The Court's View of TOLI Trustee and Fiduciary Liability
Adapted from an upcoming book entitled
The TOLI Handbook: Managing Life Insurance in a Trust Setting
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> As a general rule, the authority of a trustee is governed not only by the trust instrument but also by statutes and common-law rules pertaining to trusts and trustees A trustee has the duty to administer the trust in good faith, in accordance with its terms and purposes. A violation by a trustee of a duty required by law, whether willful, fraudulent, or resulting from neglect, is a breach of trust, and the trustee is liable for any damages proximately caused by the breach.
> *Excerpts from the Nebraska case, Rafert v. Meyer*

The trustee of an ILIT must follow the directions outlined by the trust document always, and make trust decisions solely in the best interest of the trust beneficiaries. The TOLI trustee is a fiduciary with a duty to put the interests of the beneficiary above all other interests.

The trustee has the duty to:

- Prudently invest trust assets
- Follow the specific terms laid out in the trust agreement
- Refrain from using the trust property for the benefit of the trustee
- Act impartially and administer assets in the best interests of the beneficiaries
- Avoid conflicts of interest

While case law dealing with Trust Owned Life Insurance is limited, there are some cases that do provide guidance.

The Cochran Case – KeyBank

The most important and well known case is Stuart Cochran Irrevocable Trust v. KeyBank, NA, a case decided in March of 2009. Per information gathered from the lawsuit, KeyBank was successor trustee to a trust that contained three life insurance policies and one annuity with a collective net death benefit of $4,753,539. KeyBank became successor trustee after the former trustee relinquished control over the trust at least partly because of the grantor's "insistence in having third parties," including himself and his insurance agent, "involved in the trustee's decision making process." At about the time KeyBank took over, the agent for the grantor recommended that the trust exchange the existing policies for two variable life policies, tied to the equity market, totaling $8 million in death benefit. That exchange was approved by KeyBank in the first quarter of 1999. Following the 9/11 attack in 2001, the equity market dropped, with an "adverse effect on the value of the mutual fund investments contained in the VUL policies." In both 2001 and 2002 the policies lost money. In 2003, KeyBank retained an outside consultant to audit the VUL policies. At the time, the insured was 52. For both policies, assuming an 8% return, the outside advisor said the policies would run until the insured was approximately 70. If the returns were 0%, they calculated the policies would run to approximately ages 58-60. It was noted that the grantor's "financial fortune had also taken a negative turn by this point in time," and he no longer had the ability to "supplement the trust with additional resources," so the policy reviews were run assuming no additional policy funding.

The agent for the grantor suggested the purchase of a John Hancock Guaranteed Universal Life policy, with a death benefit of $2,787,624. With the cash value in the existing policy and no other contributions, the policy would be contractually guaranteed to run to age 100. The new policy would dramatically reduce the market risk of the trust. The outside advisor listed the advantages and disadvantages of the transaction and recommended KeyBank “move forward with the proposed John Hancock coverage if the client is comfortable with the reduction in death benefit.” KeyBank did move forward placing the policy in force in June of 2003, although a final underwriting downgrade on the insured lowered the death benefit to $2,536,000. In January 2004, the insured died unexpectedly, at the age of 53. The beneficiaries filed suit claiming, among other things, that “KeyBank had breached its fiduciary duties as [t]rustee.”

The court, in two decisions, found in favor of the bank noting that “the ultimate question” was whether the trustees actions were “consistent with the Settlor’s intent as expressed in the Trust document,” whether they met their “fiduciary duties to the [b]eneficiaries,” and if “based on the circumstances facing the Trust in 2003,” whether it was “prudent” for the exchange from “from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit.” The court concluded that the trustee decisions were “consistent with the standard established by the prudent investor rule.”

While the court agreed that “in hindsight” the decisions made by the trustee resulted in a “significant reduction in the death benefit paid to the beneficiaries,” they felt that “at the time of its decision [it was] prudent [for the trustees to] protect the Trust from the vagaries of the stock market and from predicted lapse of the existing policies.”

The court did state that “it would have been preferable for the [t]rustee to provide regular accountings to the [b]eneficiaries,” but offered that the “receipt of timely financial reports by the [b]eneficiaries would not have changed the negative financial condition of the Trust.”

The court answered important specific arguments:

- The beneficiaries claimed that that KeyBank “imprudently and improperly” delegated certain decision making functions to the insurance agent and to the grantor by moving ahead with the policy replacements that the agent initiated. The court disagreed. The fact that the agent provided a policy replacement option did not “constitute a delegation of KeyBank’s decision making duties,” since KeyBank looked to an “outside, independent entity with no policy to sell or any other financial stake in the outcome” to review the policy replacement and provide recommendations. The court found that the bank did not delegate “any investment or other duties” to the writing agent.
- The beneficiaries argued that KeyBank disregarded the outside vendor’s advice concerning the replacement of the variable policies, but the court found, after reviewing the reports from the vendor, that the advisor felt both options were “palatable.” Each option had “their own sets of pros and cons. The existing VUL policies may have lapsed before Stuart Cochran reached the age of 60 and would likely have required additional premiums to finance—

money that he no longer had. The John Hancock policy, on the other hand, offered a significantly reduced death benefit, but was guaranteed to remain in force until he reached the age of 100 and would require no additional financing." The court stated that, "KeyBank merely chose between two relatively acceptable options—a decision it was entitled to make as trustee. We do not find that it acted imprudently on this basis."

- During the process of replacement, the trustee essentially reviewed only one policy type from one carrier and the beneficiaries faulted the bank for "failing to investigate alternatives aside from retaining the existing VUL policies or exchanging them for the John Hancock policy." While the court agreed that the trustee "could have done more," and the bank's process "was certainly less than perfect," they also believe it was "adequate."
- The beneficiaries argued that KeyBank breached its duties by "failing to provide sufficient information regarding its plan to carry out the 2003 Exchange." The court disagreed pointing out that the trust document "gave the trustee the power to surrender or convert the policies without the consent or approval of anyone." According to the court, the trustee had no "requirement [to] notify the [b]eneficiaries of the impending exchange . . . [since] neither their consent nor approval were required to carry out the transaction."
- The beneficiaries claimed that the bank "breached its duty of loyalty to them" through contact with the grantor concerning the policies and policy replacement, which they believed was evidence that the bank was "loyal" to the grantor, not the beneficiaries. The court did not agree, since a trustee would have to, "as a practical matter," have discussions with the grantor/insured if changes were to be made to the policy since the changes would require a physical exam. The underwriting process "cannot be effectuated without communication between a trustee and settler." The court went on to say that "nothing in the law prohibits contact between a trustee and settlor, nor should it."

Key Lessons from the KeyBank Case: Though the outcome of this case favored the bank, it was at some cost. The goal is not to "win the case," but to avoid the need to defend the case. And there are some lessons a TOLI trustee can take from this case:

- KeyBank was acting as successor trustee, with the former trustee noting it no longer wanted to act as trustee because of the grantor and others "insistence" on being "involved in the trustee's decision making process." Though the court outlined those areas where involvement was warranted, grantor involvement and outside influence can and does create conflicts that should be avoided.
- While the court decided that the replacement of the variable policies with a guaranteed universal policy with a lower death benefit was "prudent," the rapid replacement of the policies – a replacement of the existing policies in 1999, followed by another replacement in 2003, two replacements within 4 years, could suggest a "flavor of the month" selection process. The replacement of a policy comes with costs – commissions and expenses - and in this instance, the second replacement resulted in a loss of over $100 thousand in surrender charges.
- In the process of replacement, the bank looked to an "independent outside insurance consultant" who had no "financial stake in the outcome." The court pointed out that the bank could "delegate" these "investment and management functions" and though the life insurance agent "proposed" the replacement, by relying on the non-biased outside vendor for advice, the bank circumvented the beneficiaries claim that they "improperly delegating certain decision making functions" to the grantor and life insurance agent.
- The court pointed out, rightly, that in the process of policy purchase contact with the grantor, who is typically the insured, will occur, but simply "rubber stamping" the grantor request or advisor recommendation is still not recommended. The addition of a non-biased outside specialist to review and provide trust documentation is advised if internal resources are unavailable.
- While the banks process of policy replacement was deemed "adequate," a more rigorous review of policy options based on trust circumstances is probably warranted in most situations. Most pundits believe that the court set a low bar and a more comprehensive written review process for replacements is preferable.
- While the courts stated that the bank had no "requirement" to "notify the [b]eneficiaries of the impending exchange," if all had been made completely aware of all options and outcomes, the probability of winding up in court would have probably been decreased.

The documentation on this case by the bank showed a "prudent process" that could be tracked and though you could differ with the rigorousness of the process, you could easily track it and see that the outcome was based on the best facts and circumstances available at the time. This is an important point.

French, et al. v. Wachovia Bank N.A.

The French v. Wachovia case grew out of another replacement case, one which resulted in a large commission for the trustee's insurance affiliate. Per court documents, the primary claim against the bank was for "self-dealing," as the beneficiaries "were taken aback" by the more than $500,000 in commissions earned in the transaction. The revenue generated, though large, was considered "industry-standard." The beneficiaries' claim the bank had breached its "duty of loyalty" was rejected with the court "relying on an express conflict-of-interest waiver in the trust document."

The grantor, a successful entrepreneur, approached Wachovia after he grew disillusioned with his former trustee. His trust held two whole life policies that were "underperforming assets." After meeting with insurance advisors at Wachovia on several occasions, a proposal was developed to exchange the two whole life policies for John Hancock Guaranteed Universal Life policies that would provide "the same death benefit but at a much lower premium." A memo was provided that outlined the pros and cons of the transaction; for example, the new policies "ensured that the contracts would pay the promised death benefit as long as the premiums were paid," but the trust would lose some premium flexibility, as well as the higher cash value of the whole life policies, since the new policies would not generate much cash value.

After signing the application for the new policies, the grantor was provided with a waiver that disclosed Wachovia would receive compensation for the transaction and included a broad release of claims arising out of Wachovia's purchase of the insurance on behalf of the trust. The grantor inquired about the possibility of rebating the commission, and after being informed that that was not allowed under law, refused to sign the conflicts waiver. After consultation with legal counsel, Wachovia withdrew its request for signature and proceeded with the policy replacement.

A few months later, the grantor and beneficiaries complained to Wachovia about the "process surrounding the insurance exchange" and retained a law firm, attempting to reverse the transaction, which could not be un-done. The children, as beneficiaries, moved ahead and sued Wachovia.

The beneficiaries claimed that the insurance replacement "violated the prudent-investor rule" and if not, the bank at least "made the insurance swap in bad faith." The court noted that the trustee "is under a duty of undivided loyalty to the beneficiaries of the trust," and that "one aspect of the duty of loyalty is the strict prohibition against self-dealing." However, the court pointed out that the "trust instrument may waive the general rule and authorize the trustee to engage in transactions that involve self-dealing," and pointed to an "express conflicts waiver" in the trust document that allows the trustee to operate "without regard to conflicts of interest."

The beneficiaries also argued that the replacement was "such a bad investment that it amounted to a violation of the bank's duty of prudence," but the court disagreed. The exchange of the whole life policies for the new policies "maintained the same death benefit and saved $620,000 in premium costs." Although the new policies lacked the cash values of the whole life policies, "the trust did not need life insurance cash value as a tool; the trust was well diversified in other assets." The courts found in favor of the bank and awarded the bank over $700,000 in attorney's fees.

Key Lessons from the Wachovia Case: This case is important as it provides needed guidance in those situations where a bank or trust company may have an affiliated entity that is receiving compensation from a transaction occurring within the trust.

- Understanding the trust document when bringing a trust is key to successful TOLI management. In this case the trust document language allowed self-dealing, and overrode the prudent investor rules because of its specific language.
- While the trust language benefited the trustee in this case, the fiduciary must still show it acted in good faith. The bank could show a rigorous review that included numerous meetings with both the grantor/insured and the beneficiaries. That comprehensive review process was headed up by experienced life insurance professionals who provided all parties with documentation outlining the advantages and disadvantages of the existing and replacement policies. The policy replacement provided the trust with a "less expensive" policy, but also less cash value, which was pointed out.
- When deciding on a policy replacement, the policy characteristics and performance must be considered, but so should other factors that could affect the decision-making process. Does the trust document call for any types of distributions that might make a cash rich policy more attractive? Are there other assets in the trust to draw upon? Often there are no other assets, but in this case, there were significant assets, therefore the decision to purchase a more efficient death benefit at the expense of cash value was deemed prudent under the facts and circumstances.
- The documentation kept by the bank on its policy review procedure was instrumental in offsetting the possible negative effect of the large commissions paid in the case. The policy purchased was substantial and the commission paid was not out of line with industry standards, but to an outside observer such significant revenue may have been considered unwarranted had the bank been unable to outline the lengths to which it went to provide thoughtful analysis to the grantor and beneficiaries. The analysis and memos that outlined the pros and cons of the transaction, along with the numerous meetings with the grantor, beneficiaries, and advisors, showed that the bank had satisfied its duty to show good faith and make a prudent decision, as well as earn a large, but warranted, fee.

A few other cases warrant mention and can provide guidance for the TOLI trustee:

Hatleberg v. Norwest Bank, Wisconsin was a case from 2004-05 centered around a poorly written trust document and the trustee's responsibilities to alert the grantor, once made aware. The representative of the bank suggested to a client that an irrevocable life insurance trust be set up. The grantor utilized her neighbor, a local attorney, who, "by his own admission . . . was not an expert in estate planning," to draft the document. The trust document, which was essentially copied from a form book, "was defective because it did not contain Crummey provisions." This error was not initially noticed until the bank performed an annual review. While both the bank and the attorney who created the document evaluated the situation they did not alert the grantor. In fact, the issue was not mentioned until the grantor passed away, at which point a representative of the bank wrote to the probate attorney and expressed concern over the lack of "lack of Crummey provisions" in the trust document.

The court found that the trustee "had no duty to review the trust to ensure its effectiveness as an instrument to avoid estate taxes," since "the trust instrument did not assign this responsibility to the trustee and the trustee did not draft the trust." However, the court agreed that the trustee "breached a duty" to the grantor by continuing to direct her to contribute to the "trust to save estate taxes after it realized the trust was defective." The court found that both the trustee and attorney were financially liable for the additional estate tax costs.

Key Lessons from the Hatleberg v. Norwest Bank, Wisconsin: While it is reassuring that a trustee is not to be held liable for a poorly drafted document that hinders the goals of the trust, it is clear that once alerted to an issue regarding the document, a trustee bears a responsibility to alert the grantor and beneficiaries, and can be held liable for potential damage. The case also points out the need for the proper administration of the Crummey provision when present, since a challenge to the use of an annual exclusion could subject the ILIT to estate taxes, as in this case.

Paradee v. Paradee was a 2010 case filed in Delaware, in which the trustee and a non-fiduciary family member were found liable to the beneficiary because of a trust transaction. According to court documents, William Charles Paradee (Charles Sr.) set up a life insurance trust in 1989 for the benefit of his grandson (Trey), the son of his estranged son, (Charles Jr.). The policy, which was a single pay survivorship policy, insured Charles Sr. and his second wife, Eleanor. Charles Jr. worked in the family business, but due to familial disagreements, the business was divided, and a portion of it was run by Charles Jr. as a separate entity. Charles Jr. believed his father's second wife "turned his father against him, and he felt slighted by the small portion of the company he received." His father believed that he was betrayed by his son, and that his son "received far more than he deserved."

The initial trustee of the ILIT was the agent who sold the policy, who over the years had "generated significant business" from the family firm.

Three years after creating the trust, the Paradees instructed the agent/trustee to revoke the trust. Trey, who sued in the case, believed that his step grandmother, Eleanor, was the "driving force" behind the request. His grandfather had suffered from heart issues, and began to slip mentally, at which point Eleanor had taken over their financial affairs. Eleanor said the family business needed the cash from the policy to pay unexpected back taxes, though there were significant other assets to draw upon.

After receiving the request to surrender the policy, the trustee/agent reached out to the family attorney that had drafted the trust document, who consulted with Eleanor and told her the Paradee family could not access the policy's cash value by revoking the trust. Eleanor asked whether the trust could loan the money, and after the attorney discussed the idea with the trustee/agent, a loan was made, but only after an outside attorney cautioned the loan could be made only if terms were "comparable to those which a commercial bank would offer," with security "equal to 125% of the loan." A loan was obtained on the policy at an interest rate that was higher than the rate charges to the trust. Interest was paid on the loan, but Eleanor again asked for the policy to be surrendered. The request was denied and soon after, Charles Sr. passed away. Per the court documents, "the Trust had the right to recover the principal and interest due," but the trustee/agent "made no effort to collect."

Shortly after his grandfather died, Trey turned thirty which meant that he was "entitled to serve as trustee." Although this was specified in the trust document, no one informed Trey of his right.

In the ensuing years, Trey and his Eleanor grew apart, the original trustee/agent passed away, and Eleanor appointed herself trustee of the trust. Interest was not paid on the policy and the policy lapsed. Shortly thereafter, Eleanor resigned and appointed a family handyman as trustee. Eventually, because of the new trustee's insistence, Trey was finally informed of his rights by the drafting attorney. After becoming trustee, he demanded the loan be repaid, and it was paid back.

The court declared that the original trustee who sold the policy breached his fiduciary duty and was "aided and abetted" by Eleanor. The trustee was "under a duty to [the] trust beneficiary to administer trust property solely in the interests of the beneficiary," but when deciding whether to allow a loan from the trust, he did not evaluate "what was in the best interests of the Trust, he evaluated whether he could please his long-time clients."

Eleanor was also found liable as the "conduct of one who knowingly joins with a fiduciary . . . in breaching a fiduciary obligation, is equally culpable." She was held liable for over $1 million, with additional awards shared by Eleanor and the trustee.

Key Lessons from Paradee v. Paradee: While this case involved a non-corporate trustee, the findings of the court rings true for corporate trustees who hold a higher standard of care than non-corporate trustees. Often the grantor of a life insurance trust has other, more profitable, business dealings with the trustee, but the value of that business cannot sway the trustee from following required duties to "administer trust property solely in the interests of the beneficiary." The grantor requests must not damage the assets of the trust, or the trustee could be held liable. Family squabbles, second marriages, failing physical and/or mental health of the grantor are all red flags that signal a trust requires special diligence. The failure of a life insurance trust often comes, not because of the poor performance of a policy, but because of the poor performance of those surrounding the trust. Advisors and even family members can sometimes get caught up in litigation, but the trustee will always be the central figure in any lawsuit.

Rafert v. Meyer was a breach of trust case that found its way to the Nebraska Supreme Court in 2015, in which the trustee's action, or lack thereof, was not held defensible because of exculpatory language in the trust document.

Jlee Rafert had her attorney draft an Irrevocable Life Insurance Trust in 2009 that contained three policies totaling $8.5 million in death benefit. The attorney named himself trustee. According to court documents, Article II of the trust instrument provided "that the trustee had no duty to pay the insurance premiums, had no duty to notify the beneficiaries of nonpayment of such premiums, and had no liability for any nonpayment."

The drafting attorney, as trustee, signed applications for all the policies in the trust. It is not known why, but on each application, he provided a false address in South Dakota as his address as trustee. Approximately $250 thousand in premiums were paid to start the policies, but subsequent premium and lapse notices were sent to the false address. Another $250 thousand in premiums was paid to the agent of record, but was not forwarded to the carrier. Per court documents, the beneficiaries did "not know what happened to the premiums." All three policies lapsed and a suit was filed by the beneficiaries alleging the trustee "breached his fiduciary duties as trustee" and as a direct result of the breach, "the policies lapsed, resulting in the loss of the initial premiums," as well as the monies paid directly to "a corporation owned by the agent."

The trustee cited the exculpatory language found in Article II as his defense, but the Nebraska Supreme Court disagreed. Citing "common law rules," the court stated, "as a general rule, the authority of a trustee is governed not only by the trust instrument but also by statutes and common-law rules pertaining to trusts and trustees." They found the trustee's defense "untenable," since it "challenges the most basic understanding of a trustee's duty to act for the benefit of the beneficiaries under the trust," the most fundamental duty being the protection of the trust property. The exculpatory language could not be relied upon to "abrogate" the trustee's duty to "act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries."

Key Lessons from Rafert v. Meyer: While we have seen, in some cases, that trust language can alter or even waive some trustee responsibilities, the fundamental duties of a trustee must be followed and exculpatory trust language will not necessarily provide protection. This case also points out some basic administrative guidelines. Review every life insurance application to verify all information is correct, especially if you are signing an application you have not personally filled out. Never provide a check for premium payment that is not made out to the carrier, and send all checks directly to the carrier.

Nacchio v David Weinstein and [illegible] is not a TOLI case, but should be one that every TOLI trustee should review, as t[illegible] case were deemed to be fiduciaries and the settlement awarded to the plain[illegible]

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Joseph Nacchio was CEO of Qwest Communications. Davis Weinstein was a longtime advisor who worked at AYCO, a subsidiary of Goldman Sachs. AYCO had developed an executive compensation plan that utilized life insurance as part of an "estate enhancement program (EEP)." According to the lawsuit, Weinstein encouraged Nacchio to take part in the program and he agreed and allowed Weinstein to "to implement all aspects of the EEP program."

According to Mr. Nacchio, based on Mr. Weinstein's suggestion he purchased two survivorship variable life policies with approximately $95 million of death benefit with a single payment of $4.5 million in 2000. At the time of purchase, it was assumed that the policies would run until age 100 assuming investment returns of 10.68% and 10.8% on the policies, respectively. In 2010, the policies were evaluated and it was found that they were underperforming and participation in the EEP program was discontinued at a cost of over $2 million in termination and legal fees and taxes. Mr. Nacchio and his wife moved ahead and purchased approximately $85 million in life instance coverage for a total premium of just under $27 million. The coverage that they obtained was single life coverage on Mr. Nacchio's wife, Anne Esker, since Mr. Nacchio, by this time was a convicted felon, having served prison time for insider trading of Qwest stock in 2007.

Mr. Nacchio and his wife filed suit in 2010 while Mr. Nacchio was still in prison. They alleged that their adviser, who testified at Mr. Nacchio's trial, had breached his duty of care to Mr. Nacchio and had a life insurance expert testify that Mr. Weinstein was a fiduciary under the Investment Advisers Act of 1940 and that based on his analysis the policies had a less than 25% chance of persisting until the insureds age 93, assuming the policy funding. The lawsuit alleged that Mr. Weinstein was negligent and deviated from an expected level of care.

The defendants had their own expert who testified that the EEP program identified the risks of the plan, and the fact that additional premium might be needed, a point that the attorneys amplified in the trial. They mentioned that not only were Mr. Nacchio and Ms. Esker informed of the issues, but their estate planning attorney was made aware also.

After a 75-minute deliberation, the jury awarded the plaintiff's $14.2 million dollars, which was the amount that would have been needed to purchase the coverage they thought they were getting in 2000.

Key Lessons from Nacchio v David Weinstein and the AYCO Company: While this case does not deal directly with a TOLI trustee, even the defendants' expert witness agreed that Mr. Weinstein was a fiduciary. Mr. Weinstein designed a life insurance program with an expectation of a 10.5% plus return over the life of the policies. And even though court testimony showed that he and representatives of AYCO met with the defendants at least quarterly, the jury found that the defendants deserved compensation of over $14 million dollars. This case should give a TOLI trustee pause and highlight the need when bringing a policy into their trust to disclose and document the expectations around the policy. It also highlights the need to make sure that the expectations are reasonable and that actual policy performance is monitored with documentation that all pertinent parties have been made aware

While guidance available to TOLI trustees is minimal, the information provided in these cases helps to illuminate proper and prudent trust administration and policy management procedures.