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THE IMPORTANCE OF DEVELOPING AND DOCUMENTING A PRUDENT TOLI RISK MANAGEMENT PROCESS

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Imagine that you are the trustee of an Irrevocable Life Insurance Trust (ILIT) or the advisor to an unskilled trustee as well as providing ILIT administration services such as Crummey Notices. Imagine you receive carrier notice that the $2,750,000 death benefit policy in trust is estimated to lapse in the next 12 months. The insured is age 78 and premiums paid to date exceed $500,000. Corrective action is needed – what do you do?

For reasons explained in our February 1, 2014 article, "The Importance of Monitoring and Evaluating Life Insurance Policy Performance," approximately 38% of inforce flexible premium non-guaranteed death benefit Trust-Owned Life Insurance (TOLI) policies are illustrated to lapse prior to the insured's life expectancy. Amateur ILIT trustees, also known as "Accommodation" or "Do Nothing" trustees usually are family members or friends who serve as a favor to the grantor at no expense. They are not familiar with ILIT trustee duties and lack life insurance product and policy evaluation expertise. Rather, they rely upon either the grantor's attorney who drafted the ILIT and trust administration guidance or tax professional for all ILIT administration and TOLI risk management activities.

Corrective action is needed to avoid policy lapse and, equally important, assure the policy (ies) are being managed consistent with the ILIT's current liquidity objectives and trustee's life insurance product and policy evaluation expertise. It is estimated that amateur ILIT trustees are responsible for approximately 90% of inforce TOLI policies. In considering how they can document a prudent and reasoned process consistent with trust objectives, it is important to address the gap between responsibility and capability, and identify the options available to resolve this gap. Clearly, the grantor's legal and tax advisors play a critical problem-solving role in identifying neglected policies as well as reviewing and implementing these options. If the professional lacks the requisite expertise to credibly evaluate the available options, then it is incumbent upon the advisor to engage a third-party provider with that expertise.

Trustee Considerations

The corrective action first steps are to obtain a 'credible' fact-based policy evaluation report and formalize a TOLI Investment Policy Statement (TIPS). TIPS is the single-most important document for the purchase and management of life insurance, no different from fixed income and equity investments. Properly drafted, TIPS formalizes a prudent "best practices" risk management process for informed new, in-force, and restructured TOLI policy determinations. It safeguards all insurance trust parties – grantor, trustee, beneficiary, professional advisors, and life insurance agent – in clarifying trust objectives, carrier/product/policy suitability considerations, delegated TOLI consulting and policy

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risk management functions, beneficiary communication, and expected professional advisor roles.

TIPS is not a legal document. It is generally prepared and periodically updated by a TOLI trustee to affirm current trust operation objectives and procedures to systematically monitor trust asset performance. It is based on the grantor's objectives and expectations as well as guidance set out in the trust agreement and trust operation memo prepared by the attorney drafting the trust agreement. Since an insurance trust may span a 10 to 50 year time horizon, TIPS provides practical guidance in dealing with changes in trust objectives, tax law, grantor gifting capacity, carrier financial condition and life insurance products.

TIPS should outline the trustee's policy selection and management process, including risk evaluation criteria. If the trustee lacks life insurance product expertise and dispute defensible policy evaluation capabilities, these functions should be outsourced (delegated) to experienced TOLI third-party providers. The Cochran v. Key Bank decision reinforces the importance of delegating the product and policy performance monitoring determinations to an experienced and objective third-party. Subsequently, most skilled institutional ILIT trustees and an increasing percentage of lawyer-trustee, professional advisor co-trustee, and family member personal trustee arrangements have outsourced TOLI product analysis and risk management functions. As a result, TIPS should set out the terms of delegation along with the trustee's expected provider screening and annual monitoring process.

Provider selection warrants special comment. Since the early 1980s, non-guaranteed death benefit policies have been the TOLI policy-of-choice, especially for larger death benefit policies. Most third-party providers lack the expertise to credibly evaluate non-guaranteed policies, particularly "indeterminate" premium adjustable life, universal life, and variable universal life policies. Even fewer providers offer volatility simulation expertise requisite to defensible variable universal life policy management. A trustee is well-advised to annually request provider confirmation that its evaluation process is actuarially certified and that premium adequacy evaluations are volatility tested. Further, a trustee should expect to pay a fee for this service ranging from $250 to $1,000 per policy depending upon product type and scope of evaluation. Finally, a trustee should not rely on a life insurance sales agent for TOLI policy performance monitoring and risk management evaluation unless the agent contractually affirms dispute defensible policy evaluation capabilities.

Beneficiary Considerations

TIPS serves an essential beneficiary communication purpose that, properly undertaken, evidences the trusteeÐs care, skill, and caution in carrying out a reasoned investment strategy to achieve the trust's purpose and the needs of the beneficiaries. The trust agreement typically provides for an annual accounting to trust beneficiaries. TIPS should set out the form of such accounting and facilitate informed annual asset management communication.

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If a beneficiary does not have a TIPS copy, it should be requested. A discussion of fiduciary law and professional practice management guidance is beyond the scope of this article; however, a written Investment Policy Statement and periodic beneficiary communication (per the trust agreement) are essential to evidencing a prudent process. Moreover, institutional trustees who "possess a degree of skill greater than that of an individual of ordinary intelligence" must demonstrate compliance with trust acceptance and asset management guidance set out by their functional regulator. If a TIPS and current policy evaluation report are not available, an independent policy evaluation should be obtained to review and update trust objectives, TIPS, and appropriate beneficiary communication going forward.

Asset Restructure Considerations

A properly drafted TIPS should also provide restructure guidance recognizing that trust objectives and life insurance products will change over a 10 to 50 year time horizon. For example, restructure options due to a failing and/or unsuitable policy situation include: (1) a non-commissionable exchange with the existing carrier to maximize death benefit coverage by avoiding un-necessary costs when accumulation value is already minimal, (2) exchange to a commissionable or non-commissionable policy underwritten by another carrier, and (3) policy sale in the secondary market if its fair market value is more favorable than its accumulation or cash surrender value.

In conclusion, it is questionable why an affluent individual or affluent family group continues to rely upon an unskilled 'accommodation' ILIT trustee who lacks fiduciary practices knowledge and life insurance expertise to carry out the required trust duties unless the grantor's legal and/or tax advisors actively oversee the prudent and timely performance of trust administration and policy risk management duties. Also, it is questionable why an affluent individual will actively monitor the performance of a traditional investment portfolio and pay an annual fee for this service, yet totally neglect the performance monitoring of a life insurance portfolio. As a result, a client's professionals play a critical corrective action role in avoiding policy lapse and implementing a prudent and reasoned process that maximizes the probability of a favorable outcome to the trust estate. Formalization of a TOLI Investment Policy Statement addresses the gap between responsibility and capability and keeps all ILIT parties focused on the ILITĐs liquidity and multi-generational wealth preservation objectives.

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