ILLUSORY INSURANCE TRUSTS AND THE DECEPTIVE MARKETING OF HEALTH INSURANCE

By Tim Ryles, Ph.D.

Trusts are common in a variety of insurance arrangements, but when asked to review a filing for a “trusteed product,” regulators rarely verify existence of a legitimate trust. After all, regulators are schooled in insurance regulation, not trust law. This article describes why health insurance products marketed through trusts, usually under the umbrella of discretionary groups, may be detrimental to consumers.

The Marketing Scheme

Consider the following arrangement. An insurer (acting as “settlor” or “grantor”) develops a trust agreement naming a bank as trustee; the trustee’s only express duty under the trust agreement is to “hold” a health insurance policy issued to a trust; once a policy is issued, the bank-trustee serves as the nominal Master Policyholder; all administrative and discretionary duties are retained by the insurer; the trustee as master policyholder plays no role in negotiating the terms or conditions of coverage, pays nothing for the insurance policies it holds, never communicates with insureds, and sets no performance goals for the insurer. Premiums are set by and go directly to the insurer, not to the trustee; when new mandated offerings are added in a state, the insurer either rejects them on behalf of insureds or orders the trustee to do so. The trust has no board of directors, and insureds, whether individuals, families or small employers, have no say in how the trust is governed.

The trust has no members upon its creation, but the trust agreement states that the trust is created for the benefit of some yet-to-be formed group. The insurer recruits agents and markets a health insurance policy, representing that it is selling group insurance to individuals. Consumers enrolled in the “trust” insurance product receive certificates, not insurance policies. The certificate states that it is not a contract of insurance.

My contention is that such an arrangement is not truly a legitimate trust and that it defies key principles of group insurance.

STANDARDS FOR DETERMINING A TRUST’S LEGITIMACY

According to a leading authority on trusts, “a trust is a fiduciary relationship in which one person is the holder of the title to property subject to an equitable obligation to keep or use the property for the benefit of another.” (Bogert, p. 1) Beneficiaries have equitable title to trust property. “Equitable title” is “a title that indicates a beneficial interest in property and that gives the holder the right to acquire formal legal title,” according to Black’s Law Dictionary.

Alabama is a popular venue for trusteed insurance products. According to that state’s Supreme Court in Coosa River Water, Sewer and Fire Protection Authority v. Southtrust Bank of Alabama, et al., 611 So. 2d 1058 (1993)
there are five elements of a valid trust:

1. The existence of a trustee,
2. The existence of a beneficiary,
3. Some type of trust property, not a relationship involving merely personal duties,
4. The passing of title of the property to the trustee to hold title for the benefit of another; and grantor has parted with total control over the property of the trust,
5. A manifestation of intention to create an express trust relationship.

Given these elements of a bona fide trust, the scenario described above falls short of satisfying the essential elements for several reasons. I examine these shortcomings below.

Standard: The existence of a trustee.

Under the trust agreement, the bank is trustee in name only. Its only responsibility is to “hold” an insurance policy, meaning that its true role is that of bailee, not trustee. A bailee is “a person who receives personal property from another as a bailment.” (*Black’s Law Dictionary*)

Standard: The existence of a beneficiary.

Theoretically, the trust’s beneficiaries are the certificate holder-insureds. Yet, to the extent that anything of value is generated for the arrangement, it is derived from premium dollars paid by the beneficiaries. Hence, to the extent that beneficiaries exist, they do so only as certificate holders of insurance policies.

Standard: Some type of trust property, not a relationship involving merely personal duties.

Since premium dollars pass directly to the insurer, bypassing the trustee, there are no trust assets. Hence there is no trust property.

Standard: The passing of title to the trustee.

Because the bank-trustee merely holds the insurance policies as bailee, no title to the policies passes to the bank itself; hence the arrangement fails this standard.

Standard: Grantor has parted with total control over the property of the trust.

Since there is no property in the trust, this standard is not satisfied; however, the grantor/insurer not only fails to relinquish control over the property but also retains absolute control over the administration of it, assuming the trustee’s discretionary duties. According to Bogert, (pp. 328-329), discretionary duties requiring the use of skill or judgment are non-delegable.

The trust marketing scheme outlined above fails to satisfy the commonly recognized elements of a trust. Consequently, when an insurer informs a regulator that a policy is issued to such a “trust,” the representation is simply false; instead, what the insurer created is an “illusory trust,” described by *Black’s Law Dictionary* as “an arrangement that looks like a trust but, because of powers retained in the settlor (grantor), has no real substance and is not a completed trust.” In effect, though, the insurer uses the illusory arrangement to issue a group master policy to itself, falsely representing that there is a trustee or some other entity standing between the insurer and the insureds. This negates the principles of group insurance, including effective elimination of a master policyholder.

The Maryland Court of Appeals confronted just such an arrangement in 1982 in *The Guardian Life Insurance Company of America v. Insurance Commissioner of the State of Maryland et al.* (293 Md. 629), concluding, “The trust … is essentially one in name only, an artifice which serves no legitimate purpose…. In actuality, because Guardian itself is in total control of the...”

(ILLUSORY, continued opposite)
(ILLUSORY, continued from opposite)

accurately saw a form-over-substance arrangement.

Substituting itself for the master policyholder also renders an insurer vulnerable to charges of self-dealing and inherent conflict of interest on such key factors as premium setting, underwriting, claims handling, deductibles, contract amendments, renewals and benefit structures.

Some states not only abolish illusory trusts, but declare that any assets pass directly to the beneficiaries. (Bogert, p. 170)

Viewed from another perspective, since the insurer goes to great lengths to fabricate a marketing mechanism, part of which is the voluntary assumption of a trustee’s fiduciary duties, the insured-insurer relationship is perhaps unwittingly altered. Since a trustee owes a duty of loyalty to beneficiaries “to administer the affairs of the trust solely in the interests of the beneficiaries and to exclude from consideration his own advantages and the welfare of third persons” (Bogert, 341), arguably an insurer that voluntarily assumes a trustee’s duties creates a fiduciary relationship with policyholders.

Whether the entire scheme positions the insurer as a fraud or as a fiduciary presents an interesting conundrum. (On this point, see the July 23 Order of the trial court judge in Betty J. Wendland, et al. v. Insurance of America Agency, et al. in the District Court of Travis County, TX, Cause No. GN-00-3014. The order finds a fiduciary relationship between an insurer and insureds where the National Business Association in an association plan assigned fiduciary duties to the settlor/insurer. The structure of the plan parallels the example cited here.)

CONCLUSIONS

The use of illusory trusts as a marketing device should serve as a red flag for regulators, compliance professionals and attorneys representing insureds. If the trust fails to satisfy the definition of a trust, it is a misrepresentation to state otherwise; if the trustee lacks independence from the settlor/insurer, conflicts of interest are inherent in the plan design; if the group is a discretionary one, most likely it is not substantially similar to any of the eligible groups to which master group contracts are issued; and if the insurer assumes discretionary duties of the trustee, the insured-insurer relationship may be that of a fiduciary one. Finally, banks or other entities that act as “trustees” under such arrangements may be liable for assisting in the formation and execution of a fraudulent insurance scheme.

REFERENCES


Tim Ryles, Ph.D., is an associate consultant with Robert Hughes Associates, Inc. He is the former Georgia Commissioner of Insurance, Fire Safety, Industrial Loans and Comptroller General.
The RHA Review is published quarterly by Robert Hughes Associates, Inc. — an independent international litigation support, actuarial, risk management and insurance consulting company based near Dallas, Texas, with offices in Houston, Texas, and London, England. The purpose of this publication is to offer insurance-related information and critical comment pertinent to the clients, friends and fellow professionals of Robert Hughes Associates, Inc. This publication is available free to interested parties. The information contained in this publication is intended to be general in nature; readers should obtain professional counsel before taking any action on the basis of this material.

For more information, contact
John R. Oakley, Editor
508 Twilight Trail, Suite 200
Richardson, TX 75080
Tel. (972) 980-0088.

Copyright © Robert Hughes Associates, Inc., 2003. All rights reserved.