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Avoiding Consequential Liabilities for Trustees of Trust-Owned Life Insurance

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The following is an update to an article which appeared in the Spring 2014 edition of The Senior Lawyer.

Low interest rates over recent years, combined with neglect on the part of the private owners and trustees, have resulted in an increasing number of non-guaranteed life insurance policies expiring prematurely. The majority of these policies were purchased from the mid-1980s to 2003. The primary reason can be traced back to the early 1980s when prevailing interest rates were 18% to 19% and there were only two types of life insurance policies available:

- Term Life Insurance, in which a specific dollar amount of life insurance was guaranteed to remain in force for a specific period of time and at a specific guaranteed premium, and
- Whole Life Insurance, which was guaranteed to remain in force for the life of the insured as long as he or she paid the stated premium on time. These Whole Life policies contained a tax-deferred accumulation account known as Cash Value, which earned 3% annually.

Universal Life Insurance Policies

With high interest rates in the early 1980s, buyers of life insurance who wanted permanent coverage chose to buy Term Life and invest the difference in other guaranteed investments, as an alternative to Whole Life policies that were only paying 3%.

In 1982, E.F. Hutton Life was the first insurer to combine the two elements, term insurance and an investment component, into a single policy originally called "Total Life," then "Complete Life." By 1983, nearly every major life insurance company offered a "Universal Life" policy.

While the product was designed to pay a competitive interest rate similar to bank accounts and certificates of deposit, its largest drawback was that, unlike its predecessors, a Universal Life policy was not guaranteed to last for the rest of one's life. Instead, policy owners assumed 100% of the responsibility for policy performance. It was up to them to make certain that the policy was adequately funded so that it would remain in force for the rest of their lives.

The Problem

As a result of sustained low interest rates and unintended neglect on the part of owners who owned a policy outright rather than through a trust, or the sons and daughters who acted as accommodation trustees for their parents irrevocable life insurance trusts, as well as the trusted friend or professional adviser acting as a trustee, Universal Life policies are expiring seven to nine years earlier than originally anticipated. It's now apparent that neither many of these owners, nor the Insured, nor the accommodation trustees were aware that they were solely responsible for the performance of their non-guaranteed policies and did not know that they should have increased premium payments to make up for the lower than anticipated earnings caused by reduced interest rates. They treated their policies as Buy and Hold, rather than as Buy and Manage assets.

Solutions

Many grantors, trustees and their advisors mistakenly believe that the life insurance agent or broker is watching over their policy to make certain that it does not lapse. Others believe that the insurance company itself will make sure that premiums are collected so that the policy does not lapse.

However, it is an agent's or broker's role to market and distribute the policy. It is the company's role to administer bills and issue an annual report indicating where the policy stands. It is exclusively the trustees' or private owners' duty to manage the policy to make certain they are not paying more in expenses than they should and that a sufficient premium is paid to keep the policy in force, up to and beyond the insured's normal life expectancy.

When the policy has not been appropriately managed by the private owner or trustee, corrective action involving these options is available to them:

- Increase the premium to maintain the death benefit to a desired age,
- Reduce the death benefit to achieve same results,
- Attempt to exchange to a more competitive policy,
- Consider a "life settlement," a sale at a higher valuation than the cash value (explanation of life settlement on next page),
- A combination of all or some of the above.

Considering these options, what's the best way for an insured or trustee to proceed?

As a first step, they have to inform themselves of the facts and discover whether the policy is in fact a nonguaranteed policy that may be in danger of expiring prematurely. If it is, intervention is needed and the logical source for assistance is a tax or legal advisor, working in conjunction with an experienced Independent life insurance consultant, who would conduct an independent performance evaluation of the policy. To avoid fixing a problem by creating another problem, a request for proposal process should be used to assure that an objective, unbiased consultant is engaged and credible policy evaluation is provided.

The next step is to develop a risk management plan as follows:

1. Formalize a "Trust Owned Life Insurance Investment Policy Statement" that:

- Updates the trustees' / beneficiaries' current death benefit requirement.
- Summarizes the trust's parties and their respective responsibilities.
- Sets out trustee risk management criteria for carrier and product suitability.
- Identifies the life insurance product and policy evaluation duties.

- Establishes vendor due screening requirements for delegated life insurance.
- Affirms annual beneficiary communication requirements.

2. Obtain an actuarially certified life expectancy evaluation that includes:

- A percentage probability that the payment of currently scheduled premiums will sustain coverage to the insured's life expectancy and the policy's maturity.
- The earliest predicted lapse age for the insured's policy.
- A corrected premium amount that would sustain the death benefit to the insured's life expectancy

3. Verify that the trust file contains:

- A signed copy of the trust agreement.
- A policy contract and signed copy of the "as sold' delivery illustration.
- A current Trust Investment Policy Statement.
- A Grantor Guidance Letter providing guidance at time of policy issue concerning policy purpose and long-term performance expectations.
- Product suitability evaluation signed by writing agent when purchased.
- Copy of annual performance monitoring reports.
- Copy of annual beneficiary communication.

Based upon this information, a risk mitigation plan can be initiated that provides for appropriate delegation of expertise functions and determinations to insure that a policy lapse can be avoided.

Additional Considerations

Trustee Hold Harmless Clauses

Every trust warrants review to determine if what was important to the grantor then, is still relevant and accurate today—in particular if it contains a trustee hold harmless provision, and to make certain its existence has been clearly explained to the grantor and trustee.

Since 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 evaluation expertise, how will suitability of the carrier, product and policy be addressed and managed? And, if the policy unnecessarily lapses, what is the trustee's liability?

The Court of Appeals reminded trustees of their exposure to personal liability in the recent case of Penman v. Penman [1] when it dismissed the appeal of a trustee who was found liable for not making inquiries as to the performance of her co-trustee. Because she had abdicated her duties as a co-trustee, she could not avail herself of the protection afforded trustees by statute or the exculpatory clause in the trust instrument and the court found that she did not act reasonably.

In another recent decision regarding the subject of a hold harmless provision, co-authors Steve Leimberg and Howard Zaritsky of Tax Planning with Life Insurance comment on a recent Nebraska Supreme Court case Rafert v. Meyer 2 stating that:

a trustee has a non—waivable duty to keep beneficiaries informed about the status of life insurance policies held in trust, and a non-waivable duty to act in good faith and in the best interest of the beneficiaries. Among the trustee's duties is the responsibility to inform the beneficiaries fully of all material facts so the beneficiaries can protect their own interests where necessary. Furthermore, as demonstrated in Rafert v Meyer, such a clause may not even protect the trustee from liability for failing to maintain the trusts insurance policies. The better approach for all parties is to require that the trustee treat a life Insurance policy as it would any other trust asset, that the trustee evaluate it and determine its appropriateness on a continuing basis, and that the trustee be paid for these services. Sometimes, penny wise really is pound foolish—for both the payor and payee.

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… relieving a trustee of various duties may result in lower trustee's fees, but it also leaves the trust without anyone to assure that the policy in question remains in effect, and that it is the correct policy for the trust, and that full advantage is being taken of its options.

In Rafert v. Meyer, 3 we see that a trustee has the responsibility to inform the beneficiaries that their trust assets are in danger of being lost. "Meyer the trustee contends that the lapses of the policies occurred prior to the time such reports were due. But annual reporting was a minimum requirement in the ordinary administration of the trust. A reasonable person acting in good faith and in the interests of the beneficiaries would not wait until such annual report was due before informing the beneficiaries that the trust assets were in danger of being lost.'

Regardless of whether a violation by a trustee of a duty required by law was willful, fraudulent, or resulted from neglect, it's a breach of trust, and the trustee is liable for any damages caused. A trustee is responsible to administer the trust in good faith, and in accordance with its terms and the interests of the beneficiaries, and Code. s 30-3866.[4]

Life Settlements

Just as an individual can sell a car or home, so too can an owner of a life insurance policy sell his or her policy. A life settlement is the process in which an owner of a life insurance policy sells his or her policy to another individual or group of individuals, i.e., a hedge fund, in what's called the secondary market, rather than surrendering it to the Insurer for the cash surrender value. It has been a common practice for insurance companies that use agents rather than brokers to discourage their agents from discussing a life settlement as an option with a client faced with lapsing or surrendering a life policy because a life settlement would reduce profitability for the insurers as they count on a percentage of their policies lapsing and being surrendered. This practice is now changing as a result of Grill v. Lincoln National Life Insurance Company, a 2014 federal court case the significance of which one commentator described as follows:

In the Grill case, the plaintiff's attorney asserts that Lincoln's agent did in fact have a fiduciary duty to review all potential options when the policy no longer became affordable. .. With respect to life settlement disclosure, an inherent conflict exists between insurance companies and their agents. An advisor's duty to exercise the reasonable care standard is hindered by carrier directives to conceal the life settlement option. Until this issue is resolved, lawsuits like the one filed in Riverside County may become more common.

Chronic Care and Long Term Care Riders

In addition to regularly evaluating a life insurance policy, one should also consider alternatives such as Chronic Care and Long Term Care riders which first became available at the end of 2011. Either of these allow an Insured to withdraw up to $120,000 tax free in 2015 (adjusted annually for inflation), directly from the death benefit of a policy, to pay for qualifying long-term care expenses. Care, however, must be taken to distinguish between the two as there is an additional upfront cost for a Long Term Care rider, while that's not the case for a Chronic Care rider. There are also many planning opportunities to remove the asset from the estate while yet allowing the Insured to have direct access to the funds in the event they were needed to pay for long term care costs.

Conclusion

While it is important to be aware of the potential problems involving non-guaranteed life insurance, particular attention needs to be paid to the attorney or accountant who acts as a trustee, yet does not have, nor retains an expert with, the requisite skills necessary to evaluate the performance of a life Insurance policy.

A trustee can be sued by a beneficiary if the life insurance coverage prematurely expires and the beneficiary is not made aware that a shortfall could have been corrected-or if the trustee does not examine policy expenses, since beneficiaries can claim the trustee was overcharged and the policy could otherwise have provided a greater death benefit.

The earlier a trustee learns of a potential problem, the easier and less costly it will be to fix it, especially in those situations where the replacement of a policy is called for, since an insured's health may deteriorate with age making it more difficult and costly to obtain a better performing policy.

Endnotes

1. 2014 ONCA 83 (CanL11) [Penman].

2. Steve Leimberg and Harold Zaritsky, Tax Planning with Life
Insurance, March 2014.

3. _N.W.2d _ (Neb. 2015).

4. Trieweiler v. sears, 268 Neb. 952, 689 N.W.2d 807 (2004).

5. Larry Grill et al. v. Lincoln National Life Insurance Company, 5:2014cv00051, U.S. District Court, California Central District
(case not yet adjudicated).

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BIO

Henry Montag is an Independent Certified Financial Planner in practice since 1976 with offices in Long Island and New York. He is a principal of The TOLI Center East, which provides independent fee-based performance evaluation for private trustees, their advisers and institutional trustees regarding trust-owned life insurance. He has had articles published in various publications including those of the New York State Bar Association, NYSSCPA's Tax Stringer, Tax Facts, National Conference of CPA Practitioners, Accounting Today, and Suffolk County Women's Bar Association. He has lectured extensively on the proper utilization of financial products to protect and preserve assets to the New York State Bar Association, the New York State Society of CPAs, The American Institute of CPAs and the National Conference of CPA Practitioners.