

# The Banking Law Journal

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MAY 2002

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# **LIFE SETTLEMENTS AND TRUST ACCOUNTS: A POSSIBLE MODIFICATION OF THE TRUSTEE'S RESPONSIBILITY?**

DEAN EDWARD MILLER

*According to the author, developing trust law may now impose new duties upon the trustees of trusts holding life insurance policies; one salient cause of this development of trust law is the emergence of the life settlement. This would seem to mean, at the least, that in numerous instances a bank or trust company serving as trustee of such a trust must regularly consider whether to sell a policy pursuant to a life settlement.*

**T**he life settlement business is a relatively recent development. Companies began offering them in the past decade, and it has been estimated that well in excess of \$1 billion in policies have been purchased since that date. Participants in the business purchase life insurance

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policies covering relatively healthy seniors. Specifically, most participants in the life settlement business purchase policies covering persons who are at least of 65 years of age, who do not have a terminal illness, and who have a life expectancy of at least two years. The purchase is made for an amount that is somewhat less than the policy's face value, but somewhat in excess of the cash surrender value of the policy. Eligible policies for such purchase include whole life, universal life and convertible term policies. The life settlement purchaser will then make all subsequent premium payments, and will receive the face amount of the policy upon the death of the insured. This business is to be distinguished from the viatical settlement business, in which life insurance policies are purchased which cover the lives of persons with terminal illnesses; usually with life expectancies of two years or less. Viatical settlements are not considered in this article.

The emergence of the life settlement has altered the landscape of the insurance trust business. It has presented an alternative course of action for trustees of trusts holding life insurance policies on the life of the settlor. This alternative significantly changes the options available to a trustee in a number of possible fact situations. In some cases, sale of a policy pursuant to a life settlement will redound to the benefit of the trust and its beneficiaries dramatically, providing them a benefit that may be substantially in excess of what the more limited options previously available permitted, or by opening to them an alternative that is more in keeping with their present interests. This truth has several implications. Let me touch upon some specific examples in which a life settlement is advantageous to policyholders and insureds, and then explore the implications.

For a number of reasons, the owner of a life insurance policy may determine that the policy is no longer needed; or that the owner's interests will be better served by replacing it with a more liquid asset. It may be a policy that was purchased many years previously to provide protection against risks that are no longer significant, such as protecting a young family in the event of the premature death of a breadwinner. It may be a business owned key-person policy where the insured is no longer connected to the business, or in which the enterprise's success is no longer dependant on any one person. It may have been envisioned as a means to provide estate taxes or final expenses, and ample funds are now available for those expenses. It may be simply

that the premiums on the policy have become so expensive that it is no longer economically feasible to continue funding it. In all these cases, circumstances have changed from when the policy was obtained, to the point that the purposes for which it was obtained can better be accomplished by its sale and distribution of the proceeds; or by its sale and reinvestment of the proceeds in media more in keeping with the current needs of the parties presently having an interest in the policy.

Many life insurance policies are owned by trusts; and in many cases, the policy is the only asset of the trust — what is referred to in corporate fiduciary circles as an “unfunded life insurance trust.” Often in either circumstance, the question of the appropriateness of the policy to the purposes for which the trust document was drafted, or the present interests of the beneficial interest holders, is not a frequent subject of inquiry. This course of action, or inaction, if you will, may have been more appropriate — or at least, more defensible — in times in which purchasers of such policies were not readily available and/or the limited range of options permitted no other course.

## TRUSTEE CHALLENGED

In the mid 1990s, there occurred a threatened lawsuit in which the beneficiaries challenged a trustee for failure to protect their interests in an irrevocable insurance trust. While the case was settled, it attracted widespread notice, and gave rise to an article discussing this event entitled “Unexpected Liability Awaits Many Trustees of Life Insurance Trusts,” written by Mark Donahue, which appeared in the April 1994 issue of *Trusts & Estates* magazine. Not long thereafter, two life insurance companies settled lawsuits by policyholders that alleged vanishing premiums fraud. While these cases did not involve insurance trusts, observers began to fear that these issues would spill over into trust management.<sup>1</sup> The scenarios viewed by these observers as most likely to expose trustees to liability included:

- failing to analyze the difference between vanishing premiums and level premiums;

- holding inappropriate or obsolete life insurance policies; and
- failing to purchase enough life insurance for the premiums that were paid.

In some measure as a reaction to these events, statutes were enacted in some states, the so called “hold harmless” statutes,<sup>2</sup> that provided that the duties of a trustee in such circumstances were strictly limited, and reflected the limited revenue potential that the account contained. More specifically, these laws prescribed that the duties of a trustee did not include:

- determining whether the insurance remained a proper investment;
- exercising options under the contract; or
- diversification of the contract.

Now, however, with the development of the life settlement business, a more convenient avenue for sale of life insurance policies at a price in excess of the policy’s cash surrender value has become available, and this may have altered the situation — perhaps even in the states with “hold harmless” laws. What may be a very possible consequence is that along with that availability there may have arisen a corresponding modification of the obligations of a trustee holding a life insurance policy as an asset of the trust, to consider whether to sell the policy. Further, this obligation may be one that must be observed regularly during the life of such a trust.

## **LIFE SETTLEMENT**

For today, as the result of the development of the life settlement, a more viable and feasible alternative to holding an insurance policy until maturity has come into being. This alternative enables a trustee to obtain immediate funds to facilitate attainment of the current objectives of the trust, and in the process, eliminate what may be a significant burden of premium payments. While the amount of these newly available funds will be significantly less than the policy’s death benefit, it may be significantly in excess of the policy’s cash surrender value, and it will be immediately available. Obviously, it

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. However, in other cases, for the reasons touched upon above, this will not be a clear result; and in some, this analysis will result in a clear determination that the aforesaid considerations will be better served by the immediate sale of the policy and employment of the proceeds in a manner better suited to the accomplishment of the purposes of the trust, and the service of the best interests of the beneficiaries.

I submit that the law of trusts, particularly as it has developed in modern times, supports this interpretation of the duties of a trustee in the “life settlement” world. The best source of support for this proposition may be found in the Uniform Prudent Investor Act. This Act, drafted by the National Conference of Commissioners on Uniform State Laws was recommended for enactment by that body in 1994; and then approved by the American Bar Association in 1995. It has been adopted in full by the legislatures of 35 states, and substantially so in several others. The list of those states that have enacted it in whole or in significant part includes all of the major jurisdictions, as well as all in which a substantial volume of commercial activity takes place.<sup>3</sup> In this process of its conception and acceptance, with which a number of the most distinguished contemporary legal scholars have been involved, the Act has become one of the most significant indicators of the direction being taken by the modern trust law.

While the Uniform Prudent Investor Act does not specifically mention insurance, the principles which its provisions establish would appear to be totally in keeping with the conclusions enunciated above — that it is the duty of the trustee of a trust containing as one of its assets a life insurance policy, to examine regularly the question whether that policy should be sold under a life settlement, and the proceeds thereof invested in assets providing a more immediate return, consistent with the trust’s purposes. For example, in Section 2, which is recognized in its accompanying comment as being the heart of the Act, the trustee is required in carrying out its responsibilities and managing the trust’s assets, to consider the purposes, terms, distribution requirements and all other relevant circumstances of its trust in managing the trust assets. The comment to this section is especially illuminating as to

the Uniform Act's philosophy:

"... (T)his Act follows the Restatement of Trusts 3d: Prudent Investor Rule §227(a), which provides that the standard of prudent investing '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 should incorporate risk and return objectives reasonably suitable to the trust.'"

Further, Section 2 (c) of the Act, which enumerates the factors that a trustee must consider in investing and managing trust assets, provides additional support for this conclusion. Included in this list of relevant factors are: the role that each investment or course of action plays within the overall trust portfolio; the expected total return from income and the appreciation of capital; other resources of the beneficiaries; the needs for liquidity, regularity of income, and preservation or appreciation of capital.

## CONCLUSION

From the foregoing, it would appear to be persuasive that a trustee that is subject to the Act, in paying heed to its responsibilities must, in cases where a substantial portion of the assets of a trust is an unmatured life insurance policy, consider whether the foregoing considerations will be best served by the sale of that policy under a life settlement and investment of the proceeds. While in many cases, the conclusion must be negative or not completely compelling, in some the most reasonable answer to that question will be in the affirmative. And in that event, a trustee — particularly a professional trustee, such as a bank or trust company — is obligated by its fiduciary duty to seek a buyer for that policy. If a buyer can be found, such as a life settlement company, who is willing to purchase the life insurance policy for a fair price, I submit that the trustee should — indeed, must — sell it and reinvest the proceeds in keeping with the purposes of the trust and/or the best interests of its beneficiaries.

In the case of a state which may have both the "hold harmless" statute (or a similarly oriented judicial decision) and the Prudent Investor Act, a

good case is made that the latter has modified or amended the former, simply because the principles of the two are inherently inconsistent, and the latter will be more recent in the usual case. And in states that have not adopted the Prudent Investor Act, but that may have recognized the hold harmless philosophy, the emergence of this enhancement to the tools available to a trustee of a life insurance trust may in and of itself furnish the basis for a judicial reevaluation of the hold harmless law; particularly when one considers that the principles of the Prudent Investor Act are incorporated into the Restatement of Trusts. Significantly, we are advised that some professional fiduciaries have already amended their policies and procedures to recognize this possible or probable legal modification of their duties and responsibilities, indicating a measure of agreement with our conclusions.

Finally, it must be recognized that some professional fiduciaries are employing new business materials that advertise to prospective settlors of insurance trusts the wide range of services and activities that they provide with reference to insurance policies in the trusts they administer. Among services which we have seen represented are: a review of the life insurance policy owned by a trust to assure that it is of sufficient value and quality to satisfy the trust's purposes; regular monitoring of all activity of the policy and proceeds for conformity with the terms and objectives of the trust; and maintenance of detailed records to ensure that the insurance meets the legal requirements to remain gift and estate tax free. A bank or trust company that utilizes such representations to attract insurance trusts would be hard pressed later to assert as a defense for its subsequent inaction a hold harmless statute or precedent; particularly in today's environment.

In conclusion, it appears manifest that developing trust law imposes new duties upon the trustees of trusts holding life insurance policies; and that one salient cause of this development of trust law is the emergence of the life settlement. At the least, one might conclude from the foregoing, a trustee of such a trust must regularly consider whether to sell a policy pursuant to a life settlement in cases where:

- The cash surrender value is being used by the trustee to pay the premiums of the policy;
- In cases where the funds exist to pay premiums, they have become so

expensive that it is no longer economically feasible to continue funding the policy;

- The original purposes for the trust are now better served by other assets of the trust, or of the beneficial interest holders;
- The original purposes of the trust are no longer relevant or valid, so that the sale of the policy and investment or distribution of the proceeds would be more compatible with the current interests of the beneficial interest holders of the trust.

## ENDNOTES

<sup>1</sup> See the January 2, 1996 article in the *American Banker* entitled “A Life Insurance Time Bomb in Trust—And How to Diffuse It.”

<sup>2</sup> See e.g. S.C. Code Ann. § 62-7-302; W. Va. Code § 44-6-2a; Md. ESTATES AND TRUSTS Code Ann. § 15-116; N.C. Gen. Stat. § 36A-2.

<sup>3</sup> See the history and present status of this Uniform Act on the website of the National Conference of Commissioners on Uniform State Laws at [nccusl.org](http://nccusl.org).