

Reinventing the Life Insurance Industry
through the application of the
Uniform Prudent Investor Act...

...Pulling back the curtain!



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Reinventing the Life Insurance Industry through the Application of the Uniform Prudent Investor Act... *...Pulling back the curtain!*

A New World Emerging

When reviewing existing or acquiring new life insurance, would you rather work with an agent legally bound to represent the carrier or a fiduciary legally bound to represent you? While the answer may seem obvious, until recently there was no decision to make. The only options available were to either deal with an agent who, by definition, is legally bound to represent the carrier or hire an outside consultant to act as your advocate and represent your interests. Fortunately, a third option is beginning to emerge.

Though still very rare, some insurance advisors are now structuring their practice to operate under the standards set forth in the **Uniform Prudent Investor Act (UPIA)** as their business model. Established for the investment and trust industry in 1994, the UPIA provides a set of criteria new to the life insurance industry. These include a fiduciary obligation to:

- put the client's best interest first and foremost
- minimize costs
- provide full transparency through the disclosure of risks, alternative products and designs, conflicts of interest, and compensation
- provide clearly articulated, documented criteria for the initial selection process and then a defined system for ongoing management.

Clearly, this is a dramatic change and is likely to forever alter the insurance distribution system for the ultra affluent and family office marketplace.

This shift is being driven by three primary factors:

- demand from more sophisticated advisors for a level of objectivity that requires transparency and disclosures
- the current economic upheaval which has rocked the financial industry creating demand for more openness
- judicial and legislative changes as a result of then NY Attorney General Eliot Spitzer's suits against Marsh McLennan, AON, and others

The Changing Face of the Insurance Representation

Until the 1980's, life insurance products were almost always provided through agents who were primarily associated with a single insurance company. The products themselves were almost exclusively either term or whole life. With the introduction of universal and variable life, many agents began to represent multiple carriers and present themselves as independent brokers representing the client rather than the insurance company. In reality however, most were simply acting as agent for each of the carriers.

This was the point made in the Spitzer suits against Marsh, Aon and others. A review of their marketing materials revealed claims such as:

“Our guiding principle is to consider our clients’ best interest in all placements”

“We are our clients' advocates and represent them”

“We do not represent insurance companies but the client”

“Our approach to client service begins with establishing credibility and trust”

“We are our clients’ trusted business partner, not simply an insurance agent”

In spite of their assertions of “client advocacy” they were found to be accepting additional undisclosed compensation and withholding and altering offers and product designs. Settlements from the three largest “client representatives” totaled over one billion dollars. As a result, while they may continue to offer verbal assurances or insinuations, most brokers have removed the above language from their written materials in hopes of avoiding the legal liability of being held to that standard.

For clarity, is important to distinguish among the types of representation available to the client:

Agent – legally obligated to act on behalf of the insurance company and contractually, obligated to provide that company's products before others. There is no obligation for transparency or disclosure, yet monetary incentives often exist to recommend a particular product type or design.

Broker – acts on behalf of client in obtaining most competitive coverage. In reality, many who hold themselves out as brokers are actually simply agents for multiple carriers. This is especially true in life insurance. Varying commission structures may create incentive to recommend certain carriers or to structure products in a specific manner. As with the agent, no transparency or disclosure is required.

Registered Representative – because variable life is considered both insurance and a security, it requires a higher level of disclosure, whether sold through an agent or broker. Product details are outlined in a prospectus as required by the Securities and Exchange Commission (SEC).

Fiduciary – is *legally obligated to represent the client and act in their best interest*. As such, a fiduciary must provide full transparency and disclosure regarding advantages, disadvantages and risks of products, structure, cost minimization alternatives, conflicts of interest and compensation. Thus, the fiduciary is held to a much higher standard and, in essence, becomes the client’s professional buyer and advocate.

Regardless of the form of representation, the client, especially if an Irrevocable Life Insurance Trust (ILIT) trustee, should require a written Letter of Engagement in which the representative clearly and very specifically defines their role. It should also outline the scope of the engagement and services to be provided and determine the representative’s compensation methodology. In other words, the engagement should be treated with the same level of dignity and clarity as other professional services.

A Need for Insight

Why is the fiduciary level of representation important? Numerous studies have shown the number one attribute family offices seek in an advisor is objectivity. To provide objectivity requires transparency and a conflict free process that aligns the interest of the advisor with those of the family. Similar attributes are sought by Multi-Family Offices (MFO’s) as they select outsource providers for specialized services.

The investment industry has responded to this over the past two decades shifting from a bundled, non-transparent, commission driven process that was fraught with conflict to today’s fee based, open architecture environment. Even larger Property & Casualty acquisitions have evolved into fee based structure in which commissions are minimized or removed from the product. Yet the life insurance industry continues to provide a confusing process in which product structure and pricing remain hazy at best and nearly every transaction creates potential for conflict between buyer and seller. While many consumers and advisors recognize the needs for or uses of life insurance, they dislike the process and distrust the product. Considering these conflicts, many agree that the life insurance representation model and process is ripe for a change.

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Consider the quandary of the trustee of an ILIT who, faced with the duties and liabilities of prudent asset management, is bombarded with contrary and irreconcilable claims made by competing agents. While the investment industry has developed quantifiable performance analysis with the object of limiting the ability of money managers to “game” their track record or present misleading performance results, the insurance industry doesn’t even bother to focus on past results, only future projections. However, since these projections are based on numerous, non-guaranteed assumptions, they can hardly be relied on except for fairly general comparisons. The lack of standardization in product structure, contract provisions, or carrier pricing coupled with the numerous subtle and

hard to determine nuances make accurate comparison difficult for those not actively engaged in the industry. Even then, since the majority of agents are compensated only to place new product, many lack the time, intellectual curiosity, or capacity to get inside the black box of policies themselves. So with the Prudent Investor responsibilities firmly on his back, how is the trustee to cope?

Adhering to a Higher Standard

While the Uniform Prudent Investor Act (UPIA) has set a standard for the trust and investment industry since 1994, it has rarely, if ever, been applied to the life insurance industry. Running counter to traditional practices of the life insurance industry distribution system, the UPIA tenants require the fiduciary:

- to put the client's best interest first.
- to identify and disclose all risk and conflicts of interest that arise in the selection of carrier, product, design and funding structure. (It should be noted that many products create wide latitude for the agent to manipulate client price by adjusting agent commissions.)
- to provide full transparency and disclosure without which the agent has little accountability.
- to minimize costs. Costs may be managed through carrier, product and design selection, limitations on commission, professional underwriting (for example, one medical rating level can have as much as a 25 percent impact on Cost of Insurance (COI)), and through professional ongoing management of the products themselves. This means there should be a clearly articulated process for systematic retesting, benchmarking and tweaking of the product as this can significantly impact the long term performance.
- To provide diversification of assets. In an ILIT, this applies to a diversification of carriers and product types. A product type decision can be equated to an investment style decision.

Overall, the UPIA standards serve to create a much more objective, transparent approach which more closely aligns the interests of the insurance representative, client and other advisors. While the process is likely to result in more efficient pricing, in many situations it is the transparency and disciplined process that both clients and advisors may find most useful. ILIT trustees in particular are likely to greet this alternative with open arms as it will make it much easier for them to carry out their duties and responsibilities as prudent asset managers, not only in the initial analysis and acquisition, but with ongoing oversight and management. Adherence to UPIA by the insurance representative

creates much greater assurance all the client's advisors are abiding by the same guidelines and sharing the same interest.

ILIT Trustee: Duties and Liabilities

Traditionally, some have dismissed the duties of the ILIT trustee as little more than administrative, fulfilling tasks such as distribution of Crummey notices and paying premiums. The grantor typically took the initiative to select the insurance representative and product, and only involved a trustee at the time of application. But as a result of increased regulatory pressure, greater awareness of fiduciary responsibilities and increased fiduciary litigation, many are now recognizing that the trustee of an ILIT is subject to the same standards as for other trusts. Many institutions who have traditionally accepted ILITs as loss leaders for other business and thus charged only a nominal fee have eliminated this practice. Others have stopped accepting ILITs altogether unless tied to other investment oriented relationships.

This created a move to “friendly” trustees such as family, friends and business associates. While they typically “serve” for free, most lack qualifications for the role and unknowingly risk personal liability. The grantors’ words of assurance are unlikely to

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provide adequate liability protection should either the grantor or beneficiaries later have reason to find fault. If the trustee is listed as the insurance purchaser, he bears full liability for the acquisition of that asset. In addition, these trustees often rely on recommendations of the grantor’s insurance agent who is not bound by, and is often unfamiliar with the fiduciary standards imposed on the trustee. This creates a very real fiduciary problem as the agent, no matter how big a spreadsheet or how nice a presentation, is, by legal definition, representing the carrier. Thus, the trustee is standing very alone from a legal perspective.

While earlier trust law originally envisioned a two tiered system with institutions held to a higher standard than friendly trustees, UPIA does not distinguish between the two as to the standards under which performance is to be evaluated.¹ This “represents a departure from traditional trust law and would have created a patent unfairness for non professional trustees, but for the delegation option which became an equalizer for the various performance skill levels of professional and non professional trustees.”² Considering the responsibilities and high level of accountability of the ILIT trustee, it is no wonder some are rethinking their willingness to serve. Trustee duties include, but are not limited to:

- performing pre-purchase analysis of the life insurance

¹ Ballson, Collins and Jurkat, “Trust Administration of Life Insurance”, ACTEC Journal (2006)

² Reif, Frank, J. III, “Life Insurance Planning Techniques”, ALI-ABA Course of Study Materials (1999)

- determining the appropriateness, merits and disadvantages of the uses of life insurance for this particular situation or purpose
- measuring financial risks and rewards of insurance overall and of specific products being considered
- investigating and analyzing policy type, design and options
- determining reasonableness of product illustrations
- evaluating carrier financial status
- creating a written investment policy and management statement
- monitoring, evaluating and managing the insurance portfolio
- creating diversification among carriers and product types to avoid concentration of carrier financial or present product risks

Informed trustees may seek some type of protection, including liability insurance or indemnification from the grantor, and may be well advised to seek independent legal counsel. In addition, they may be wise to delegate certain duties such as analysis, acquisition, and management of the insurance, as well as documentation of due diligence of each phase, to a qualified third party.

Delegation of Duties and Liabilities

“Regardless of whether a family/friend or professional acts as trustee of an ILIT or other trust holding life insurance, the UPIA standard means that a trustee is expected to possess a sophisticated knowledge of the life insurance industry, insurers, policy types and finance in general. More specifically, an ILIT trustee is expected to have the ability to evaluate the policy issuer; the current and prospective economic viability of the life insurance policy; the likelihood of the policy proceeds satisfying the objectives and needs of the trust and its beneficiaries, and competing insurance products.”³

Fortunately the trustee can delegate certain duties where it is determined there is a need for specific professional advice.⁴ In order to delegate, a trustee must abide by certain standards in the selection of the third party and then monitor that party’s performance throughout the term of delegation.

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Clearly the selection criteria and process are critical and must be well documented. Obviously the third party must possess expertise with regard to the insurance industry, its carriers and its products. In addition, he should provide written documentation which clearly defines the trust’s goals, criteria for investment and carrier selection, and a formal program for ongoing policy management. While not required, the selection of a third

³ Harris and Prince, “The Problems With Trusts Owning Life Insurance”, Trusts and Estates (May 2003)

⁴ Uniform Prudent Investor Act of 1994, Section 9, also The American Law Institute, “Restatement (third) of Trusts” (AKA Prudent Investor Rule), section 227

party advisor who is also acting as a fiduciary, with an obligation to put the client's best interest first, provide full transparency, and minimize costs, better aligns the interests of the trustee, third party advisor and grantor. It also assures that the trustee and third party are abiding by the same set of rules which is likely to enhance trust and minimize future conflict.

The following reports should be written to memorialize expectations, identify responsibilities of each party and set specific time lines for each step of the process. The purpose of this documentation is to bring a level of professionalism and discipline to the process of analyzing, acquiring, and managing a life insurance portfolio. Topics that should be addressed include:

- **Engagement Agreement**
 - Establish level of representation of insurance advisor: agent, broker or fiduciary
 - Establish scope of the engagement and services to be provided
 - Identify and resolve potential conflicts of interest of the insurance advisor
 - Establish compensation methodology
 - Clarify roles of the trustee, grantor, attorney, insurance advisor, and other professional advisors involved in the process
 - Establish termination causes and procedures

- **Life Insurance Design Questionnaire™** - to identify and clearly define:
 - Goals of grantor and trust
 - Purpose of coverage
 - Time horizon for the coverage
 - Risk tolerance of the grantor and trust
 - Premium tolerance and gifting limitations

- **Create Policy Management Statement**
 - Selection criteria for carrier, product and design features (similar to Investment Management Statement used by investment firms)
 - Guidelines for carrier and product diversification, asset allocation, specific fund selection (if variable life), and periodic rebalancing

- **Comprehensive Market Analysis**
 - Underwriting process, procedures and results
 - Analysis of products and designs available to meet specific goals
 - Consideration of ownership structure and various premium funding options

- **Product Review and Monitoring Procedure**
 - Type and frequency of reporting

- Maintenance of records such as policies, annual reviews, Crummey notices, etc.

Unlike due diligence for most trust assets, the selection and management of life insurance has traditionally not been held to the same standard as other financial decisions and certainly not to the level mandated by the UPIA. The acceptance of this standard and implementation of the initial and ongoing management system provides the trustee with consistent, clear and specific analysis and documentation to ensure professional management and optimization of the life insurance portfolio.

Summary: Creating Best of Class

Creating a life insurance advisory firm that adheres to the fiduciary-based criteria defined in the Uniform Prudent Investor Act (UPIA) redefines “best of class” and dramatically raises the standards for true “client representation” in the insurance industry. The adoption of these standards actually creates a watershed moment as insurance representatives will no longer be able to hide behind the veil of ambiguity as to:

- Whether they represent the client or carrier and to whom their duty lies
- Accountability regarding conflicts of interest that could influence the selection of the carrier, product and design
- Risks and compensation imbedded in the product and how they can be minimized to create greater assurance and pricing efficiency

Family Offices in particular have long requested the same level of transparency for life insurance as they expect and demand for virtually all other financial tools and transactions.

While transparency and disclosure are the right step toward professionalizing the analysis, acquisition and management processes, they still require the discipline of formal written agreements and of a clearly defined performance reporting process. This not only provides a level of representation that is unique in the industry, but provides trustees, whether institutions or friends and family, with a clearly articulated set of standards and criteria by which they can document and benchmark their decisions. This will serve to both minimize their fiduciary liabilities and provide everyone involved with a comfort and depth of understanding that is rarely found with life insurance issues.

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Perhaps, like open architecture in the investment world, this will one day be commonplace in the insurance industry. Until then, it will behoove sophisticated families

and their advisors to seek those few insurance representatives willing to accept fiduciary level duties and raise their standards to those set forth in the UPIA.

February 3, 2009

Footnotes:

1. Ballson, Collins and Jurkat, “Trust Administration of Life Insurance”, ACTEC Journal (2006)
2. Reif, Frank, J. III, “Life Insurance Planning Techniques”, ALI-ABA Course of Study Materials (1999)
3. Harris and Prince, “The Problems With Trusts Owning Life Insurance”, Trusts and Estates (May 2003)
4. Uniform Prudent Investor Act of 1994, Section 9, also, The American Law Institute, “Restatement (third) of Trusts” (AKA prudent Investor Rule), section 227

Michael J. Brink, CLU, AEP and Thomas R. Love, CLU, FLMI, are principals of PELAGOS ADVISORS, LLC, a fiduciary based life insurance advisory firm. PELAGOS ADVISORS, LLC was founded to provide families of significant wealth and their advisors with a level of objectivity and representation unique in the life insurance industry. As such, they abide by the standards set forth in the Uniform Prudent Investors Act (UPIA) and legally bind themselves to put the client’s best interest first. This, coupled with their documentation systems, has been designed to provide ILIT trustees with the due diligence tools necessary to delegate both the responsibilities and liabilities of their role.

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