

THE LAPSING TOLI POLICY CRISIS – THE NEED TO DO SOMETHING

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April 29, 2014

Fiduciary Inattention Disorder (FID) is a problem specific to the unskilled ‘Accommodation’ trustee of an Irrevocable Life Insurance Trust (ILIT) and it has reached epidemic proportions. The reasons can be easily understood but, to date, there seems to be no remedy or cure for this condition. This article concludes a 4- - part series and intentionally uses humor to explain why the Trust- - Owned Life Insurance (TOLI) lapsing policy crisis exists. We wrap- - up with a cure that can safeguard the interests of all ILIT parties.

FID was first diagnosed in the late 1970s and early 1980s following carrier introduction and aggressive agent marketing of flexible premium non- - guaranteed death benefit adjustable life and universal life products. CD rates were 14%, AAA bond yields 16%, and these new products were illustrated with 16% crediting rates, in comparison to 6% to 8% for traditional fixed premium guaranteed death benefit products sold by these carriers. These new policies were marketed as “buy term and invest the difference” bundled policies. Along with the policies came illustrations that calculated policy values never to be realized, and an agent marketing era often referred to as ‘win the illustration beauty contests’.

The underlying symptom of FID is life insurance confusion which is perplexing. Fiduciaries, their professional advisors and affluent insureds are smart people, and most own personal life insurance policies. How can a lapsing TOLI policy crisis exist and smart people still be so confused about how it happened and what to do?

Based upon FID extensive research, there are several reasons for confusion:

- The buyer had no idea what terms such as ‘flexible premium’ and ‘buy term and invest the difference’ meant.
- The buyer had no idea the policy death benefit was not guaranteed and the buyer retained policy performance risk. Moreover, they did not know and were not specifically told of the risks to be monitored or where to find the tools to do so.
- The buyer listened to the ‘invest the difference’ sales pitch, yet was told these products were not investment products but rather life insurance products. Whatever this comment was supposed to mean, they relied upon the ‘as sold’ illustration, and its high crediting rate at the time of policy purchase, as the expectation for future premium payments to sustain death benefit coverage to the insured’s death. They had no idea it was meaningless in regard to predictive value planning and decisions.

- Variable Universal Life Insurance was introduced in the mid- to - late 1980s and marketed as an ‘investment- linked’ life insurance product but considered an investment whereas Adjustable Life and Universal Life were life insurance. (Add Indexed Universal Life to this discussion and the confusion compounds.)
- The buyer/grantor usually assumed the attorney who drafted the ILIT would understand the product issues and assist the ‘Accommodation’ or Corporate Trustees in determining how the asset should be managed. However, the grantor did not provide a guidance letter as to why the policy was purchased or what periodic performance review expectations should be considered.
- The sales agent was an informational resource at the time of policy acceptance by the trustee but did not have contractual customer service duties thereafter.

So, pulling these introductory comments together, we know there is a lapsing policy crisis due to FID and, despite the best of intentions, confusion as to what to do persists and its adverse implications escalate. Is there a cure?

In our February 1, 2014 article, “The Importance of Monitoring and Evaluating Life Insurance Policy Performance”, we discussed the lapsing flexible premium non--guaranteed death benefit crisis and the ‘do nothing’ confusion frequently demonstrated by Accommodation ILIT trustees. In our March 1, 2014 article, “The Importance of Developing and Documenting a Prudent Risk Management Process”, we discussed why corrective action is needed and the essential role played by a TOLI Investment Policy Statement (TIPS). In our April 1, 2014 article, “The Importance of Getting It Right – Knowing and Performing Your Fiduciary Responsibilities”, we discussed how to eliminate the responsibility- - capability gap by delegating the ‘Get It Right’ life insurance and policy evaluation expertise functions, and avoiding the continuation of a ‘Keep It Wrong’ process (or lack thereof).

We reminded readers that the duty of a trustee is to maximize the probability of a favorable outcome to the trust estate, noting that the question of whether a breach of trust has occurred turns on the prudence of the trustee’s conduct, not on the eventual results of investment decisions. Said differently, it is necessary for an ILIT trustee to demonstrate a prudent and reasoned process.

The Cure

After 20 years of forecasting a lapsing policy crisis due to inattention, it seems obvious that ‘Getting Started’ is no small undertaking ... or is it? The first curative step involves taking inventory of the following:

1. Does the policy remain suitable for the trust’s purpose set out in the TOLI Investment Policy Statement (TIPS)? If a TIPS does not exist nor a Grantor Guidance Letter, then TIPS must be added to the ‘to do’ checklist.

2. Are scheduled premiums adequate to sustain the policy to contract maturity of insured life expectancy as a minimum? If this question cannot be answered, it must also be added to the 'to do' checklist.
3. Have the underwriting carrier's third- - party ratings deteriorated? If this question cannot be answered, it is another item for the "to do" checklist.
4. Are trust administration and policy costs reasonable and appropriate? This question must either be answered or added to the "to do" list.
5. Have ILIT gifts, Beneficiary Crummey Notices, and premium payments been administered in accordance with trust documents and fiduciary law? If this question cannot be answered, it must be added to the 'to do' checklist.
6. Does the trust file contain:
 - A signed copy of the trust agreement.
 - A policy contract and a signed copy of the 'as sold' policy delivery illustrations.
 - A current TOLI Investment Policy Statement.
 - A Grantor Guidance Letter or attorney memo providing guidance at the time of policy issue concerning the policy purpose and long- - term performance expectations.
 - Carrier and product suitability evaluation prepared and signed by the writing agent at the time of policy issue.
 - Copy of annual performance monitoring reports.
 - Copy of annual beneficiary communication.

This inventory determines the extent of FID and sets out the next step priorities, recognizing that policy lapse avoidance is of the highest priority.

If the trust file is empty and none of the questions can be answered positively, it demonstrates the worst case of FID, but also the easiest situation to remedy. The next step (for which there is no option) is to engage a fee- - based experienced TOLI consultant to coordinate and gather all needed trust file documentation, address the above questions, obtain a credible policy evaluation and assess carrier, product and policy suitability relative to the current trust objectives. It is likely that policy replacement will be a consideration; hence, this consultant should have the expertise to recommend product types suitable for current objectives and should coordinate a Request for Proposal process among commission- - compensated life insurance agents selected by the insured or insured's family members.

It is important to differentiate between an experienced fee- - based TOLI consultant and a commission- - motivated life insurance agent. The consultant works for the trustee and can play an ongoing role in maintaining a prudent process to avoid FID problems in the future. The agent serves a transactional role. Said differently, FID and the current lapsing policy crisis is due primarily to a misunderstanding of the agent's role. An agent plays a key role in the policy placement process and can assist with periodic policy information

needs, but all the other prudent process activities are the responsibility of the trustee/TOLI consultant.

As mentioned, the worst case of FID is the easiest to remedy. Often some of the 6--
- point information exists but it is not necessarily helpful in setting out a prudent and reasoned process going forward. A TOLI Investment Policy Statement (TIPS) is the critical document that establishes this process and how it will be informed (see March article for an in- - depth TIPS discussion).

The trust agreement warrants review to determine if it contains a trustee 'hold harmless' provision. Remember, the trustee has the sole responsibility for managing the trust asset. If the trust has a hold harmless provision and the trustee lacks life insurance product and policy evaluation expertise, how will the carrier, product and policy suitability issues be addressed and managed? And, if the policy un- - necessarily lapses, what is the trustee's liability other than possibly reputation? The 'hold harmless' issue is a hurdle that must be addressed.

In summary, FID has reached epidemic levels but a cure exists and is readily- - available. ILITs remain a cornerstone of sophisticated estate liquidity planning and multi--
- generational wealth management. The broad range of life insurance products available today for both death benefit and investment planning are ideally suited for trust--
- ownership. But, all these products, including fixed premium guaranteed death benefit products, require annual or periodic management attention. Returning to the lapsing TOLI policy crisis, lapse as well as lapse avoidance is a trustee as well as grantor family choice. Intervention should not be avoided and is often necessary.

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