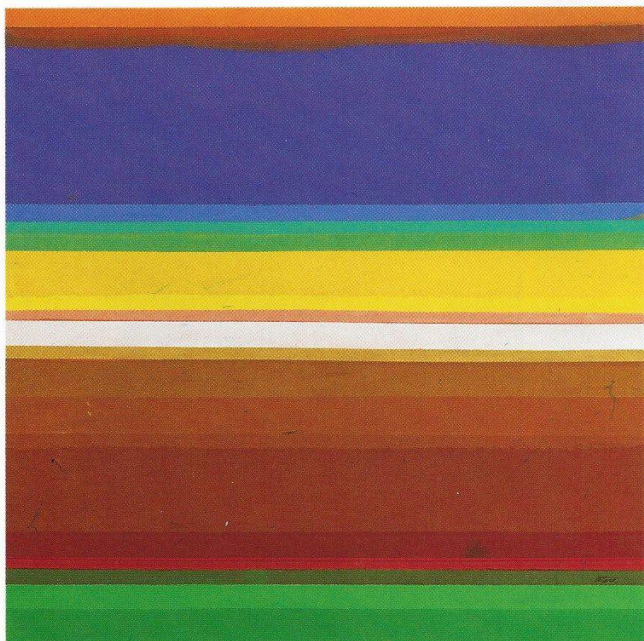


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How to Relieve the Plight of Unskilled Irrevocable Life Insurance Trust Trustees Unfamiliar with Their Duties

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Abstract: Irrevocable life insurance trusts (ILITs) have been a cornerstone of sophisticated estate liquidity and wealth management planning for over 40 years. State Uniform Prudent Investor Act (UPIA) provisions generally place fiduciary-level responsibilities on trustees—whether skilled or unskilled—yet there remains a “disconnect” between ILIT duties and trustee activities. This article explains how this disconnect can be resolved and the form this process should take to protect the interests of all ILIT parties.

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It is estimated¹ that the majority of in-force trust-owned life insurance (TOLI) policies are managed by unskilled trustees, typically family members, friends, and advisors of the irrevocable life insurance trust (ILIT) grantor. Unskilled² trustees are more commonly described as amateur, accommodation, or do-nothing trustees because they usually lack awareness of their duties, life insurance product expertise, and dispute defensible policy evaluation capabilities. However, an unskilled trustee does have a duty to take reasonable steps to obtain sufficient competent advice, guidance, and assistance. This article sets out how these steps can be taken in a form that maximizes the probability of a successful outcome to the trust estate, and documents a prudent and reasoned process.

The TOLI policies primarily at risk today are those purchased in the 1980 to 2000 time period—flexible-premium nonguaranteed death benefit adjustable life, universal life, and variable universal life policies. These product types contractually transfer performance risk from the carrier to the policyowner/trustee. The policy illustration disclaims predictive value, as its purpose is only to depict how the policy works. The illustration shows an annual premium based upon current assumption nonguaranteed crediting rates and policy charges; however, as current rates and charges change, it is the responsibility of the policyowner to adjust the scheduled premium in order to achieve originally illustrated policy values. Also, the illustration shows policy sustainability based upon the policy's guaranteed minimum crediting rate and maximum policy charges, which frequently indicates payment of the current assumption

scheduled premium will result in policy lapse during the insured's lifetime.

What does this mean? Assume at policy issue the current crediting rate was 12 percent and today the current crediting rate has declined to the 4 percent guaranteed minimum. Further, assume that the carrier cannot earn 4 percent on invested reserves and, hence, increases the current charges to make up the difference. Unless the policyowner/trustee is annually or periodically increasing the annual premium payment, the policy is likely to lapse during the insured's lifetime. This simple example explains the current lapsing policy crisis³ due to inattention and lack of appreciation of the need to monitor policy performance.

Intervention is needed and its form should be dispute defensible.⁴ A number of TOLI myths persist and frustrate the TOLI market segment represented by unskilled trustees, such as the belief or understanding that all life insurance products are fixed-premium guaranteed death benefit policies—simply pay the scheduled annual premium and the death benefit will be paid upon the insured's death. These myths, summarized later in this article, need to be dispelled and replaced by a prudent, time-tested process that safeguards the interests of all ILIT parties.

Such a process does exist. Skilled ILIT trustees, with the benefit of regulatory oversight and litigation guidance, have developed an ILIT administration and TOLI risk management process that can serve as a model for unskilled trustees, with one exception: the credible evaluation of flexible-premium nonguaranteed death benefit policies (universal life, variable universal life, and indexed universal life). Life insurance is a “buy-and-manage” financial asset typically purchased for a 10- to 50-year time horizon. Carriers and their contracted agents provide the “buy” function, but the “manage” function is missing. However, credible policy performance monitoring evaluation is available. Skilled and unskilled fiduciaries can integrate this essential asset management component into their risk identification and mitigation process and avoid either an empty ILIT file or one papered with meaningless analysis that documents an imprudent process.

Intervention should recognize that a trustee has a duty to the trust beneficiaries to maximize the probability of a favorable outcome to the trust estate. An ILIT involves the interaction of a number of parties—trustee,

grantor, beneficiary(ies), grantor's legal and tax advisor(s), life insurance carrier, life insurance producer, and third-party vendors—with different responsibilities and loyalties. As a result of intervention, the ILIT trustee and beneficiaries or their representatives should understand the specific role and expertise of each party. If the trustee lacks life insurance product expertise and the ability to evaluate policy performance, the trustee has a duty to delegate these functions. In turn, vendor “due diligence” screening and selection should be based upon a Request for Proposal setting out service expectations so that the trustee can document informed carrier suitability, product suitability and policy risk management determinations, and a dispute defensible annual performance monitoring process.

The TOLI Risk Management Hurdles

The first hurdle facing any ILIT trustee administering an in-force policy is to understand why the policy was purchased, identify the risks to be managed, and determine the credible tools available to manage these risks. Since the policy purchase decision is usually made by the grantor and his/her trusted life insurance producer, grantor guidance is needed, especially if the trustee is an unskilled accommodation trustee. If available, such guidance should take the form of a grantor guidance letter, typically prepared at the time the policy was purchased and the ILIT funded.

The second hurdle is avoiding policy lapse. Between 1980 and 2000, the life insurance product of choice was a flexible-premium nonguaranteed death benefit policy, such as adjustable life, universal life, and variable universal life. Performance risk was contractually transferred to the policyowner/trustee from the carrier. Most purchasers were not aware of this performance risk transfer, the risks to monitor, and credible tools to do so. In turn, without a grantor guidance letter, it is difficult to imagine a trustee understanding the scope of needed risk management, especially an accommodation trustee who lacks life insurance product expertise. It should be noted that approximately 40 percent of in-force flexible-premium nonguaranteed policies are carrier-illustrated to lapse during the insured's lifetime or within five years of the insured's estimated life expectancy.

ILIT and TOLI Myths to Dispel

To maximize the probability of a favorable outcome to the trust estate, the action to be taken must address and dispel ILIT myths. For example, if the accommodation trustee arrangement includes “hold harmless” protection for doing nothing, how can the trustee maximize the probability of a favorable outcome to the trust estate? Aren't the beneficiaries better served to request resignation in favor of a successor trustee who can provide the expected standard of care? Other myths to consider:

- *An ILIT is a “dry” trust requiring no attention until the insured dies and the trust receives the death benefit proceeds.* Most ILITs own flexible-premium nonguaranteed policies, meaning performance risk and its annual monitoring are the responsibility of the trustee. Unless this performance monitoring and risk management are provided, there is a reasonable probability the trust will be “dry” because the policy has lapsed.
- *ILIT trustees should not be compensated and fees should not be paid for periodic carrier and policy monitoring.* While this myth is no longer an issue with skilled trustees, it remains a hurdle with unskilled trustees, who must rely upon qualified third-party vendors to provide the expected standard of care. To implement a dispute defensible process using an experienced fee-based TOLI consultant, a one-time cost of \$2,000 to \$3,000 should be expected. Thereafter, a \$250 to \$500 performance monitoring fee, depending on policy type, should be expected for a fact-based policy performance review. Putting the annual trust investment monitoring fee in perspective, assume the trust investment is a \$1,000,000 death benefit policy and the performance report cost is \$500—the annual cost is less than one basis point of the investment amount. By comparison to a \$1,000,000 equities investment, the annual fee would approximate \$5,000 to \$10,000.
- *The selling life insurance agent of record is responsible for providing annual or periodic policy performance monitoring information.* The life insurance agent contractually represents the underwriting carrier and is responsible for policy sales and delivery requirements as set out in his/her contract with the carrier. Normally this contract does not include postdelivery policy service requirements.
- *The underwriting life insurance carrier is responsible for providing annual policy performance monitoring information.* The carrier is responsible to provide only an annual policy anniversary statement. The trustee can call the carrier's Customer Service department to review questions and request additional information, but most accommodation trustees are not familiar with the performance monitoring questions to ask or the additional information to request.
- *All carriers and all life insurance products are the same.* Carrier asset size, core business, and third-party rating should be evaluated annually, especially considering the 2008-2013 economic and financial institution environment. Life insurance products take two basic forms: fixed-premium guaranteed death benefit (carrier retains performance risk) and flexible-premium nonguaranteed death benefit (policyowner retains performance risk).
- *Carrier illustrations for nonguaranteed products are credible and appropriate for predictive value determinations.* The purpose of a carrier illustration is possibly the most misunderstood life insurance issue. A carrier illustration depicts how a policy works but is neither credible for predictive value determinations (read the policy contract and policy illustration disclaimers) nor appropriate for policy comparisons.
- *Third-party vendors that employ illustration-based analysis for nonguaranteed products provide dispute defensible performance monitoring.* Since illustrations for nonguaranteed products are not credible for predictive value determinations, these vendor reports are not dispute defensible. The vendor selection and management process should require a letter from the selected vendor affirming that its policy evaluation process is dispute defensible and explaining why.
- *Fixed-premium guaranteed death benefit products do not require annual or periodic monitoring.* Carrier suitability should be reviewed annually. Guarantees can be compromised. For example, what happens if a scheduled premium is not paid timely? An ILIT trustee should assure premiums are paid timely and the guarantee is not compromised.

The Intervention Process

Given policy lapse risk due to inattention or inappropriate policy analysis, an accommodation trustee or successor trustee should review the ILIT file to determine if it contains the following information:

1. Trust Agreement Administration Memo: document prepared by the ILIT drafting attorney that summarizes all administration activities and the form they should take. If this memo is available, does it set out criteria for the management of life insurance assets and annual accounting to trust beneficiaries?
2. Trust File Documentation: Using typical skilled trustee practices, the ILIT file should contain the following documentation, as a minimum:
 - A. Copy of the drafting attorney's Trust Agreement Administration Memo
 - B. Signed copy of the trust agreement
 - C. Policy contract and a signed copy of the "as sold" policy delivery illustration
 - D. Current TOLI Investment Policy Statement
 - E. Signed grantor letter providing guidance at the time of policy issue concerning the policy purpose and long-term performance expectations
 - F. Carrier and product suitability evaluation prepared and signed by the writing agent, summarizing:
 - i. Carriers and products considered;
 - ii. Specific reasons for the selected carrier/product;
 - iii. Performance risks that require annual monitoring;
 - iv. Form of analysis appropriate for this monitoring; and
 - v. Compensation earned (including commission, override, and office support)
3. Copy of annual performance monitoring reports
4. Copy of annual beneficiary communication.

If the trust file lacks this information, the key intervention considerations are:

1. **Eliminate "Hold Harmless" Protection:** If the Trust Agreement or trustee arrangement or state statutes provide for hold harmless protection, how are expected asset management decisions made, recognizing that the trustee has the sole responsibility for trust and asset management decisions? If the trust agreement has a successor trustee provision and the

existing trustee is not providing any administrative services, successor trustee appointment should be considered so that competent expertise is retained.

2. **Establish an Investment Policy Statement:** An Investment Policy Statement is not a legal document and, hence, can be implemented at any time. If a TOLI Investment Policy statement (TIPS) has not been prepared and maintained current, it should be established. As a minimum, it should set out carrier and product suitability monitoring as well as annual beneficiary communication criteria. Further, if the ILIT owns a nonguaranteed death benefit policy, the TIPS needs to establish credible policy risk management criteria along with vendor screening and annual monitoring criteria. Finally, the TIPS should provide restructure guidance and criteria if the policy becomes unneeded or unaffordable.
3. **Engage a Vendor That Provides Dispute Defensible Policy Performance Monitoring and Risk Management Evaluation:** In 1992, the Society of Actuaries clarified that the purpose of an illustration was only to show how a policy works, not to provide predictive value and policy comparison determinations. In 2006, in a four-part series of articles, the American College of Trusts and Estate Counsel explained in detail the inappropriate use of current assumption illustrations, as well as the appropriate use of benchmarks and policy standards in making informed, fact-based risk management determinations: "Just as the use of appropriate benchmarks levels the playing field between investment managers, and facilitates accurate measurement of investment skills and risks so, also, benchmarks can put competing insurance products on a level playing field to generate meaningful risk/reward insights and comparisons."⁵ For flexible-premium nonguaranteed death benefit policies, three data points warrant annual monitoring: (1) Are scheduled premiums adequate to sustain the policy to insured life expectancy and contract maturity? (2) When is the policy projected to lapse and how does this lapse date compare to the insured's estimated life expectancy?⁶ and (3) Are current policy charges competitive? Actuarially certified policy evaluation⁷ is

available at an affordable cost to monitor these data points and correcting actions, if appropriate.

4. **Policy Restructure:** A TOLI policy is usually purchased for a 10- to 50-year duration. Trust objectives, tax legislation, carrier financial strength, and life insurance products continually change. Restructure should be expected, especially if the policy is no longer suitable per current trust objectives, or affordable, or needed. The TIPS should set out the restructure process and criteria. Actuarially certified policy evaluation should be used in considering restructure options.
5. **Life Insurance Expertise:** If the trustee lacks life insurance carrier, product, and policy performance monitoring expertise, this expertise should be delegated to a qualified third party, as already mentioned. Four external expertise roles should be considered:
 - A. **TOLI Consulting:** A fee-based life insurance consultant that offers TOLI-specific fiduciary process, carrier suitability, and product knowledge experience so that the trustee can formalize a prudent risk identification and mitigation decision-making process.
 - B. **TOLI Policy Evaluation:** A fee-based TOLI policy administration vendor that offers credible fact-based policy performance monitoring reports. It is critical for the trustee to obtain in writing an explanation of why the vendor's analysis methodology is dispute defensible.
 - C. **ILIT/TOLI Administration Support:** A fee-based vendor that offers administrative support services such as notification of scheduled grantor gifts and TOLI premium payments, preparation of gift notices, Crummey Notices to beneficiaries, etc.
 - D. **Life Insurance Sales:** A commission-based life insurance sales agent/broker that represents major life insurance carriers offering competitive individual products.

The first three vendors contractually work for the trustee. An agent/broker contractually works for the underwriting carrier.

TOLI Litigation and Regulatory Guidance

Litigation continues to define how a prudent and reasoned process can be demonstrated and documented

in providing the expected standard of care. For example, *Cochran v. Key Bank*⁸ affirmed the importance of trustee investment discretion, establishment of an Investment Policy Statement, delegation of policy evaluation to an independent unbiased third party, client communication, and client affirmation of recommended policy changes. *French v. Wachovia Bank*⁹ reinforced the importance of client and client-advisor communication in a policy restructure situation. Skilled ILIT trustees have integrated litigation guidance into their procedures, and unskilled trustees should do the same.

Also, while regulatory guidance applies only to skilled corporate trustees, the guidance is just as relevant to unskilled trustees taking reasonable steps to develop dispute defensible procedures based upon competent advice. For example, the Office of the Comptroller of the Currency (OCC)'s "Unique and Hard-to-Value Assets" August 2012 Handbook offers excellent trustee guidance concerning life insurance including:

- A bank fiduciary must understand each life insurance policy that the trust accepts or purchases, or the bank fiduciary must employ an advisor who is qualified, independent, objective, and not affiliated with an insurance company to prudently manage these assets.
- Many states have recently passed legislation to limit the liability of bank fiduciaries, in certain situations, by rescinding requirements under state law to perform due diligence on insurance companies as a directed bank fiduciary. The OCC, however, continues to require bank fiduciaries to follow 12 CFR 9.6c and 12 CFR 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion. This review should weigh the financial health of the issuing insurance company as well as whether the policy is performing as illustrated or whether replacement should be considered.
- Bank fiduciaries need to have well developed risk management practices to evaluate and administer accounts with insurance policy holdings. A bank fiduciary with discretion over the account must complete formal preacceptance, initial postacceptance, and annual reviews of the insurance policy. Independent of these reviews, a fiduciary bank must have risk man-

agement systems and reviews that address the following: (1) sufficiency of premiums to maintain the policy to maturity or to meet the insured's life expectancy, (2) suitability of the insurance policy if the bank fiduciary identifies concerns with the condition of the insurance provider or if that provider does not meet the needs of the grantor or beneficiaries, (3) carrier selection (evaluate the carrier's financial condition), and (4) appropriateness of investment strategy.

Conclusion

TOLI-specific best practices can be defined as policy acceptance, management, and restructure determinations based upon known fiduciary duties, the ILIT agreement, TOLI Investment Policy Statement, and TOLI-specific expertise. By comparison, predatory practices can be defined as the conscious and willful inattention to, avoidance of, and disregard for the ILIT agreement, known ILIT trustee duties, and known life insurance guidance. Ignorance and lack of awareness are not defensible excuses.

Unskilled accommodation trustees typically demonstrate predatory policy management practices, if they undertake any practices at all. Due to the lapsing TOLI policy crisis, intervention is needed. The skilled corporate trustee "model" offers excellent intervention guidance for unskilled trustees with the addition of dispute defensible policy evaluation. Unskilled trustees should engage competent third-party vendors, no different from skilled trustees. As summarized in this article, expertise and policy evaluation tools are readily available to provide the needed intervention and continued best practices scope of services—they just need to be used. ■

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- (1) Reliable data concerning life insurance policies owned in ILITs is unavailable. Since 1993, TOLI risk management articles have suggested that unskilled trustees administer up to 90 percent of in-force policies.
- (2) "The duty to exercise both care and skill in investment management may require knowledge and experience greater than that of an individual of ordinary intelligence, depending on the investment strategy to be employed. This does not prevent an ordinary intelligent person from serving as a trustee. In that role, however, such a person may have to take reasonable steps to obtain sufficient competent advice, guidance and assistance in order to meet the standards of this Section and to formulate and implement a prudent investment strategy for the particular trust." UPIA §227d.
- (3) The TOLI Center, LLC (TTC) has provided fee-based policy administration and risk management services to skilled and unskilled trustees, attorneys, affluent family groups, and ILIT beneficiaries since 1992. TTC maintains portfolio statistics since TOLI-specific statistics are unavailable from traditional life insurance sources. As of October 2013, approximately 40 percent of in-force universal and variable universal life products are carrier-illustrated to lapse prior to the insured's estimated life expectancy or within five years of the insured's estimated life expectancy. Further, approximately 12 percent of whole life and guaranteed universal life policies have compromised guarantees.
- (4) "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. The trustee is not a guarantor of the trust's investment performance." UPIA §227b. Duty to Conform to Fiduciary Standards. The term "dispute defensible" is frequently used in this article, possibly overused, for emphasis reasons. ILIT trustee inattention to expected duties and expertise is likely to result in disputes and litigation. Further, a lapsed policy due to inattention documents an imprudent process and clearly does not maximize the probability of a favorable outcome to the trust estate.
- (5) Kathryn A. Ballsun, Patrick J. Collins, and Dieter Jurkat, "Evidencing Care, Skill and Caution in the Management of ILITs (Part 3 of 4)," *ACTEC Journal* (2006): 148.
- (6) For insureds over age 70, consideration should be given to obtaining a life expectancy report so that policy duration/sustainability is based upon the insured's health situation versus group insured mortality tables. The cost for such a report ranges from \$250 to \$500 depending upon the report provider.
- (7) Dispute defensible TOLI product suitability determinations require credible and unbiased fact-based policy evaluation. To meet this test, a trustee's policy acceptance, management, and restructure evaluation of nonguaranteed policies should be based upon actuarially defensible policy evaluation. Actuarial evaluation uses generally accepted actuarial methods, impartial analysis, and objective data to assess the probability that a carrier's illustrated schedule premiums will successfully sustain the policy to contract maturity or insured life expectancy, as a minimum. Further, actuarial evaluation provides policy lapse, pricing/charges, and correcting premium information so that informed, fact-based annual performance monitoring determinations can be made and communicated to trust beneficiaries.
- (8) *In re Stuart Cochran Irrevocable Trust*, 901 N.E. 2d 1128 (*Ind Ct of App*) 2009. The author was an expert witness for the plaintiff.
- (9) *French v. Wachovia Bank, N.A.*, U.S. Dist. Lexis 72808 2011.