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THE IMPORTANCE OF GETTING IT RIGHT – KNOWING AND PERFORMING YOUR FIDUCIARY RESPONSIBILITIES

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The responsibility of an Irrevocable Life Insurance Trustee (ILIT) trustee is to maximize the probability of a favorable outcome to the trust estate. In other words, 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. It is therefore essential for the trustee to know and discharge fiduciary responsibilities in a manner that demonstrates a prudent and reasoned process. They need to get it right.

Imagine that you are the trustee of an Irrevocable Life Insurance Trust (ILIT) or the advisor to an unskilled trustee or the CPA or Attorney in charge of a Family Office and responsible for its life insurance policies. You are uncertain of ILIT administration responsibilities and life insurance policy performance monitoring needs. You lack life insurance product and policy evaluation expertise. The grantor or policy owner cannot even recall why the policy type(s) were chosen and purchased or what carrier and policy performance risks, if any, require periodic review. The sales agent does not offer annual policy service or is no longer active in the life insurance business. That said, a carrier notice is received that a $2,750,000 death benefit TOLI policy 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?**

In our February 1, 2014 article, "The Importance of Monitoring and Evaluating Life Insurance Policy Performance", we explained that approximately 38% of in force flexible premium non-guaranteed death benefit Trust-Owned Life Insurance (TOLI) policies are carrier-illustrated to lapse prior to five years of the insured's life expectancy. This problem is made worse by virtue of the fact that amateur ILIT trustees usually are not familiar with their duties and rely upon the grantor's attorney or tax professional for all trust administration and policy risk management activities.

In our March 1, 2014 article, "The Importance of Developing and Documenting a Prudent Risk Management Process", we explained that corrective action is needed to avoid policy lapse and to assure a plan is formalized to risk manage the policy(ies) going forward consistent with the trust's current liquidity objectives and trustee's expected life insurance product and policy evaluation expertise. This plan starts with formalization of a TOLI Investment Policy Statement (TIPS) that sets out the fiduciary and life insurance duties to be performed and the form they should take to meet a defensible standard of prudence. Legal and tax advisors can and should play a problem-solving role in identifying neglected policies, developing a TIPS, reviewing corrective action options and needed expertise (as set out in the TIPS), and engaging credible third-party providers .

It is critical to address the gap between trustee responsibility and capability, and identify the options available to resolve this gap. The process and tools to do so are well-known for fixed income and equity investments, and the same is true for life insurance. Corrective action can be taken to meet the standard of prudence and get it right. Said differently, the gap between responsibility and capability can be eliminated, meaning the decision not to take corrective action is a conscious decision to keep it wrong (predatory practice) in many cases.

Eliminating the Responsibility-Capability Gap

The corrective action first steps for an in force non-guaranteed death benefit life insurance policy is to i to understand the issue that there may be a policy performance problem due to sustained declining interest rates and performance monitoring inattention. Then the next step is to obtain a credible fact-based policy evaluation report and formalize a meaningful TIPS for trust-owned policies. This Statement updates and clarifies policy owner trust objectives, policy suitability considerations, delegated life insurance consulting and risk management functions, beneficiary communication, and expected professional advisors roles.

These are the first steps in getting it right and frequently identify problematic policies due to suitability and performance monitoring inattention. As a practical matter, the process of formalizing a TIPS often recognizes that the in force policy did not meet the purchaser's goals and risk tolerance objectives at the time of purchase. As a result, in force policy restructure should be expected and can take one of three forms: (1) premium payment and/or death benefit changes to the existing policy, (2) replacement for suitability reasons, and (3) policy sale,

Policy Evaluation

Defensible life insurance policy suitability determinations for flexible premium non-guaranteed death benefit products require credible, unbiased and fact-based policy evaluation. To meet this test, policy acceptance, management, and restructure evaluation of non-guaranteed policies should be based on actuarially-defensible policy evaluation and avoid reliance upon carrier illustrations that disclaim predictive value. Such reliance is the problem, not the solution.

Delegation

Getting it right requires fiduciary practices and life insurance expertise that typically has not been used prior to receipt of a lapse notice. Delegation should be considered for two functions – consulting and policy risk management. It is estimated that 90% of in force TOLI policies are administered by unskilled ILIT trustees who serve at no cost as an accommodation to the grantor. In most instances, an accommodation ILIT trustee is unfamiliar with trustee fiduciary duties so that no duties are performed or, alternatively, relies upon the grantor's legal or tax advisors to perform these duties. Legal and tax advisor may accept responsibility for TRUST administration activities but usually decline POLICY administration and risk management ASSESSMENT responsibility because they lack life insurance product and policy evaluation expertise.

Given this missing asset management expertise, getting it right necessitates engagement of experienced ILIT and TOLI-specific consultants and policy administrators. All consultants and policy administrators are not the same. A thoughtful vendor screening and engagement process should be used to assure the trustee's defensible procedural prudence objectives are matched with the vendor's experience and capabilities.

In eliminating the responsibility – capability gap, three issues need further consideration:
1. Credible consulting and policy risk management services for life insurance have a cost. Free services should be a red flag. For the past 10 years, free policy evaluations have been aggressively marketed by life insurance agents and brokerage general agents for commission-motivated replacement reasons. These life insurance marketing practices pose an unnecessary risk to the unskilled trustee that should be avoided. Engagement of an experienced ILIT and TOLI-specific vendor and employing a due diligence process can eliminate selection of a vendor that may document an imprudent decision and a subsequent unwarranted replacement decision. A consultant typically summarizes the scope of expected service charges in an engagement letter along with hourly and/or project fees. A policy administrator typically charges a fixed fee based upon the needed type of reporting. The combined fee paid for these services generally is significantly less than paid investment advisors for fixed income and equity investments who manage portfolios of equal amount to the life insurance policy death benefit.

2. Open Architecture is available. Just as asset management information is readily available from firms such as T.D. Ameritrade or Fidelity, life insurance policy administration and risk management services are available from credible and experienced vendors. This accessibility is especially convenient for attorneys, law firms and tax advisors responsible for affluent individual and family group clients, private trust companies and especially Family Offices lacking life insurance policy performance evaluation services.

3. Asset Restructure is an important periodic consideration. Trust objectives, tax legislation and life insurance products continually change and, hence, thoughtfully-prepared TIPS should include trustee guidance concerning these changes. Life insurance is a 'buy-and-manage' financial asset usually purchased for a 10 to 50-year time horizon. The manage function should be responsive to carrier and product changes that may be more suitable in achieving the trust or policy owner's objectives. Asset restructure evaluations should be based on a thorough in force policy evaluation, including such factors as carrier size and third-party ratings, carrier surrender or exchange charges, in force and restructure policy risk assessment and agent commission compensation so that the financial and non-financial trade-offs are considered.

In conclusion, prudence is a process that requires not only planning but execution. Getting it right or keeping it wrong is a choice and the consequence of each choice is now known. The keep it wrong choice is unnecessary since the cost of getting it right is minimal. Within force life insurance policies, the responsibility – capability gap can be significantly reduced, if not eliminated, by taking advantage of available experienced and independent delegated expertise.

Returning to our introduction and the $2,750,000 policy at risk of lapse, what is the impact to the trust estate if its $2,750,000 liquidity investment is lost due to inattention? In a recent meeting, a senior trust officer commented, "If a trust officer treated a portfolio of stocks and bonds similar to the way they treated life insurance, the trust officer would be fired." Life insurance is a tax and cash flow leveraged financial asset that has become a cornerstone of sophisticated estate and business planning over the past 35 years, but it is not self-managing. The tools to getting it right are readily available – they just need to be used.

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