* (Vol. 70, 2003), pp. 509-526.

[60] The ACLI reports that, in 2000, 21.4% of policies were issued at preferred risk rates, 74.1% at standard rates, and 4.5% at substandard rates. *Life Insurers Fact Book 2001, supra* at 109.

[61] Restatement (Third) of Trusts, §227.

[62] For a comprehensive discussion of substandard life insurance underwriting *see* Grubin, Les, "A Substandard Life Brokerage General Agent's Perspective Of Underwriting," *Journal of the Academy of Life Underwriting* (Vol. 16, 2000), pp. 84-92. The article describes the following underwriting experiment: "You can take the same case, send it to eight companies and get back all kinds of offers. I know this because we have tried this as an experiment. We got everything—a standard, a table two, a table four, a table four with a $5 flat extra, a table six, an eight, another four, and another two. On top of that, the premiums for the two table fours and the two table twos weren't just a few cents apart, but they were tremendously far apart." Trustees should not accept coverage based on the risk classification label. In some companies, a standard risk classification for a policy form may be less favorable than a table two classification for another carrier's comparable policy form.

§4.4.5 Other Asset Management Issues

A written IPS offers trustees the opportunity to communicate asset management guidelines and decision-making processes to interested parties. Disclosure of how the trustee may respond to events prior to their possible occurrence provides an agreed upon framework for prudent asset management. It is especially useful to have clearly outlined administrative policy for management of life insurance assets because of the substantial leverage factor incorporated in the asset. Small premiums may control state-contingent rights to receive large sums of money, and trustees find themselves particularly vulnerable from Monday-morning quarterbacks if trustee decisions do not yield optimal results. Each time the trustee exercises a contractual right or policy option, alternative elections that, in retrospect, may provide a superior result, remain unexercised. Inquiring plaintiff attorneys may wish the trustee to provide an explanation for asset management elections. The following list of issues, although not exhaustive, briefly touches on some representative situations. Obviously, the written IPS should have sufficient specificity to be meaningful yet it must have enough flexibility to be practical. Although creation of investment policy should closely reflect the ILIT's actual circumstances and objectives rather than becoming an exercise in boilerplate document creation, nevertheless, the written IPS may wish to state clearly and in advance how the trust will respond to certain issues and events.[63] Not surprisingly, some asset management issues reflect the elections that the trustee makes on the application for insurance coverage. Elections made at the time of application have economic consequences that may reverberate over many years. Therefore, the prudent trustee should, where possible, communicate a sound and defensible decision-making rationale.

Dividend Elections

For traditional whole life policies, the trustee may choose several dividend options. Typically, these include (1) payment in cash; (2) accumulation with interest at the insurance carrier; (3) an offset to future premium obligations; (4) purchase of paid up insurance additions; (5) purchase of one-year term insurance; or (6) combinations of the foregoing elections. Although dividends are not guaranteed,[64] it is often the case that the trustee election in this matter can have profound economic consequences. For example, the election of paid-up additions tends to produce a future pattern of death benefits that rises with an increasing slope due to increasing dividends generated by larger underlying policy cash value. Although the initial insurance benefit may seem paltry, future projected benefits are larger at older ages when the probability of a claim is greater. Election of one-year term insurance, however, produces a pattern of large initial death benefits that decrease at older-ages as the projected slope of dividend increases is less than the slope of mortality-driven insurance costs. The prudent trustee will want to communicate the dividend election so that interested parties have sufficient information to determine the likely economic consequences of the trust administration. Needless to say, the rationale for selecting among the dividend options is a function of the needs, terms, purposes and economic circumstances of the trust. If the ILIT is hedging against the loss of labor wealth (human capital), the one-year term election may be easily justified.[65] If the ILIT is seeking to diversify beyond an insurance portfolio, the election to receive dividends in cash, to be reinvested in stocks, bonds and other capital markets, may be defensible.

Premium Inadequacy and Non-Forfeiture Elections

Grantors have been known to discontinue making gifts to the ILIT. As a result, there may not be cash sufficient to pay premiums. Trustee liability can be extraordinarily high in the event that required premiums are not forthcoming. Does the trustee let the policy unwind on its own until it spirals into oblivion? Or does the trustee elect a settlement or non-forfeiture option to preserve existing value?[66] If current and projected dividends exceed the scheduled premiums, the trustee can elect the option to use dividends to reduce or, perhaps, fully pay future policy costs. Often, however, the dividends will be insufficient to fund the ongoing premium obligations. In the event that premiums are not paid, the insurance carrier will look to the

[63] Recently, for example, many ILIT trustees grappled with issues surrounding demutualization of insurance carriers and receipt of company stock.

[64] Although it is a popular myth that dividends reflect policy-owner experience, the adjustments to dividends are actually made to bring company profitability into alignment with asset share projections. Atkinson & Dallas, *supra* at 14.

[65] As may the election to select option B (increasing death benefits) rather than option A (level death benefits) for a Universal Life contract.

[66] One case, under litigation at the time of this article's writing, involves a bank's liability for an ILIT that lacks an IPS. The trust document provides guidelines regarding election of non-forfeiture options in the event that the trust resources are not sufficient to pay premiums. The policy owned by the ILIT, however, is a Universal Life policy that lacks the required non-forfeiture provisions—that is to say, the policy is not suited to the terms of the trust instrument. Needless to say, the trustee should select and manage the insurance portfolio so that it reflects the terms of the trust.

policy application to determine the applicable election. Generally, whole life policyowners have the right, at the time of application for coverage, to choose one of several options. The statutory non-forfeiture elections include: (1) cash surrender; (2) extended term insurance coverage; or (3) reduced paid up permanent coverage. Alternately, many jurisdictions provide an opportunity to select an automatic premium loan provision, and many insurance contracts offer policyowners the right to receive annuity income in the form of guaranteed settlement options.[67]

At the time of application, the trustee may be tempted to dismiss the selection of policy elections as an unimportant formality accompanying the requisite paperwork. Non-forfeiture elections are, in the main, calculated so that their actuarial value is equivalent to the cash value at the time of exercise. However, there are important differences in the determination of actuarial value. For example, the extended term option (full face amount of coverage continued for a specified but limited time period) uses a loaded mortality table (Commissioner's Extended Term table) to reflect the likelihood of adverse selection.[68] Insureds with substandard health may wish to keep the "big payola" in full force recognizing the increased likelihood of an early death. But election of the extended term option must be balanced against trustee duties to avoid unreasonable or inappropriate costs. If the early death does not occur, disappointed beneficiaries may want to know why the trustee kept coverage in force on a loaded basis when a secure and certain benefit was available through a reduced paid up option that is generally calculated using a more favorable mortality table.

Trustee election, at the time of application, of the option for automatic premium loan ("APL") generates some particularly hair-raising litigation possibilities. Agents often recommend that policyowners check the automatic premium loan box on insurance applications because, unlike other elections, policy continuance under APL preserves renewal commissions. The APL provision allows the insured to use the existing cash value as collateral for a loan from the carrier in an amount sufficient to pay currently due premiums. As long as the cash value of the policy equals the accumulated loan principal and interest, the death benefit (net of the loan balance) remains in force. However, compounding of loan interest plus continued compensation to the agency force usually results in a depletion of policy value at a rate faster than the extended term non-forfeiture option. However, there is a potential advantage in electing the APL provision in that any supplemental riders to the base insurance policy, such as disability riders, usually remain in force. Given the right fact pattern, continuation of rider benefits may prove to be critically important. At this point it is easy to see that the liability fault lines spread out in all directions.[69] Consider, for example, a line of inquiry unfolding as follows:

- A trust-owned whole life policy is no longer funded because of non payment of premiums;
- The trustee has non-delegable duties including a duty of cost consciousness and a duty to assure that the trust property remains productive;
- At the time of policy application, either a non-forfeiture election or the APL election box was checked without any documentation as to the underlying rationale for the election; and
- The insured's mortality/morbidity evolution follows a path that renders the trustee's initial elections economically disastrous.

In these circumstances, what liability does the trustee incur and what is the proper measure of damages? The written IPS provides an opportunity for the trustee to develop and communicate asset management policy prior to a period of funding shortage.[70] Such communication may prove vital for successful defense against fiduciary breach allegations.

Policy Design Options

It is worth noting that insurance programs sometimes fail not because the expected future benefits cannot be supported by projected premium inputs, but because the timing, magnitude and actuarial benefit platforms are poorly matched to the premium schedule. "Expected future benefits" is a term replete with the concept of probability. At younger ages, there is little expectation that beneficiaries will reap large ben-

[67] Easton & Harris, *supra* at 73-82.

[68] The 2001 Commissioners Standard Ordinary Table recently approved by the National Association of Insurance Commissioners is a select and ultimate table and does not contain a separate table for extended term. All life insurance products must be brought into compliance with this table by January 1, 2009. DesRochers, Christian, "Life-Altering Experience," *Best's Review* (February, 2003), pp. 72-74.

[69] The unique non-forfeiture provisions of some Universal Life contracts may complicate the task of prudent asset management a bit further. When administering some UL policy forms from the early 1980s, the trustee must be careful not to trigger large monetary penalties should the aggregate premium payments fall below specified minimum targets or should cash values fall below the amounts required to collateralize applicable surrender charges.

[70] Alternatively, an IPS may communicate the trustee's intention to apply for trust termination in the event that the grantor is not responsive to the trustee's requests to continue making gifts. *See, for example,* Soskin, William H., "Early Termination of Irrevocable Trusts," *California Trusts And Estates Quarterly* (Winter, 2002), pp. 39-47; and Soled, Jay A., "Strategies for Handling a Life Insurance Trust that No Longer Meets the Grantor's Needs," *Tax Management Estates Gifts and Trusts Journal* (September, 1996), pp. 207ff.

efits following the death of an insured. If, for example, there is only a one percent likelihood of death during a year in which the insured is covered for a face amount of $1 million, the expected value of the death benefit during this period is $10,000. Likewise, if the insured is covered for $250,000, the expected value is $2,500—the difference between $10,000 and $2,500 is a sizeable difference when considered proportionally but a rather trivial difference when considered from a dollar-value perspective.

A common design for ILITs intended to provide estate liquidity is a level amount of initial coverage, such as $1 million whole life, funded through a level annual premium designed to comply with present interest taxable gift exemption regulations or with lifetime exemption regulations. The coverage continues on a level basis for many years with, perhaps, projected death benefit increases in the distant future. Is this an optimal policy design? If a policy fails in some future year, does the trustee have liability if it can be shown that alternative, less costly insurance options were available through the underwriting company and that those options had an expected value, over the applicable planning horizon, that were substantially greater or, at substantially less risk than the policy design actually put into force? This issue goes to the heart of Restatement (Third) of Trusts (Prudent Investor Rule), §227 black letter law on the general standard of prudent investment that directs trustees to develop an "overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."[71]

Raising these questions necessarily involves consideration of some opaque areas of product design and marketing strategies that are complementary to the main themes of this study and that deserve a more thorough treatment than can, at present, be offered. However, a fully informed trustee should recognize that the traditional insurance policy design puts into force high levels of current death benefits with relatively low expected values relative to the initial premiums paid. This means that a substantial amount of the initial premium is freed up to pay commissions to the agent. That is to say, the trustee may acquire coverage under a traditional policy design that maximizes the benefit to the salesperson at the risk of future policy lapse because of insufficient cash accumulations and dividend credits. A well-designed insurance program attempts to provide beneficiaries with reasonable financial expectations throughout a spectrum of ages rather than merely at the time of purchase or at life expectancy.

There are at least two steps that trustees can take to mitigate this risk. First, it is important to determine that the death benefit is being delivered to the trust on cost-effective platforms. The payoffs of expensive, high commission, traditional policies can often be replicated through combinations of low-commission paid-up addition riders and low-cost term insurance riders placed on a more modest whole life base.[72] Secondly, assuming payment of the agreed-upon premium for the hypothetical $1 million policy, putting only modest amounts of initial coverage in force lowers commission expenses while, simultaneously, boosting the cash accumulation account. Indeed, the trustees may wish to trade asset liquidity, including funding past the modified endowment limits that trigger tax penalties for certain types of policy withdrawals, for policy stability, and, most importantly, for higher and more likely death benefit increases at older ages.[73] It is vital to recall that expected value is both a function of the amount to be received during the policy year and the probability of a claim. Even on a present value basis, generous funding of a lower initial death benefit may result in significantly higher probability-adjusted net present value over the applicable planning horizon. Funding lower initial death benefits in the expectation of receiving higher overall benefits seems counterintuitive. Therefore, trustees should make critical inquiries regarding alternative policy designs as well as regarding insurance benefit platforms. It may be relatively easy for a plaintiff's attorney to draw analogies to mutual fund share purchases where a lack of critical inquiry results in purchase of a high-cost share class so that total sales compensation increases beyond reasonable bounds.

Policy Surrender and Policy Sale

Generally, a permanent life insurance policy offers the owner the option to surrender the policy to the insurance carrier for its net cash surrender value. The development of a secondary market for sale of life insurance policies, however, introduces a new dimension to trustee administration of insurance programs. Traditionally, most insurance policies are both purchased and redeemed only on the primary insurance market. However, beginning in the 1980s, a viatical settlement market provided individuals with a life expectancy less than two years, primarily those suffering from AIDS, an opportunity to sell insurance policies to private investors for amounts in excess of their contractual surrender value. The emergence of a secondary market catering primarily to the terminally ill generated a storm of controversy. Policy purchase and

[71] Restatement (Third) of Trusts, §227.

[72] Atkinson & Dallas, *supra* at 16-17.

[73] *See, for example,* Pinkans, Michael, S., "Don't Sell that MEC! Or Should You?" *National Underwriter* (July, 2003), p. 21.

resale activities were largely unregulated, and the tactics of some market makers led to indictments for fraud. Prospective investors were warned that scam artists were advertising unrealistically high returns without disclosing the attendant risks, and at least one prominent insurance commentator maintained that any business enterprise designed to promote policy assignments to investors lacking an insurable interest in the life of the insured is against public policy.[74]

More recently, the secondary market expanded to include both viatical settlements as well as life settlements. A life settlement or senior settlement is an offer to purchase an insurance contract, usually with a face amount of at least $250,000, insuring a person aged 65 or over who has experienced a decline in health such that the insured's current life expectancy is impaired. The impairment does not have to be a terminal illness expected to result in death within 24 months. Rather, the impairment must lead to a shortening of expected life span such that the present value of the policy's death benefits relative to the present value of projected premiums makes the policy an actuarial bargain. In addition to an expansion of the secondary market's scope, it appears that the market has also become more stable. The entrance of institutional investors, implementation of state regulation, development of self-regulatory trade association standards, and promulgations of investor guidelines by the North American Securities Administrators Association, Inc. have led to market improvements.[75]

The market is not, however, without pitfalls. Promoters of secondary market policy sales pay either finders' fees or commissions to life insurance agents to convince health-impaired insureds to sell their insurance contracts. Even absent higher medical care costs, curtailment of life expectancy often increases an individual's propensity to consume, especially if the reasons for acquiring insurance coverage have diminished or disappeared. There is concern that a loosely regulated secondary market will contribute to widespread misconduct on the part of insurance agents and settlement promoters. The areas of possible concern encompass conflict of interest and elder abuse issues including:

- Unjustified policy replacement activities, such as surrender of a life insurance contract to purchase other types of commissionable insurance, annuity and investment programs; and
- Misleading and deceptive sales pitches "proving" that policy sale is preferred financial alternative for the insured.

The debate, which continues unabated, frames arguments primarily from the perspective of individuals as opposed to trusts.[76] ILIT provisions, however, generally prohibit the grantor-insured from benefiting directly from proceeds of policy sale or surrender.[77] Thus, to a certain extent, trustees may be able to sidestep some of the claims and polemics emerging from supporters and detractors of secondary market policy sales. Indeed, as one commentator suggests "…in many cases an analysis of the feasibility of this alternative will result in the determination that the purposes of the trust, and the best interests of its beneficiaries, will be best served by continuing to hold the policy—possibly until it matures with the death of the insured."[78]

The arguments for exploring secondary market policy sales have special importance for trustees who lack the funds necessary to pay premiums adequate to maintain ongoing insurance benefits. The trustee who lacks the resources to manage trusts assets in a manner appropriate to the needs and terms of the trust and to maintain trusts asset so that they remain productive and continue to discharge the grantor's goals and the beneficiaries'

[74] Belth, Joseph M., "Viatical Transactions: The Frightening Secondary Market for Life Insurance Policies," *The Insurance Forum* (Ellettsville, Indiana, 2000). *See also,* Swanson, K.C., "Cash Out That Life Insurance at Your Own Risk," *TheStreet.Com* (www.thestreet.com/pf/funds/belowradar/100005391.html) December 13, 2001.

[75] Buerger, Alan H., "Life Settlements Come of Age," *Trusts & Estates* (November, 2002), pp. 33-35. *See also* Panko, Ron, "Package Deal," *Best's Review* (August, 2001), pp. 103-105; and "Cashing Out," *Best's Review* (April, 2002), pp. 92 -95.

[76] Life insurance companies that prohibit agents from assisting policyholders with life settlement transactions under the "selling away" regulatory restrictions accompanying state securities regulations incur criticism from those who claim that insurance companies wish to retain monopoly powers that may constitute an "unlawful, unfair, or fraudulent business act." *See, for example,* Kirsch, Paul F., "Will History Repeat Itself," *California Broker* (March, 2003), pp. 61-62.

[77] Adams, Roy M., Kurlander, Glenn & Marlar, Kimberly L., "Unlocking New Value From Old Policies: Life Insurance Planning and Life Settlements," *Trusts & Estates* (May, 2000), p. 52. The authors point out that there may be a variety of circumstances where a trustee might consider selling a life insurance policy on the secondary market. One example is a case where a trust needs to raise cash to purchase a controlling interest in an asset previously owned by an insured. If such a purchase created minority discount valuations that reduce estate tax liabilities, such a strategy might prove economically advantageous to trust beneficiaries. This type of analysis indicates the danger of making broad-brush claims regarding secondary market sales. Rather, trustees should eschew meaningless generalizations in favor of evaluating the facts and circumstances at hand.

[78] Miller, Dean E., "Life Settlements and Trust Accounts: A Possible Modification of the Trustee's Responsibility?" *The Banking Law Journal* (May, 2002), p. 487.

expectations may have a duty to explore the liquidity options offered by the secondary market. Additionally, changes in economic circumstances may eliminate the peril against which the insurance program hedges.

Health impairments make a policy more attractive to both investors, because they can assume the obligation to pay premiums based on the health status determined at a policy issue date prior to the impairment's onset, and to beneficiaries, because they have the expectation of receiving death benefits sooner than anticipated at the time of issue.[79] This suggests the wisdom of a careful analysis and thorough documentation by the trustee of the relevant policy management options. For trustees who lack funds sufficient to support the insurance program, management options include surrender of the policy to the insurance carrier, use of policy cash values to maintain coverage, election of non-forfeiture options or sale on the secondary market. For trustees maintaining insurance programs when the hedged perils no longer exist, management options include maintaining coverage under one of several payment options, such as dividends, surrender of paid-up additions, policy loans, non-forfeiture elections, or discontinuance of the coverage through sale or surrender.[80]

§4.5 SAMPLE INVESTMENT POLICY STATEMENT

The following written IPS provides a sample structure as well as suggested language for the draftsperson. The IPS also contains commentary that appears in italics. The commentary usually points out options that are available, pitfalls to avoid and other information that the draftsperson may find useful. Although the sample IPS assumes a whole life or universal life insurance policy, the commentary provides some suggestions for modifying the IPS for variable life and term insurance programs.

Certain sections of the sample IPS provide a short statement or preface outlining the underlying rationale for an asset management policy. The draftsperson can, of course, elect to eliminate these prefatory statements and, thereby, create a more minimalist document or, conversely, to expand the statements to create a more education-oriented document.

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[79] For a comprehensive study of the economic implications of a viable secondary market for life insurance policy sales *see* Doherty, Neil A., & Singer, Hal J., "The Benefits of A Secondary Market for Life Insurance Policies," *Working Paper,* The Wharton School, University of Pennsylvania (Modified 10/14/02). Often there is ambiguity in the terminology employed by commentators on the subject of life settlement sales. Specifically, the term "affordability" is often confused with the term "need," and terms such as "competitive rate of sale," "market price," and "fair market value" are often used interchangeably. Furthermore, "fair market value" to a beneficiary may be a number considerably different than the "fair market value" to an insured. Thus, trustees are cautioned to make sure that the trust receives adequate compensation upon sale or surrender of an insurance policy. The force of arbitrage for tradable securities in deep, liquid and continuous markets assures that market price and fair market value remain closely aligned. Likewise, arbitrage and the law of one price work to align the cash market for securities with the derivatives market for futures and options contracts. If we view an insurance policy as a derivative security the value of which is, in part, dependent on the financial performance of the insurance carrier, there is no guarantee that competitive and efficient markets will produce a justified price on the secondary market. To a great extent, insurance policy owners remain price takers and, therefore, the trustee should determine that the price taken does not shortchange the beneficiaries. *See, for example,* Katt, Peter, "Does it Make Sense to Sell Your Life Insurance Policy?" *AAII Journal* (May, 2002). Assistance with insurance policy valuation is available at Glenn Daily's website whatsmypolicyworth.com.

[80] For an example of a financial analysis of an insurance policy sale *see* Katt, Peter, "Be Your Own Beneficiary," *AAII Journal* (May, 2002). Katt's analysis compares, over a reasonable time horizon, policy retention (present value of death benefits less present value of projected premium obligations) with policy sale (after tax value of secondary market offer). A more complete analysis for a trust owned life policy might modify the Katt calculation algorithm by including the value of policy non-forfeiture elections; and might apply a present value factor to a distribution of results from investment of the sales proceeds. A good summary of arguments, both pro and con, is found at Lysiak, Fran Matso, "Policy For Sale," *Best's Review* (April, 2005), pp. 42-44. This article suggests that the growth of the life settlement market may be distorting the pricing assumptions on large blocks of in-force life insurance policies.

SAMPLE INVESTMENT POLICY STATEMENT FOR THE [NAME OF TRUST]

POLICY AND THE INVESTMENT PROCESS

DEFINITION & PURPOSE OF POLICY

A written Investment Policy Statement is the set of guidelines and procedures that direct the long-term management of the trust's asset portfolio. The Investment Policy of the [NAME OF TRUST]:

- Clarifies the trust's objectives and the expectations of the grantor;
- Sets forth a specific portfolio design to achieve the grantor's expectations;
- Specifies the risk tolerance levels which the grantor wishes to bear in pursuit of the trust's objectives; and
- Establishes a procedure for timely monitoring and review of performance results.

The Investment Policy evidences the careful consideration given by both the grantor and the trustee to the formulation and implementation of appropriate and prudent asset management strategies. Likewise, it provides an objective, written rationale for the fiduciary exercise of the requisite care and skill in ongoing portfolio asset management.

PRINCIPLES OF PRUDENCE

This document sets forth the goals and objectives of the [NAME OF TRUST]. It draws upon the Principles of Prudence enumerated in the Prudent Investor Rule (as adopted and promulgated by the American Law Institute and enacted into law by the state of California). These principles instruct trustees that:

1. Sound diversification is fundamental to risk management and is therefore ordinarily required;
2. Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the trust's asset portfolio;
3. Trustees have a duty to avoid fees, transaction costs and other expenses that are not justified by needs and realistic objectives of the investment program;
4. The duty of impartiality requires a balance between production of current income and the protection of purchasing power against inflation; and
5. Prudent investing may require or at least benefit from expert assistance in investment matters.

The General Standard of Prudent Investment specifies that:

> *The trustee is under a duty...to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which would incorporate risk and return objectives reasonably suitable to the trust.*

This document outlines a framework for the prudent implementation and ongoing administration of the trust's asset portfolio. It sets forth written and objective guidelines for the acquisition of assets including life insurance policies, for their reasonable and appropriate review, and for the monitoring of their performance.

The portfolio review shall encompass a consideration of both portfolio risk and expected return. Such a review shall take place at least once during each year. In general, the trust's assets will be invested in the sole interest of the beneficiaries with the care, skill and diligence that would be applied by a prudent professional in a similar capacity maintaining appropriate levels of risk and diversification.

The trustee may employ outside investment advisers or consultants to assist in the determination of the advisability, availability, expected return and pricing of life insurance contracts or other investment alternatives. Upon establishment of a trust, the trustee may employ outside investment advisers to evaluate the performance of trust-owned assets in order to determine their ongoing suitability.

ALLOCATION OF RESPONSIBILITIES

Responsibility for defining and implementing trust-owned life insurance policies, and for trust administration and operations, shall be allocated to various parties and entities as described below.

The Trustee

The trustee shall be responsible for the safe custody and investment of trust assets. The trustee's responsibilities include:

- Ongoing and regular consultation with the grantor-insured to ascertain and verify objectives, health status, needs and circumstances, continuity of purpose and to verify that the trust's investment policies continue to satisfy the needs of the trust beneficiaries;
- Determining an appropriate investment structure for trust assets, including but not limited to acquisition of life insurance contracts, in order to best achieve the grantor's goals and objectives;
- Monitoring the performance of individual investments and the aggregate trust portfolio to assure that performance results meet the guidelines and criteria set forth in this document;
- Receiving all contributions and paying all benefits under the terms of the trust documents; and
- Performing administrative functions, including required functions such as collection, deposit and disbursement functions, tax reporting functions and all other fiduciary duties required of a trustee under applicable laws and regulations.

The Attorney

The attorney shall be responsible for performance of all tasks required under the terms of the engagement with his or her client in a manner which complies with the standards of practice prevailing in the community at the time such services are performed and with the standards of practice prescribed by the California Rule of Professional Responsibility and, if applicable, by the rules of the American Bar Association. With respect to the assets to be incorporated into the trust, the attorney's responsibilities include:

- Drafting and review of trust documents to determine that such documents are suitable and appropriate to the needs and objectives of the grantor-insured;
- Review of ownership and beneficiary designations of all trust-owned assets to determine that they conform with the planning objectives of the grantor-insured; and
- Review of any transfers of existing assets to the trust to determine the tax and legal consequences thereof. This review encompasses any policy exchange that seeks to comply with the rules of Internal Revenue Code Section 1035.

The attorney shall not be responsible for rendering opinions that may be deemed to be investment or insurance advisory opinions. Such opinions include, but are not limited to, opinions regarding the expected performance of trust assets, level of ongoing funding necessary to maintain the productivity of trust assets, the financial condition of the vendors of trust assets, the suitability of the trust assets to the needs and objectives of the trust, nor the contribution of any individual trust asset to the risk/reward profile of the aggregate trust portfolio.

Although Rule 3-300 (California Ethics Opinion 1995-140) permits a lawyer to sell insurance or to accept referral fees from insurance agents recommended by the attorney, in order to maintain and exercise independent judgment it is not contemplated that the attorney will engage in such transactions. Where the attorney recommends one or more insurance agents, analysts, financial planners or other advisors (including investment advisors) to the client, it is anticipated that the client and the trustee will receive disclosure regarding the amount and frequency of referral business between the parties. Such a disclosure, however, shall not be in conflict with the rules or code requirements that impose a duty of confidentiality on the attorney.

The Investment Advisor / Insurance Analyst

The investment advisor shall assist the trustee with the development and implementation of the Investment Policy Statement. The advisor shall provide this service in its capacity as investment counsel under the 1940 Investment Advisers Act and shall comply with all duties and requirements imposed by the Act as well as by the regulatory agencies under which the advisor conducts business. With respect to trust-owned insurance policies the invest-

ment advisor shall be responsible for performance of all tasks required under the terms of the engagement with the trustee. These tasks may include advice on:

- Determining the amount of insurance required to meet the goals and objectives of the trust;
- Recommending suitable insurance carriers;
- Evaluating the risk/reward tradeoffs of selected insurance contracts;
- Determining appropriate policy types, designs, and funding levels;
- Supervising the life insurance agent to facilitate underwriting and policy implementation; and
- Monitoring and evaluation of the insurance portfolio's performance.

The Life Insurance Agent

In addition to complying with the duties imposed by the California Insurance Code, the life insurance agent shall assist other members of the planning team to apply for, underwrite, implement and service appropriate insurance contracts. The agent, within the terms of the employment contracts under which he or she works, will provide information and assistance in the following areas:

- Disclosure of any employment contract constraints, compensation schedules and other provisions that may materially influence the information and advice provided to the trustee, grantor, or other members of the estate planning team. The investment advisor shall provide a disclosure checklist for agent completion and for retention in the attorney's and trustee's files;
- Provision of financial data and independent rating-company evaluations of selected carriers, contract illustrations, and other data necessary for the trustee to evidence "the exercise of reasonable care, skill, and caution…" required by law. The investment advisor shall consult with the agent regarding the nature and scope of such materials and the investment advisor shall evaluate these materials;
- Investigation into the health, avocation and financial factors which may have a significant affect on the pricing of insurance contracts so that the trustee can determine that coverage is available and is appropriately priced. The investment advisor shall consult with the agent in the performance of these tasks;
- Completion of applications or pricing inquiry forms to selected insurance carriers. The investment advisor shall review the applications or forms prior to submission;
- Delivery of insurance or annuity contracts and collection of the premium amounts necessary to implement coverage;
- Preparation of annual in-force policy illustrations. The investment advisor will direct the agent regarding the required information and shall review such illustrations as part of the ongoing asset surveillance and monitoring program; and
- Assistance in all policyholder service activities such as changes in premium schedules, processing of policy loans and distributions; beneficiary changes, election of non-forfeiture options and so forth.

[Alternately, the trustee may implement an Insurance Service Contract with the agent. The provisions of the service contract govern the agent's duties and responsibilities. Responsibility for disclosure information regarding the existence of products offering move favorable terms to the trust or regarding the financial consequences of "blended" product design using low cost/low commission riders may form part of the agent service contract or may be allocated to the agent or advisor.]

STATEMENT OF TRUST CIRCUMSTANCES AND OBJECTIVES

Insert here a Profile of the Grantors and Insureds. The statement should include information on:

Objectives and investment policy constraints. This might include the underlying rationale for obtaining insurance coverage (e.g., protection of illiquid assets), identification of future financial obligations or other economic perils to be hedged by the insurance program, insured's health status, existing insurance coverage or liquid assets and so forth.

Time horizon. The expected length of time for maintenance of an insurance hedge. This might be defined in terms of asset illiquidity (until a closely held business is sold or becomes publicly traded), in terms of mortality (until the death of the surviving spouse), in terms of income replacement (until the youngest child reaches a certain age or status) and so forth.

Income needs. Defines the income distribution objectives, if any, for trust beneficiaries. The trustee may be given discretion to elect a policy surrender (or secondary market sale) or to exercise income settlement options if, in the trustee's opinion, the need for current income to beneficiaries outweighs the potential benefits of maintaining death benefits.

Liquidity. Defines the expected demand for liquidity (anticipated need for the trust to be able to convert the asset to cash).

Special legal and tax issues. Limitations on present interest gifts, constraints on distributions or payments to agencies, institutions and individuals and so forth. For example, the trustee may be given discretion to loan money to the grantor's estate or to purchase assets from the estate and may be prohibited from making direct cash payments to the IRS in satisfaction of estate tax liabilities.

Trust Assets Are a Completion Portfolio

The [NAME OF TRUST] portfolio shall be considered to be a "Completion Portfolio." A completion portfolio complements or completes an existing portfolio. Its intent is to act as a specialized portfolio to provide for adequate diversification of the Grantor's overall investment allocation. The completion portfolio will invest in those asset classes that are underrepresented in the Grantor's aggregate or core investment positions. Thus, it is a customized portfolio designed to fill in asset allocation gaps or to hedge potential liabilities. When combined with the Grantor's other assets, the aggregate portfolio is more balanced, prudent and diversified. The trustee's performance reporting and asset supervision activities focus exclusively on the completion portfolio.

Diversification

The goals and objectives of the NAME OF TRUST reflect one element of a diversified and integrated plan of family wealth management. In achieving the goals of the larger wealth management program, the trust shall limit the assets within its portfolio to the class of financial instruments, including insurance or investment products, that can best accomplish the grantor's intent. Within these classes of financial instruments, however, the trustee shall diversify unless it is prudent not to do so.

In recognition that one of the primary benefits of diversification is to protect against the shock of an insurance carrier's insolvency, it is the policy of the NAME OF TRUST to immunize a reasonable portion of the trust portfolio against the adverse effects of creditor claims on the general assets of insurance companies. To this end, the trustee shall determine the percentage of insurance coverage that will be tied to the general portfolio of any insurance carrier and the percentage of the coverage that will be backed by separate accounts not subject to creditor claims.

If policy design (level, increasing, decreasing benefits) is comparable to asset/liability matching, portfolio diversification is comparable to asset allocation. The IPS draftsperson may wish to outline an appropriate target portfolio structure for the trust. The asset allocation guidelines may allow the trustee to design a matrix allowing for reasonable percentages of insurance coverage underwritten by:

- *"No Load" universal life carriers*
- *"No Load" whole life carriers*

- *"No-Load" variable (or variable universal) life carriers*
- *Mutual insurance carriers*
- *Stock insurance carriers*
- *Commission paying UL, whole life, or variable life carriers.*

There is no standard of prudence that demands that the trustee fill each cell of such a matrix with an insurance product. Rather, the matrix illustrates that the trustee considered the marketplace as a whole (as opposed to the particular segment represented by an agent) and that the trustee made a conscious evaluation the level of concentration and liquidity risk appropriate for the trust. Such a matrix allows for flexible percentages (i.e., "between 10 and 30%" or, "no more than 25%") and allows for construction of a portfolio which can happily accommodate a whole life product from a "blue-chip" mutual company selling through a sales force, a no-load variable product marketed through fee-for-service agents, a universal life product acquired directly from the manufacturing carrier, and so forth. Obviously, important determinates of an appropriate degree of diversification include the size of the portfolio and the resources available to the trustee to pay premiums.

For variable life policies, the trust's asset allocation guidelines dovetail more closely with traditional investment-oriented IPS documents. Care, skill and caution are required to determine that the net expected wealth accumulation of the underlying investment portfolio bears a reasonable relationship to the accumulation rates projected on the policy illustration. It is difficult to see how this is possible unless the agent or trustee has the skill set to perform simulation (i.e., "failure rate") analysis. It is of little value to inform a gamesman that the expected return of a single die roll is 3.5 when such an actual result is somewhat unlikely to appear. Variable life policies funded with hedge funds are generally poor fits for portfolios operating under an investment policy simply because ongoing monitoring and surveillance requires a degree of transparency that hedge fund managers would find burdensome.

PROCEDURAL GUIDE

The Procedural Guide outlines risk/return expectations and asset management strategies to be employed by the trustee during the term of insurance policy administration.

RISK AND INVESTMENT STRATEGIES

Insert here the findings of the benchmark model report concerning the expected costs and benefits of the insurance program to be implemented. An expanded benchmark model report can illustrate the relative merits and disadvantages of using investments in place of insurance products (or a combination thereof) to achieve trust objectives. In this case, it is recommended that the report compare "lower bound" investment results to "guaranteed value" projections provided on policy illustrations. Additionally, expected (median) investment results as well as "upper bound" results can be compared to projected (non-guaranteed) insurance policy values.

Often, an attorney is asked to draft a trust instrument and the trustee is asked to assume the duties of the office only after the grantor, at the encouragement of the insurance agent, has applied for insurance coverage. It is easy to see, however, that the hasty design and implementation of an ILIT may itself be evidence of an imprudent decision making process and may leave the trustee vulnerable to future surcharge actions by disgruntled beneficiaries.

When insurance is used to hedge against the economic consequences of specific perils, it is important for the trustee to memorialize the planning objective lest the trustee be accused of failing to match trust assets with grantor objectives. Insurance agents and estate planning attorneys often convey their recommendations in terms of multi-generational "wealth building" or "wealth enhancement" strategies. This vocabulary can impart a double meaning to unsophisticated grantors and beneficiaries who may be displeased to find that the insured hedge subtracted rather than added value to the estate. Insurance is a valuable, although not a free or discounted, good.

Under the California Uniform Prudent Investor Act, the trustee has "the duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer…." The Investment Policy for the [NAME OF TRUST] sets forth a procedural guide and underlying rationale for portfolio management policies with regard to the following risks:

Going-Concern Risk (Risk of Insurance Company Insolvency)

Academic evidence suggests that there does not yet exist an accurate model or foolproof method to predict insurance company insolvency. Among the many reasons for difficulties of bankruptcy prediction for insurance carriers is the fact that the economic, tax and regulatory environments under which carriers operate can change dramatically over short periods of time. Much of traditional credit-risk analysis focuses only on the quality of assets owned by the carrier. Carriers that own risky investments, such as junk bonds, are deemed to pose a higher insolvency risk than carriers with portfolios of "safe" assets.

Unfortunately, this type of analysis may overlook risk exposures that flow from other sources such as business risks, inability to maintain competitive and profitable market share, product obsolesce and interest-rate risk. Therefore, it shall be the policy of the [NAME OF TRUST] to control the risk of untoward economic consequences following a carrier's unanticipated financial decline by diversifying the insurance portfolio among several non-affiliated companies. In selecting the carriers, absent health difficulties, underwriting constraints or other factors limiting product availability, the trustee shall be guided primarily by ratings issued by independent evaluation firms. Specifically, the trustee must rely on evaluations issued by firms conducting both a qualitative as well as quantitative examination of insurance carrier assets and management policies. These agencies include:

- Standard & Poor's;
- Moody's;
- the A.M. Best Co.; and
- the Fitch Credit Rating Company.

A review of insurance company ratings shall be conducted periodically. In the event of a ratings downgrade of an issuer, the trustee shall review the magnitude of the downgrade as well as its cause and shall determine what portfolio modifications, if any, are warranted.

No-load insurance contracts are especially attractive vehicles for ILITs because ratings downgrades do not force the trustee to make a difficult choice between retaining coverage from carriers with deteriorating financials or incurring large penalties for early termination of a contract. A diversification strategy can be especially helpful to

trustees faced with making difficult policy replacement decisions because account value losses and new policy acquisition charges apply only to the portion of the insurance portfolio represented by the underperforming contract.

The Investment Policy for the [NAME OF TRUST] hereby establishes the following insurance carrier selection criteria:

The insurance company must be rated by at least two or more major rating services and must not have a rating less than:

S&P	AAA, AAAq, AA+, AA, AAq
Moody's	Aaa, Aa1, Aa2, Aa3
Fitch / Duff & Phelps	AAA, AA+
A. M. Best	A++, A+, A

Risk of Contract Underperformance

The National Association of Insurance Commissioners, in 1994, stated, "Illustrations are not and cannot be predictions or estimates of future performance." Illustrations are financial documents prepared by the product vendor, and like any financial statement prepared by company management and disseminated to the public by a marketing department, they should be examined critically to ascertain the extent of possible manipulation.

The trustee of the [NAME OF TRUST] shall make a determination of the suitability of insurance contracts to the purposes and circumstances of the trust through an examination of the timing, risk, magnitude and probability of all cash flows according to generally accepted standards of statistical and quantitative financial analysis. The results of this analysis shall be attached to this Investment Policy Statement and maintained as part of the permanent records of the trustee *[see Benchmark Model Report].*

Liquidity Risk

In the determination of a prudent and suitable insurance contract, the trustee shall evaluate both "load" contracts, which generate commissions payable to the selling agent, and "no-load" contracts, under which no commission compensation is payable to an agent. It is the intention of the trustee to be guided by the commentary to the restated law of trusts that in reference to the decision to purchase a load or no-load mutual fund investment states:

> *Concerns over sales charges, compensation, and other costs are not an obstacle to a reasonable course of action…but they do require special attention by a trustee. Because the differences in the totality of the costs … can be significant, it is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.*

In order to document investigation into this area, commission payments will be disclosed, in writing, and those disclosures shall be retained in the trustee's records.

The decision to purchase a traditional, commission-paying insurance product may result in the acquisition of a financial instrument that offers little or no cash surrender value for a lengthy period of time. The trustee shall determine if the level of risk posed by illiquidity is appropriate to the purposes of the trust and shall determine whether there is a reasonable probability that trust beneficiaries will be sufficiently rewarded for assuming the extra risk. The analysis of the liquidity risk as quantified in the benchmark model report is attached to this Investment Policy.

Underwriting Risk

It shall be the policy of the [NAME OF TRUST] to take all reasonable steps to assure that the pricing of any insurance coverage is determined by fair and technically proficient underwriting procedures. In order to adhere to the general standard of prudent investment, the trustee shall endeavor to assure that trust-owned insurance contracts "…incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."

Whereas the pricing of insurance contracts is usually determined by the interaction of: (1) underwriters at retail insurance carriers and (2) underwriters at the reinsurance companies that provide the risk-sharing and surplus relief mechanisms required for an operationally efficient market, the trustee shall, unless the facts and circumstances indicate that it would be imprudent, instruct the insurance agent to avoid making application for life insurance coverage in such a manner that the reinsurance risk-ceding options are unnecessarily constrained or encumbered. Customarily, this will mean that formal applications used by retail carriers to execute automatic and exclusive reinsurance agreements, thus preventing the reinsurance company from negotiating with other retail carriers that might offer more favorable pricing for the coverage, will be eschewed in favor of preliminary pricing inquiries to underwriting departments.

When a carrier offers coverage on a rated basis or declines to offer coverage at all, the trustee shall ascertain whether a sufficient number of inquiries were made to insurance underwriting departments so that a fair and reasonable market evaluation was possible. In the event that ratings or surcharges appear likely, the trustee may, if it is prudent under the circumstances to do so, solicit pricing offers from carriers who do not meet the selection and retention criteria outlined above.

If the [NAME OF TRUST] owns insurance policies with rated premiums, the trustee, at reasonable intervals, shall seek, or cause the insurance agent to seek, a determination of the continued appropriateness of the extra premium costs.

Ratings may become unnecessary in the event of an improvement in the insured's health or by virtue of new medical treatments and technologies that reduce the mortality risk associated with the health impairments. A trustee that continues to pay unnecessary costs may incur liability. This is especially true if a policy lapses because of inadequate cash accumulations and dividend/interest credits. The IPS draftsperson can determine how or if a change of status from smoker to non-smoker should be addressed if the rate structure of existing policies reflects these risk categories.

The Trust Portfolio: Overall Investment Strategy, Risk, and Return Objectives

When appropriate, this section may be completed on a case-by-case basis. It consists of an objective comparison of costs and benefits to alternative financial strategies—i.e., self-insurance through investments, the use of term insurance in combination with investments, permanent insurance only, single life versus joint life policies, traditional versus variable contracts, and so forth. It is designed, in part, to enable the trustee to defend, ex post facto, the decision to use life insurance, versus alternative strategies. Calculations in support of this section may be incorporated into an expanded benchmark model report.

Asset Administration Guidelines

This section communicates the guidelines that the trustee intends to implement as part of the ongoing asset management process. We provide some sample guideline statements that may be appropriate for administration of either whole life, term or universal life contracts.

Dividend Elections

The [NAME OF TRUST] intends use dividends to purchase paid-up additional insurance coverage. In the absence of sufficient funds to pay required premiums, the trustee shall determine whether projected dividends, in conjunction with surrender of paid up additions for their cash value, are sufficient to pay projected future premiums. If this is the case, the trustee shall, if appropriate to the terms and purposes of the trust at the time of such evaluation, request the insurance carrier to change the dividend election to premium reduction and shall request the carrier to surrender, on a periodic basis, such paid up additions that are required to generate cash sufficient to pay the balance of any premium currently due.

Policy Loans

With the elimination of deductibility of interest for many types of loan, and with new IRS rules regarding treatment of collateral assignments of insurance policies in split-dollar premium financing arrangements, the motivation to execute insurance policy loans has diminished. Nevertheless, a trustee may wish to clarify asset management policies with respect to policy loans because some insurance buyers may think that insurance loans, like margin account loans from a broker, are a low-cost source of funds. Loans from universal life and whole life contracts, however, usually involve substantial opportunity costs in the form of reductions in credited dividends or interest as well as the cost of the contractual loan interest. Although loan analysis is a "facts and circumstances" exercise, a reduction in credited interest from, say 6% to 4% for amounts equal to the outstanding loan balance, represents a 2% opportunity cost. If loan interest is 4% then the economic cost of the loan is 2% + 4% = 6%, and not 0% as some insurance carriers advertise.

Generally, it shall be the policy of the [NAME OF TRUST] to refrain from borrowing against the available cash or accumulation value of any insurance contract. The combination of after-tax costs plus opportunity costs makes insurance policies an unattractive source of funds. This shall be the policy of the [NAME OF TRUST] even should the insurance carrier offer "zero-net cost" loans.

Non-Forfeiture Elections / Policy Surrender or Sale

In the event of the grantor's inability or unwillingness to continue making gifts to the trust in an amount sufficient to fund the insurance program at its projected level of benefits, and, in the event that trustee inquiry reveals that an insurance policy is likely to require future payments to continue according to its terms, it is the policy of the [NAME OF TRUST] to elect the reduced paid up non-forfeiture election absent medical evidence indicating that the insured's life expectancy is less than x% [insert applicable fraction < 1] of the amount of time until coverage termination date under the extended term non-forfeiture option. Likewise, it is policy of [NAME OF TRUST] not to elect the automatic premium loan provision in those jurisdictions offering this option. Thus, a failure to provide funds sufficient to continue required premium payments will result in trustee action to secure, for the benefit of trust beneficiaries, permanent coverage at a reduced face amount that will not require future payments from grantor gifts or trust assets.

Given the difficulties in collecting premium gifts on a timely basis and the speed at which decisions must be made in the face of premium payment deadlines, the ILIT trustee may wish to reserve several months' premiums in a tax-favored municipal money fund.

The trustee may elect a "vanishing premium" type of election (dividends or future interest credits combined with paid up addition surrenders) in the hope that the policy can be self-sustaining. The IPS language suggested by the authors has the advantage of conservatism with respect to some aspects of trustee liability.

Alternately, the trustee may wish to insert language authorizing an investigation of the secondary market value of the insurance contract. Generally, this will be appropriate when the insured is over age 65, suffers from a medical impairment and is covered by a policy with a face amount of $250,000 or greater. Finally, the trustee may wish to manage the insurance portfolio under an instrument with a "changed circumstances" provision allowing the trustee to apply for termination under state statute provisions or through court petition of the trust either prior to or after making a sale, surrender, guaranteed income settlement or secondary market sale.

MONITORING AND SUPERVISION

Where monitoring and surveillance reveal problems, or when the objective context of the trust (e.g., the family situation of the settlor or beneficiaries) changes, modifications to the trust assets may be prudent. This section lays out a protocol which ensures, as far as is possible, that such changes are made in a considered, rational and prudent manner, are documented, and are well-understood by all parties in interest.

The guidelines established in this Investment Policy Statement with respect to carrier suitability and policy funding form the basis for ongoing periodic reports provided by the agent, broker, financial planner or investment advisor providing services to the [NAME OF TRUST]. The trustee will require periodic reports from insurance professionals and will review the performance of the portfolio and its individual insurance policies no less often than annually.

The trustee intends to secure annual reports that will conform, to the extent practical, to the standards of performance accounting enumerated in the Fiduciary Accounting Guide promulgated by the American Law Institute – American Bar Association:

"Performance accounting, as applied in the trusts and estates practice area, has the twin objectives of promoting full and useful disclosure and fair representation of investment results on client assets and of instilling and maintaining client confidence in the corporate or individual fiduciary's investment abilities. These objectives may be best achieved when the fiduciary includes easily understood performance indicators in the client's periodic fiduciary statements."

It shall be the policy of the [NAME OF TRUST] to compare, at least annually, the benefits specified in the annual policy report provided by the insurance carrier to the benefits projected in the policy illustration obtained at the time of policy acquisition. Additionally, aggregate death benefits and cash values will be calculated on the portfolio level. If one or more policy components evidence substantial underperformance relative to the originally projected values, the trustee may request additional policy valuation analysis comparable to that provided in the benchmark model report.

Additionally, the trustee shall review, at least annually, the letter and number grades assigned to insurance carriers by independent rating agencies. If one or more agencies have assigned either a series of small ratings downgrades or a substantial larger downgrade to a carrier within the portfolio, the trustee shall make a determination as to the continued appropriateness of continuing to fund coverage though the carrier.

Portfolio Modification

If continued retention of one or more insurance policies appears imprudent because of contract underperformance, the trustee shall seek a remedy from among the following options:

- Increased policy funding for underperforming contracts or decreased funding for contracts performing above original projections;
- Replacement of the coverage and acquisition of a new policy either by IRC §1035 policy exchange or by other suitable means;
- Election of an appropriate non-forfeiture provision with the option to devote premiums allocated to the policy to acquisition of supplemental coverage of a type and amount suitable to the trust; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections or surrender of the contract for its cash surrender value.

If continued retention of one or more insurance policies appears imprudent because of a high likelihood that the grantor's gifting program underlying the premium funding has discontinued, the trustee shall seek a remedy from among the following options:

- Election of an appropriate non-forfeiture provision; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections, or surrender of the contract for its cash surrender value.

If continued retention of one or more insurance policies appears imprudent because of carrier downgrades by independent rating agencies, the trustee shall seek a remedy from among the following options:

- Replacement of the coverage and acquisition of a new policy either by IRC §1035 policy exchange or by other suitable means;
- Election of an appropriate non-forfeiture provision with the option to devote premiums allocated to the policy to acquisition of supplemental coverage of a type and amount suitable to the trust; or
- Disposition of the life insurance benefit either through policy sale, annuity income elections or surrender of the contract for its cash surrender value.

The grantor's circumstances and objectives recorded in this Investment Policy Statement were developed through a systematic discovery process. The basis for the investment of the [NAME OF TRUST] Portfolio reflects these objectives and circumstances. To the extent that the grantor's circumstances change materially, or the [NAME OF TRUST] objectives evolve in a manner not anticipated herein, this document may be subject to review and modification.