An Ounce of Prevention

When dealing with trust owned life insurance, trustees must develop good habits to avoid unfortunate outcomes

By Vernon W. Holleman, III

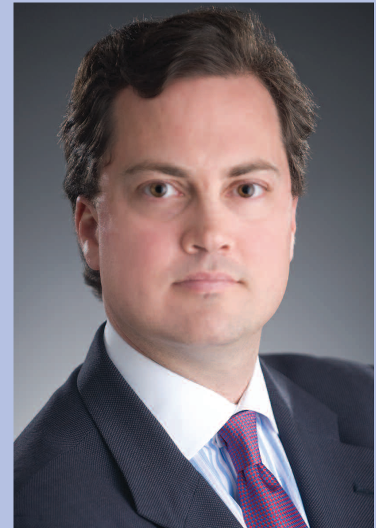
A great deal has been written in the last decade about trust owned life insurance (TOLI) and the responsibilities and obligations of trustees/fiduciaries of irrevocable life insurance trusts (ILIT). Although descriptions of a TOLI "crisis" may be hyperbolic, clearly trustee responsibilities have grown more complex in recent years with the introduction of new investment standards dictated by various state laws as well as the needs and demands of ILIT beneficiaries, new provisions in trust documents, the often confusing mechanics of life insurance and the proliferation of new life insurance products.

These dynamics have led some TOLI beneficiaries to bring lawsuits against trustees for such infractions as poor investment management decisions, improper life insurance policy design and failure to maintain or properly manage the TOLI policy. Recent lawsuits have occurred at the intersection of regulatory reforms, unrealized life insurance product performance expectations, improvements in new life product pricing and increased sophistication of TOLI beneficiaries. Further, all of this has occurred when the complexities of the life insurance marketplace have waxed while pro-active servicing of life products from professional advisors has waned. The responsibilities of the ILIT trustee are real and must be done pro-actively. To prevent unfortunate outcomes, the trustee must be aware of the fundamentals of managing an ILIT.

Beyond noting the importance of pro-actively managing TOLI, useful capacity for doing so, includes:

- Performing life insurance policy and carrier audits at least every three years
- Knowing what to look for to ensure that a policy is on track to meet objectives;
- Knowing how to determine potential problems to assess potential corrective actions;
- Assessing the merit of a proposed life insurance replacement (with a new product); and
- Continuing to listen and assess the needs of the trust grantor and beneficiaries.

Being capable of overseeing or performing these fundamentals will go a long way toward helping trustees and fiduciaries of TOLI better live up to their obligation to the beneficiaries of the trust – their true boss!



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ILIT Management Fundamentals

A trustee of an ILIT is legally responsible for managing the trust assets. Further, he is a fiduciary to the trust beneficiaries and thus must manage the trust assets prudently, considering all the beneficiaries when making decisions. The provisions of the trust document dictate the trustee's responsibilities. Although a trustee isn't bound by the grantor/insured of the trust, initial communication with the grantor/insured is, naturally, most important to gain a clear

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understanding of the expectations of how the proceeds from the insurance, that is,, the death benefit, should be used as well as the expectation for management of the policy and any other trust assets.

The general responsibilities of the trustee of an ILIT are to:

- Pay premiums;
- Provide written letter notices to trust beneficiaries (*Crummey* letters) announcing the gift to the trust. This is only necessary when annual gifts are being made to the trust, not if the gift is using the lifetime exemption (or portion), or if premiums are being paid by dividends or cash value;
- Perform life insurance policy and carrier reviews and take corrective actions as necessary;
- Manage trust investments; and
- Administer income tax reporting, which is necessary if there are assets in the trust beyond life insurance, such as real estate or stock – something that has recently grown in popularity.

Among the responsibilities listed, the management of the life insurance policy and investments, including a review of the work components for managing an ILIT, is often neglected. A trustee needs to know how to manage an ILIT not only because this knowledge critical in doing the fundamental job for the trust beneficiaries, but also because trustees are held responsible in most states, under the Uniform Prudent Investor Act, (drafted by the National Conference of Commissioners on the Uniform State Laws and enacted July 29-Aug. 5, 1994). This is particularly true of investment management. Trustees should know the state statutes for the state in which their trust is domiciled.

With regard to life insurance held in the trust, the trustee needs to know how the insurance policy is performing as it relates to the current planning objectives (commonly using both "as-sold" and "in-force" illustrations), considering such dynamics as:

- Where premium obligations stand;
- Current cost of insurance pricing (including any changes since the last review);
- Current crediting or dividend interest rates (including any changes since the last review);
- Historical variable sub-account performance in relation to baseline illustrated earned rate assumptions (if variable universal life); and
- Where the insurance carrier is rated currently, and versus peers.

If a policy has gone askew from initial projections or the current objective, the trustee should review ways to get the existing policy back on track and also consider benchmarking options in the marketplace to see if a policy replacement should be made. On the investment management front, the trustee can, in fact, delegate the investment choice responsibility but must be sure that it's being managed competently, as the trustee retains the ultimate responsibility for explaining to trust beneficiaries what investment choices and decisions were made, and why.

A trustee can certainly read the various rating agency reports, but may find using the Comdex ranking score of the insurance carrier as a reasonable place to understand the health of the carrier involved. The Comdex score isn't a rating, but a composite, or average, of all the ratings services scores for that carrier. It will allow the trustee to see where that carriers sits when compared to the rest of the carriers in the marketplace, for example, a company in the 96th percentile would have only a few peers that are better rated.

Often Overlooked Tasks

Competent management involves critical fiduciary tasks, many of which are frequently overlooked. Here's a rundown of some of the more common ones:

Confirm existence of signed and dated copy of the trust. Although this may seem obvious, many trustees have gone to their file only to find the "Draft" copy or an unsigned copy. Therefore, trustees should confirm that they and other key advisors, for example, the current estate planning attorney, insurance advisor and CPA, all have a signed and dated copy of the trust, including its tax ID number. Further, confirm that the tax ID number is, in fact, still active with the Internal Revenue Service – They've been known to go inactive without use (that is, no tax filing).

- **Confirm that the owner and beneficiaries listed at the insurance carrier are exactly as planned and expected.** This is important regardless of whether there has been an ownership change. Insurance companies are excellent at taking risk, but often not as good at administration. Therefore, ownership and beneficiaries may need updating or clarification. Also, be sure the tax ID number is on record with the carrier. These checks are particularly important if the trust has been updated, amended or changed in anyway. These missed details can materially slow down the claims process. The bottom line here is that clarity is king.
- **Notify insurance carrier of first death for joint life insurance policies.** If a first death occurs, it's important to for the trustee to notify the insurance carrier and supply a death certificate at that

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time. This is often overlooked. It may be many years until the policy pays out and going back for the death certificate of the first spouse years later is something a trustee wants to avoid. Again, a trustee shouldn't make things any harder than they need to be.

Another important reason to let the insurance carrier know when the first of a joint life (also called survivorship) policy has died is that certain older policies bi-furcated the mortality expense component of the two insureds. These so called "non-frasierized" contracts give a bump in cash value after the first death. This potential bump will be important as the trustee looks forward from the first death on. Ideally, a trustee should know if the survivorship policy in the trust is a non-frasierized policy, even before the first death. Non-frasierized contracts are limited, most were whole life contracts offered from the mid-80s to mid-90s, for example, by Manulife and Phoenix Home. Survivorship policies issued today are frasierized and so don't provide a cash value increase at the first death.

- **Understand and manage insurance policy risks.** Each type of life insurance product (term, whole life, universal life, no-lapse guarantee (NLG) universal life, indexed universal life and variable universal life) carries with it some level of risk to the owner. Term and NLG provide guaranteed death benefits (pay X premiums – period – and the coverage is guaranteed for a specific time period) but are still subject to carrier solvency risk. Participating whole life and universal life provide non-guaranteed policy charges and interest credits, which are subject to guaranteed maximums and minimums, respectively (where more or less premiums may need to be paid to keep the policy in force if the charges or interest credits are changed). Variable universal life (VUL) provides the highest risk and reward potential, because 100 percent of the investment risk is transferred to the policyholder (that is., no guaranteed minimum credited interest rate). In addition, VUL provides policyholder control of asset allocations to both fixed income and equity investments. Trustees don't have to fully understand every aspect of life insurance policy mechanics, but they do need to understand that there are performance risks inherent in life insurance that they'll need to manage.

  The key assumption for a trustee after the initial acquisition of the insurance policy is the expectation of how many premiums will be required for the policy to stay in force. Often a trustee may be told that a policy is "paid up." These are the two most dangerous words in the language of life insurance. They, and translate to "no further premiums being due, regardless of factors." A truly "paid-up" policy is rare and trustees need to understand that premiums may be required, even after they have been told no more will be due. This may be because of lowered crediting or dividends rates or longer mortality projections. Understanding both the initial projections (policy design) and ongoing projections, in the context of the larger risk issues, will truly help trustees as they review the trust insurance to meet the long-term financial objectives.

- **Provide file documentation.** Regardless of the type of insurance, illustrations show a range of potential outcomes. This is when good note-taking and record-keeping is vital. Trustees should have a thorough and organized file with the above-mentioned documents, and include all insurance or investment material, illustrations, projections and statements. This is particularly true if a policy, or policies, were transferred into the trust. In this case, the trustee must be sure the 712 forms are filed appropriately, in case the trustee needs to demonstrate that the transfer was, indeed, made. Frankly, even if not organized, a file with all of the above can go a long way to help sort out clarity during a review. The trustee should lean on the insurance or investment advisor involved for service, updates and advice. If the advisor who originally sold the insurance is no longer in practice, a replacement should be found, whether from that insurance carrier, or other. Most carriers will allow a replacement-servicing agent to be named, simply with a letter. The trustee should be confident in the advisor's independence, experience, knowledge and professional judgment.

- **De-mutualization stock.** Trust owned policies with insurance carriers that converted from a mutual company to a public stock company received that carrier's stock as part of the de-mutualization. This occurred with several carriers (for example, Manulife, Prudential and Phoenix Home). Trustees must know if there is stock in the trust and manage it properly.

RECENT NOTABLE CASE LAW

In 2009 the Indiana Court of Appeals ruled on *In re Stuart Cochran Irrevocable Trust*. This case is a great example of where understanding the risk spectrum of life insurance policies is important – the trustee in this case, Key Bank, replaced two variable universal life (VUL) policies on the insured where the total face amount (death benefit) was $8 million. The trustee made the

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exchange because of the concern that if the policy's cash was left in the market, with its associated return volatility, the insurance would eventually cease (short consistent, long-term high rates of return). This would, potentially, have caused the cash to be lost altogether. While premature death can happen, the law has upheld that the prudence standard is being met. For a more detailed account and analysis of the Cochran case, consult "A Shot Across the Bow" in the December issue of *Trusts and Estates*.

Auditing 101

The trustee should start the policy audit with the proper acquisition of "in-force" illustrations, which are future policy projections based on current policy assumptions for charges and interest credits (which may have changed since the policy was issued). The insurance carrier or agent/broker representative on the policy provides the illustrations. A trustee should know that each carrier's systems are different. The distinction in systems is primarily in the ease of getting the right information as quickly as possible. Many carriers still take days to produce in-force illustrations, and they often don't come back as requested. A trustee must be patient or work with an insurance advisor or consultant who will do this work for the trust.

When reviewing or auditing policies, a trustee should learn how thick the ice is supporting the policy, or in today's vernacular – *stress-test* the policy by determining how much gas it has in the tank, *without* future premium contributions. In other words, the trustee should ask for projections showing no additional premium payments and see what the future looks like under that scenario (that is how much longer will the policy stay in force). Also of importance is stress-testing with conservative policy assumptions for charges and interest credits, such as a 100 basis points (bps) reduction to the crediting rate for universal life or the dividend rate for whole life. Stress testing will provide the trustee with a reasonable benchmark for the health of the policy. For example, if the policy holds its death benefit without additional premium until the insured' reaches age 100, the policy may be considered generally healthy, and decisions can ensue from there.

Two different projections are typically provided in most universal life and whole life illustrations. The first projection is based on "guaranteed assumptions" and the second projection is based on "current assumptions." Guaranteed projections assume guaranteed maximum policy charges and a guaranteed minimum-crediting rate (typically 3 percent today). Current projections assume policy charges and interest credits that are currently being applied to the policy and aren't guaranteed. Current assumptions are based on current insurer experience for investment earnings, expenses and mortality (death claims).

Typically, the guaranteed illustration shows the cash value quickly evaporating, culminating in the policy terminating. This should be understood but isn't a cause for concern. For the policy to perform as illustrated under the guaranteed scenario, the insurance carrier would have to raise charges to the maximum allowable immediately, as well as lower the crediting rate to the guaranteed minimum immediately, and hold those assumptions constant for the remainder of the projection. The reality is that there's a significant margin between current and guaranteed assumptions and any increases in policy charges must be justified to the state insurance commissioner (that is, supported by actual insurer experience). These are done across an entire product line, not isolated to any particular insured. Therefore, the likelihood of policy charges at the guaranteed levels is extremely remote.

However, some crediting rates have been lowered to the guaranteed minimum due to the historical and continued reduction in interest rates. Crediting and dividend interest rates are tied to interest rates as the assets supporting universal life and whole life liabilities are primarily made up of investment grade bonds and mortgages. Therefore, as a stress test, trustees should request in-force illustrations with a crediting or dividend interest rate reduction of 50 to 100 bps lower than current, and all the way to the guaranteed level. As of today, there's still downward pressure on crediting and dividend interest rates due to new money rates continuing to drop and being much lower than portfolio yields. Note that most crediting and dividend interest rates are based on portfolio yields that lag new money rates. In addition, for in-force systems that allow specific changes to policy charges, a 10-20 percent increase in the cost of insurance for universal life will provide for the unlikely scenario that mortality experience worsens. Historically, mortality has continued to improve and mortality experts predict that mortality will continue to improve in the future, albeit at a slower rate. Additional stress testing certainly would build knowledge, but these baseline projections should allow a trustee to have a strong feel for where the policy is currently, and what the road ahead may look like.

Replacement Red Flags

As seen in the *Cochran* case, and as determined in a policy audit or review, there are valid reasons to replace or exchange life insurance owned in a trust, including:

- Change in client objectives and needs;
- Cash flow concerns;

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- The leverage of consolidation of policies;
- Shift in risk tolerance;
- Lower mortality and expense charges driving superior performance in a new contract; and
- Underwriting upgrade (where the insured's health has improved).

Each potential solution needs to make sense for the objectives and properly researched and explored. However, a few practices require particularly heavy scrutiny, such as the suggestion of moving from whole life insurance to variable life insurance. There can be situations in which this would make sense, but, as described earlier, this is a significant shift in the risk fulcrum and is clearly adding to the potential for policy issues downstream.

Another common practice that needs to be thoroughly thought through is the exchange of a policy, or policies (whole life, universal life or variable life) for an NLG policy. This exchange, although NLG pricing has been rising recently, can have tremendous benefits, the primary of which is the end of premiums with the death benefit being guaranteed. However, NLG policies typically come with a price of significantly reduced, or zero, cash values, including early in the contract's life. As we saw previously, this may require a death benefit reduction.

In other words, the contract functions similar to glorified term insurance, in which there's no cash value in the policy after a certain amount of time, even though there's a death benefit. A trustee must think about the beneficiaries – not the grantor – and their potential needs for the cash value before exchanging to a policy in which future use of the cash value will be eliminated. It's also important for the trustee to keep in mind that a switch to an NLG contract removes any upside that future increases in interest rates may yield. Further, there's often a cliff for a NLG policy's life where the policy coverage ends at a certain age, for example 94 or 100. The insurance advisor can help a trustee understand that the amount of premiums paid directly affects the guaranteed death benefit duration of coverage.

A trustee with an NLG policy must be certain that the exact amount of premium scheduled to be paid is, in fact, paid – and paid on time. If not, the initial projections will be jeopardized. As an example, suppose it was thought that the policy would last until the insured reaches age 99, but then a premium was paid late. As a result, it may now only last until the insured reaches age 97.

Therefore, NLG contracts that have continuing premiums must still be pro-actively managed. Trustees should carefully consider the argument for NLG exchange that the cash value, that has been built up for years, won't be needed – only the death benefit will be. This is, of course, aided by the truth that the cash would be hard to access for the grantor. The diligent trustee will absolutely understand the broader financial circumstances of the grantor and his family before making such a change. The right question isn't whether the grantor will need to use the money, but whether the beneficiaries need to.

A good trustee will also know to examine if a face (death benefit) reduction of the existing insurance will solve the problem (for example, cash flow constraints for premium payments), before making a change. Further, the trustee will understand that although new policies might offer an underwriting classification ("standard plus", or "preferred") that weren't available when the current contract was written, it's wise to confirm with the existing carrier to determine if any improvement in the rating may be available, before making a change (1035 exchange) to a new product.

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