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Thorny Issues under the Ohio Uniform Prudent Investor Act for Trustee-Owned Life Insurance: Working Toward Relief

Robert B. Barnett, Jr., Esq.; Carlile Patchen & Murphy LLP; Columbus, Ohio; Chairman, EPTPL Section Committee on Life Insurance and Brandon A. Borgmann, Esq.; Carlile Patchen & Murphy LLP; Columbus, Ohio

Imagine this typical scenario. A client comes into your office and says that his financial planner has analyzed his estate liquidity needs and concluded (prudently) that he needs life insurance protection of \$5,000,000, that the additional death benefit will cause the client and his spouse's combined estates to exceed the amount sheltered from federal estate tax by their combined applicable exclusion amounts, and that the client should own the policy in an irrevocable life insurance trust (ILIT) to avoid paying unnecessary estate tax. Also, after thoroughly investigating applicable insurance products, the client has chosen the policy he wants based on his financial planner's (prudent) recommendation and needs the ILIT created right away because the policy will be issued shortly. You create the ILIT, the client/settlor and his chosen trustee sign the trust agreement, the trustee signs the application and the policy is issued. From then on, the only trustee actions contemplated by the client is that his trustee will pay the premiums each year from the gifts the client will make to the ILIT for that purpose and send out appropriate Crummey notices.

The client has absolutely no expectation or desire that the trustee will pay any attention to the economics of the policy, nor does the client have any interest in paying a professional trustee to offer any kind of "professional second opinion" as to the insurance, because the client expects and desires that that will be a matter between the client and his trusted financial planner (who is charging nothing "extra" for that service). If any changes are to be made in the future with respect to the policy, the client will inform the trustee of what those are to be, and expects the trustee will carry out whatever actions are necessary to accomplish those changes.

Sound familiar? Of course it does. Also, while this overwhelmingly typical scenario plays out over and over again, meeting exactly all the objectives of the client, the trustee is left with major potential fiduciary liability issues, of which only the professional trustees are typically aware. These liability issues have been severally exacerbated by the recently enacted Ohio Uniform Prudent Investor Act (OUIPIA) in Chapter 5809 of the Ohio Trust Code. As discussed in Ted Rusinoff's article "Managing the Fiduciary Liability of the Irrevocable Life Insurance Trustee," 18 PLJO 45 (Sept/Oct 2007), the OUIPIA's standard of care, coupled with the Ohio Trust Code's notice and information reporting requirements, leaves all Ohio trustees holding life insurance policies as trust assets exposed to a greater risk of liability to better informed and, as we know all too well, often litigious, trust beneficiaries.

For the balance of this article we will refer to ILITs specifically, but only as a shorthand way of addressing the same issues facing all trustees holding life insurance policies as trust assets. This article discusses the interplay between traditional ILIT administration and the OUIPIA's standard of care, and how this interplay requires departure from traditional ILIT trustee practices; possible options available to the trustee or drafting attorney to allow the trustee to satisfy or avoid this standard of care; and an examination of current work being undertaken by the Estate Planning, Trust and Probate Law Council of the Ohio State Bar Association to come up with a le-

gislative solution to this problem in Ohio.

Ohio Trustees' Standards of Care

The OUPIA sets the default standards applicable to all Ohio trustees unless modified in the trust (if permitted). Specifically, [R.C. § 5809.02](#) requires that:

(A) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this requirement, the trustee shall exercise reasonable care, skill, and caution.

(B) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(C) A trustee's investment and management decisions respecting individual trust assets shall not be evaluated in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(D) Among circumstances that a trustee shall consider in investing and managing trust assets are the following as are relevant to the trust or its beneficiaries:

- (1) The general economic conditions;
- (2) The possible effect of inflation or deflation;
- (3) The expected tax consequences of investment decisions or strategies;
- (4) The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) The expected total return from income and appreciation of capital;
- (6) Other resources of the beneficiaries;
- (7) Needs for liquidity, regularity of income, and preservation or appreciation of capital;
- (8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Interpreting this statute requires at least a minimal understanding of the “prudent investor” concept referenced in [R.C. § 5809.02\(A\)](#). The “prudent investor” is a term largely the product of evolving investment theory, born from the tenets of modern portfolio theory (MPT). The intricacies of MPT extend beyond the scope of this article; however, a summary of MPT follows.

The prudent investor standard originated in 1830 and operated on an asset-by-asset basis. [\[FN1\]](#) A trustee faced liability if one trust asset failed despite every other trust asset rendering a positive return. Many state statutes adopted this “asset in a vacuum” approach by creating lists of inherently prudent and imprudent investments. [\[FN2\]](#) Thus, a trustee could protect himself against liability by ensuring all trust assets fell within the statutorily approved investment categories.

In the later half of the 20th century, the asset-by-asset method of assessing trustee performance began to give way to a more holistic approach known as MPT. First introduced by Harry Markowitz in his 1952 “Portfolio Selection” article in the *Journal of Finance*, MPT identified two types of risk--systematic and specific. Systematic risk is the risk associated with an entire market. Specific risk is risk associated with a particular asset or entity. MPT advocates analyzing a group of investments (i.e., a portfolio) through the group's cumulative performance, minimizing specific risk and focusing on maintaining a level of systematic risk that exceeds inflation and protects principal, thus allowing for and encouraging diversification of investments.

The general common law slowly adopted the tenets of MPT and the “prudent investor” became one who diversified his portfolio. For instance, elements of MPT are incorporated in the Uniform Prudent Management of Institutional Funds Act and the Employee Retirement Income Security Act. In 1992, MPT found its way into the Restatement (Third) of Trusts at section 227.

The OUPIA's provisions clearly demonstrate that Ohio's current concept of the “prudent investor” follows MPT. Section 5809.03(B) specifically states that a “trustee shall diversify the investments of a trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” Further, a “trustee's investment and management decisions respecting individual trust assets shall not be evaluated in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.” [FN3]

In addition to diversification, the OUPIA requires that a trustee must couple his efforts to conform to MPT with the “exercise [of] reasonable care, skill, and caution.” [FN4] In creating a diversified portfolio, a trustee must “verify facts relevant to the investment and management of trust assets” [FN5] and consider the particular circumstances, including those specifically listed in R.C. § 5809.02(D) as referenced above.

Based on the above-described duties, beyond merely making premium payments and sending Crummey notices a trustee of an ILIT must potentially perform some or all of the following duties:

- (1) Determine whether investment of trust assets primarily, or often solely, in life insurance policies violates the duty of investment diversification;
- (2) Determine whether the duty of diversification requires at a minimum multiple life insurance policies rather than one sole policy, and at a maximum whether nonlife insurance assets must also be included as trust investments;
- (3) Determine whether the policy or policies held in the trust were, and continued to remain, proper investments, even though the trustee was directed by the settlor to acquire such policy(ies);
- (4) Determine what to do when the settlor fails to properly fund the trust to pay the current premium; e.g., borrow cash value to pay the premium, surrender or partially surrender the policy, convert to paid-up insurance, use other trust assets to pay the premium, reduce the death benefit, etc.
- (5) Review and ensure that any given policy's cash balance was properly allocated and invested;
- (6) Ensure that the insurance company of each policy is and remains financially stable enough to satisfy its claim obligations now and in the future;
- (7) Determine whether the policy(ies) in the trust should be exchanged for new policies that might offer the same

or similar death benefit at a lower cost after accounting for acquisition expenses, surrender charges, and potential loss of cash value; and

(8) Review the health of the insured and make any necessary adjustments based on sudden declines or improvements.

Clearly these duties are a huge deviation from what both the client/settlor and the trustee of the ILIT contemplated or desired in our simple example at the beginning of this article. These duties, and the increased liability for failure to meet them, can give rise to multiple negative consequences. Often, private individuals agree to serve as an “accommodation” ILIT trustee. Mostly these individuals are uninformed about their duties and possible liability, and even if they are usually lack the ability and resources to fulfill the duties or are simply not equipped to deal with all the required actions. Institutional trustees must charge significant fees to be adequately compensated for performing such duties, or for taking the risk of the settlor being uncooperative in allowing the trustee to perform them at all. The unfortunate and foreseeable result is that proper and prudent ILIT administration is costly, risky and impractical, thus giving informed potential trustees pause before accepting the role of trustee, and uniformed trustees' a minefield of potential liability to navigate.

Relief for ILIT Trustees

Several options theoretically exist to alleviate the onerous burdens of ILIT administration under the OUPIA. Taking advantage of these options requires either effort on the part of the trustee or foresight on the part of the drafting attorney. Although ultimate relief may have to come in the form of legislative action, this section addresses these other options and the merits and drawbacks of each.

Delegation

An ILIT trustee can pass the buck. [R. C. § 5808.07](#) permits a trustee to delegate duties and powers, including those outlined above. The person performing the delegated duty or power equally inherits the associated fiduciary duty. [\[FN6\]](#) Delegation does not mean the ILIT trustee completely washes his hands, however. Upon delegating, the ILIT trustee shifts the potential source of liability from actually performing the analysis to selecting the person who performs the analysis. [\[FN7\]](#) Inadequate delegation paves the same path to liability as inadequate trustee performance.

In addition, delegation still leaves the ILIT trustee on the hook. Though the actual review comes from a third party, the trustee must still periodically review the third party's actions and performance to ensure the third party remains in compliance with the OUPIA and the terms of the delegation. [\[FN8\]](#) Unfortunately, the delegation option provides little solace to an ILIT trustee hoping for simple and quite administration.

Faith in the OUPIA

In the ILIT context, doing nothing may be a possible option. Shielding phrases can be found throughout the OUPIA. For example, a trustee's management and investment decisions shall be evaluated “as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust,” [\[FN9\]](#) and a trustee must diversify trust assets “unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” [\[FN10\]](#) With reference to these phrases, the unique nature of an ILIT might exonerate the trustee from liability, but certainly add little comfort.

The simplicity of doing nothing and carrying on as always with premium payments and Crummey letters would certainly appeal to practitioners, trustees, and settlors alike. However, should a beneficiary attempt to take an ILIT trustee to task, substantiating a defense based on the “shielding” language of the OUPIA may prove difficult. At a minimum, the trustee would need to prove grantor intent, surrounding circumstances demonstrating the propriety of the policy held by the trust, and negate the influence of events occurring subsequent to the original transaction that allegedly amount to a breach of the trustee's duty. [FN11]

Drafting Around the Standard

A more attractive option for protecting ILIT trustees would be to draft protective and exonerating provisions into the trust instrument. After all, the OUPIA is the default standard that may be “expanded, restricted, eliminated, or otherwise altered.” [FN12]

Through careful drafting the settlor may be able to ensure and establish a level of trustee conduct that achieves the settlor's intent while avoiding the additional costs inherent in full ILIT trustee compliance pursuant to the OUPIA. Unfortunately, drafting around the OUPIA standards may not be all that simple. Little if any authority exists as to the credence a court must give to exonerating provisions. [FN13] It is possible a court could find the requirement of diversification of such import to label it a nondischargeable duty. [FN14] Arguably, exculpatory trust clauses appear most effective as supplemental support to defending a charge of fiduciary breach. The downside for Ohio trustees, however, is a lack of primary support for exculpatory clauses.

Savings Statute

The most straightforward and binding option to deal with this dilemma is legislative action. As of this writing, 11 states have enacted some form of a “savings statute” to protect trustees holding life insurance policies as trust assets. Ten states' laws are similar in approach, relieving the trustee from several duties otherwise applicable. [FN15] The 11th, Florida's, has taken a different approach, one of specifically authorized delegation of duties with respect to life insurance to third parties. We will not discuss the Florida statute, but commend it to your reading. [FN16]

Each state's statute varies in terms of when the statute applies, which policies fall within the statute's scope, what specific acts of the ILIT trustee are protected from liability, and whether the statute protects the trustee from liability to beneficiaries for loss with respect to the policy. Their main provisions are summarized in the chart at the conclusion of this article.

Pennsylvania's statute, 20 Pa. C. S. 7208, is just one example. It specifically exempts a trustee from “liability for a loss arising from the trustee's failure to: (1) determine whether the contract is or remains a proper investment; (2) investigate the financial strength of the life insurance company; (3) exercise nonforfeiture provisions available under the contract; or (4) diversify the contract.” This wholesale exemption squares with traditional ILIT settlor administration expectations.

The benefits of a legislative option are obvious. Neither the drafting attorney nor the trustee must engage in any affirmative action such as delegating, drafting, or simply having faith in potential “shielding” statutes to protect the trustee. Nevertheless, the drafting attorney may insert whatever additional trustee duties the settlor may desire. A statute specifically exonerating an ILIT trustee from certain duties provides a much more certain and reliable defense should litigation arise. The necessity of substantiating settlor intent discussed above disappears.

In recognition of the benefits of the legislative option, the Ohio State Bar Association (OSBA) Board of Delegates at its November 2009 meeting unanimously approved the OSBA Estate Planning, Probate and Trust Law Council's proposed statute for introduction to the Ohio legislature. Bill Wiesenberg and Steve Stover, the OSBA's fine lobbyists, are presently at work seeking a sponsor for this legislation. The proposed statute is as follows.

5809.03.1. Duties of a trustee with respect to life insurance policies.

(A) Unless otherwise provided by the terms of the trust, the duties of a trustee with respect to the acquisition, retention or ownership of a life insurance policy as a trust asset do not include a duty:

(1) To determine whether any such policy is or remains a proper investment;

(2) To diversify the investment in such policy relative to other such policies or to any other trust assets;

(3) To exercise or not any option, right or privilege available under such policy, including the payment of premiums unless there are sufficient cash or other readily marketable trust assets from which to pay such premiums, or, if not, other trust assets that were designated by the settlor or other person transferring such assets to the trust to be used for such purpose, regardless of whether such exercise or nonexercise results in the lapse or termination of such policy;

(4) To investigate the financial strength or changes in the financial strength of the life insurance company maintaining such policy; or

(5) To inquire about changes in the health or financial condition of the insured or insureds under such policy.

(B) Neither the trustee, nor the attorney who drafted a trust, nor any person who consulted with regard to the creation of a trust, shall, absent fraud, be liable to the beneficiaries of the trust or to any other person for any loss arising from the absence of these duties.

(C) Unless otherwise provided by the terms of the trust, the provisions of this section apply to a trust established before or after the effective date of this section and to a life insurance policy acquired, retained or owned by a trustee before or after the effective date of this section

This proposed statute serves both settlors and trustees alike. As a blanket "savings statute," it protects both institutional and non-institutional trustees, and their counsel, from onerous duties with respect to life insurance policies held as trust assets and from an unwarranted increased risk of liability. Settlors obtain greater certainty in their trust administration and relief from preventable increased administration costs.

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[FN1]. *Harvard College v. Amory*, 26 Mass. 446, 9 Pick. 446, 1830 WL 2554 (1830).

[FN2]. Remnants of these statutes still exist in Ohio. See R.C. §§ 2109.37 and 2109.371.

[FN3]. R.C. § 5809.02(C).

[FN4]. *Id.* at (A).

[FN5]. *Id.* at (B).

[FN6]. R.C. § 5808.07(B).

[FN7]. R.C. § 5808.07(A).

[FN8]. *Id.* at (A)(3).

[FN9]. R.C. § 5809.01(C).

[FN10]. R.C. § 5809.03(B).

[FN11]. *Ballsun*, *supra* n. 3, at 290.

[FN12]. R.C. § 5809.01(C).

[FN13]. *Accord Ballsun*, *supra* n. 3 at 291; Restatement (Third), Section 227, comment g.

[FN14]. *Id.*

[FN15]. The states with savings statutes are Alabama at [Code of Ala. § 19-3B-818 \(2009\)](#); Delaware at [12 Del. C. § 3302 \(2009\)](#); Maryland at [Md. Code Ann. § 15-116 \(2009\)](#); North Dakota at [N.D. Cent. Code § 26.1-33-44 \(2009\)](#); Pennsylvania at [20 Pa. C.S. § 7208 \(2009\)](#); South Carolina at [S.C. Code Ann. § 62-7-933 \(2009\)](#); Tennessee at [Tenn. Code Ann. § 35-14-105 \(2009\)](#); Virginia at [Va. Code Ann. § 26-45.4 \(2009\)](#); West Virginia at [W. Va. Code § 44-6-2a \(2009\)](#); and Wyoming at [Wyo. Stat. § 4-10-902 \(2009\)](#).

[FN16]. The Florida Statute can be found at [Fla. Stat. § 518.112 \(2009\)](#).

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