

ESTATE PLANNING

The Need for a Fresh Look at Irrevocable Life Insurance Trust (ILIT) Fiduciary Practices

E. Randolph Whitelaw, AEP (Distinguished)

There is a lapsing Trust-Owned Life Insurance (TOLI) policy crisis¹ and, in turn, an Irrevocable Life Insurance Trust (ILIT) solvency crisis. The reasons are trustee inattention, lack of product suitability evaluation at the time of policy purchase, and lack of product knowledge and policy evaluation expertise. A policy was “sold,” not “purchased.” The policy purchaser, the trust grantor, and subsequently the trustee, did not understand the features of the product type purchased, the product risks to be managed, and how to access credible tools to prudently manage these risks. Unskilled ama-

teur ILIT trustees who serve as an “accommodation” to the grantor usually are unaware that they have any administration duties and do not consider policy performance monitoring their responsibility. Most have no awareness that a solvency problem exists, meaning the grantor and beneficiaries are also unaware. How could this happen and what can be done about it?

Three ILIT parties have fiduciary duties—the grantor’s attorney who recommended and drafted the ILIT, the ILIT trustee, and the life insurance sales agent. Each has a duty to represent the best interests of either the grantor or

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Editor’s Comments

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Many of the readers of this *Estate Planning* Section Newsletter are involved in either creating, administering, or funding irrevocable life insurance trusts (ILITs). All three of these roles involve fiduciary duties. Yet the exact nature of these duties—particularly for the amateur trustee and the life insurance sales

agent—is not always clearly understood. To address these fiduciary roles and practices I could think of no one better to ask than E. Randolph “Randy” Whitelaw AEP (Distinguished), whose excellent article, “How to Relieve the Plight of Unskilled Irrevocable Life Insurance Trust Trustees Unfamiliar with Their Duties,”

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the beneficiary(ies). A lapsed policy and insolvent trust documents an imprudent process and brings into question the role of each of these parties.

This article suggests how the fiduciary practices of the grantor's attorney, ILIT trustee, and life insurance sales agents can be aligned so that an informed carrier and product suitability determination is made at the time of (1) policy purchase, (2) annual or periodic policy performance monitoring, and (3) periodic carrier and product assessment when trust objectives change, or trustee risk management criteria necessitate policy remediation or restructure, or policy restructure is favorable to the trust estate. It should be noted that the companion article² explains the reasons for the lapsing policy crisis, the TOLI risk management hurdles to overcome and myths to dispel, the need for intervention and the form it should take. Some comments in this article will overlap but its purpose is to explain how problems can be avoided from the outset, whereas the companion article explains how to implement an intervention plan to resolve problems with in-force policies.

The Drafting Attorney

The grantor's attorney usually plays a key role in his/her client's estate planning review, liquidity needs assessment, asset protection considerations, and multigenerational wealth management and transfer strategies. An irrevocable life insurance trust is frequently recommended as part of this planning process and drafted by the attorney who also provides a trust operation and administration memo. The memo often overlooks any discussion of the life insurance product to be purchased and

its management. The drafting attorney may consider this discussion to be the responsibility of the grantor and his/her selected life insurance agent, especially when a life insurance agent refers the client to the attorney. Whatever the reason, general memo asset selection and management guidance can be helpful to the grantor, the ILIT trustee, and the life insurance agent in establishing carrier, product, and policy performance suitability criteria that allow the trustee to demonstrate a prudent and reasoned risk management process consistent with the grantor's intentions and the trust's objectives.

What form can this guidance memo take, given that the drafting attorney usually lacks life insurance product and policy evaluation expertise? As a practical matter, the guidance can take one of two forms or both. First, much has been written concerning the carrier, product, and policy evaluation process for TOLI; hence, topical articles can accompany the memo. Second, experienced fee-based TOLI consultants are available to assist the grantor and trustee in establishing carrier and product selection criteria and interfacing with the selected life insurance agent. The consultant and agent roles should not be viewed as adversarial—the consultant contractually works for the trustee and the sales agent for the issuing carrier. The consultant assists the grantor and trustee in establishing proposal criteria and the agent “shops” the competitive market for carriers and products meeting these criteria. As a practical matter, the consultant helps to facilitate performance of the agent role without disrupting the agent's commission compensation.³

As a final comment, the drafting attorney is well aware of the lapsing policy and

trust insolvency problem. Trusts, especially irrevocable trusts, are becoming increasingly popular for multigenerational wealth transfer planning. Life insurance is ideally suited for this planning. As a result, estate planning attorneys, knowing the solvency issue, should consider how to communicate the need for consulting assistance for their file documentation purposes.

The ILIT Trustee

It is difficult to be a fiduciary in today's environment, particularly an "accommodation" trustee without any guidance concerning duties and administrative support. Applying this comment to ILITs, an ILIT trustee is likely to be the target of any dispute in the event of policy lapse and trust insolvency. Skilled trustees are not expected to accept a trust or a trust investment they lack the expertise to manage.⁴ Further, a skilled trustee enters into a formal arrangement that sets out the scope of the trustee's role either to exercise full investment discretion or to take direction. By comparison, an ILIT accommodation trustee usually lacks the skill and experience to administer the trust and manage the trust asset, and serves without a formal arrangement clarifying his/her role and responsibilities. In many instances, an unskilled ILIT trustee relies upon the grantor's attorney for trust administration and the life insurance agent for carrier and product suitability guidance and annual policy performance monitoring. However, the unskilled trustee's expectation of the sales agent usually does not comport with the agent's understanding.

It is important to note that carriers provide a policyowner with an annual policy statement

that summarizes policy values but does not provide for annual or periodic monitoring of actual policy performance versus originally illustrated and continually expected policy values. In-force reillustrations can be requested but, depending upon product type, carrier illustrations are neither credible for predictive value determinations nor appropriate for policy comparisons. Credible performance monitoring is available but not from the carrier and usually not from the sales agent.

A trustee has duties and responsibilities set out in the trust agreement and the Uniform Prudent Investor Act. If the trustee accepts appointment, then the trustee is expected to perform these duties and responsibilities. An ILIT trustee's duty runs to the beneficiaries, recognizing that because of IRC Section 2042 incidents of ownership in the trust policy(ies) the grantor is restricted from any decision-making. Said differently, the trustee has the sole decision-making responsibility and is expected to demonstrate and document a prudent and reasoned trust administration and policy risk management process.⁵ The companion article sets out how this process can be demonstrated and the form it should take especially if intervention is needed with a policy on a lapse glidepath.

In recent years, delegation has played an increasingly important role for both skilled and unskilled ILIT trustees, recognizing that most lack credible life insurance policy evaluation capabilities, and most unskilled trustees lack product suitability and restructure analysis expertise. Delegation requires the fiduciary to exercise prudence in selecting vendors, estab-

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lishing the terms of delegation, and subsequently monitoring vendor performance.

Four external expertise roles should be considered by ILIT trustees administering ILITs and in-force TOLI policies:

- **TOLI Policy Evaluation:** A fee-based vendor that offers fact-based dispute defensible⁶ TOLI policy performance monitoring reports.
- **TOLI Consulting:** A fee-based trust-owned life insurance consultant that offers TOLI-specific fiduciary process, carrier suitability, and product knowledge experience so that the trustee can document a prudent risk management and reasoned decision-making process.
- **ILIT/TOLI Administration Support:** A fee-based administration vendor that offers limited-scope ILIT and TOLI administration support services such as TOLI database reports that include upcoming scheduled grantor gifts and TOLI premium payments. An outsourced vendor may also be contracted to prepare grantor gift notices, Crummey notices to ILIT beneficiaries, etc. Ideally, administration support and TOLI policy evaluation services can be provided by the same independent vendor.
- **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 represents the issuing carrier but should take direction from the trustee and consultant.

All vendors are not the same. Most TOLI policy evaluation vendors employ an illustration-based methodology known to be neither

credible or appropriate for predictive value determinations and policy comparisons.⁷ It is extremely important to use a Request for Proposal process that sets out best practices criteria and avoids consideration of any vendors that cannot provide a service platform with these criteria.

Delegation involves fees. Just as an ILIT trustee is expected to safeguard trust assets, a trustee is also expected to “incur costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.”⁸ An unskilled ILIT trustee can delegate all or specific administration and policy management functions. In most instances, the related fee(s) are significantly less than traditional investment management fees.

As a final trustee comment, the plight of the unskilled ILIT trustee is well known and has been the subject of articles for over 20 years. Unfortunately, most accommodation trustees are unaware of the problem and do not consider either trust administration or policy performance monitoring to be their responsibility. And, if the trust agreement includes a hold-harmless provision, attention to any duties is not necessarily expected. While trust insolvency may not have been the grantor’s expectation, the trust agreement does not safeguard against this possibility.

Life Insurance Sales Agent

Is a life insurance sales agent held to a fiduciary or suitability standard? State licensing and associations, such as the Society of Financial Service Professionals, speak to a fiduciary standard. But, for the sake of discussion, consider a fiduciary or suitability standard in the context of a lapsing policy and trust insolvency crisis—

how does lapse and insolvency demonstrate a product recommendation that serves the trust's best interests or is suitable for unskilled trustee administration and risk management?

If carrier or product or policy performance problems arise, typically the recommendations and supporting analysis of the commission-motivated sales agent are not questioned because the other ILIT parties lack life insurance product and policy evaluation expertise. As explained in many other articles, flexible premium nonguaranteed death benefit products were introduced in the early 1980s and quickly became the products of choice until the early 2000s when continued policy underperformance ignited a flight to the safety afforded by fixed premium guaranteed death benefit products that offered attractive flexibility in rider options and duration planning.

What is the reason for the lapsing policy crisis? The high interest rates of the late 1970s (the prime rate was 21.5 percent) triggered the “buy term and invest the difference” introduction of flexible premium products (such as universal life policies) illustrated at 16 percent to 18 percent crediting rates, thus calculating a significantly lower annual premium to sustain coverage to contract maturity by comparison to a fixed premium guaranteed death benefit policy (whole life). Flexible premium products were aggressively marketed and became the products of choice. However, these nonguaranteed products transferred performance risk to the policyowner who rarely understood this risk transfer or the risks to be managed or the tools to do so. In the mid-1980s, variable universal life was introduced so that policyowners could access investment and fixed income

returns. The sales process entered a “win the illustration beauty contest” period recognizing that policy assumptions that calculate the lowest premium are most likely to be purchased. As interest rates declined and investment returns experienced down markets, originally illustrated values were not realized and policyowners had to increase premium payments to sustain coverage to insured life expectancy or contract maturity.

What does this explanation mean in the context of trust insolvency? First, the introduction of nonguaranteed policies transitioned life insurance from a “buy-and-hold” financial asset to “buy-and-manage” but neither the carrier nor the agent provides the “manage” function—it is missing. Second, few policyowners understood they assumed performance risk. Since the product selection decision was likely made by the grantor, accommodation ILIT trustees were unaware of their risk management responsibility, especially if the sales agent did not provide this disclosure at the time of policy delivery. Is the level of risk attributable to a nonguaranteed policy appropriate for the trust if the trustee is unaware of performance risk and lacks management expertise and capabilities?

As a wrap-up comment, the sales agent generally does not have carrier-imposed post-sales⁹ responsibilities. Assuming a suitability standard as a minimum, the agent should confirm the policy risks as well as post-sales policy administration and risk management issues requiring policyowner attention along with the tools available for the risk management function.

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Attorney-Trustee-Sales Agent Alignment

There is an increased use of trusts for sophisticated planning purposes, especially irrevocable trusts. Sophisticated trust planning requires trustee expertise in administering and managing the trust assets and investments. Given the attractive range of investment-driven and death benefit-driven life insurance products, life insurance is ideally suited for this trend, as long as the requisite product and policy risk management expertise is available from the outset.

The grantor's attorney plays the key role in this alignment given his/her participation in the grantor's planning review process and probable recommendation of the ILIT. The trust administration memo can include article attachments that speak to the standard of care appropriate for ILITs and TOLI policies as well as the availability of ILIT-experienced consultants and policy administration platforms. The delegation model employed by institutional ILIT trustees is a model unskilled trustees should consider.

The role of an accommodation trustee is questionable unless supported by an experienced ILIT consultant and trust administration/policy risk management platform. All the administration and management functions can be delegated. As explained in the companion article, a TOLI Investment Policy Statement (TIPS) sets out trust objectives, trustee responsibilities, delegation parties and their roles, and beneficiary communication. Except for inattention, there is no reason for trust insolvency.

The role of the sales agent remains a key role but only in the carrier and product selection decision since the agent has no post-sales policy administration and risk management

responsibilities. Based upon trust objectives and trustee risk tolerance criteria, carrier and product suitability criteria can be established so that the selected agent considers carrier and policy options that meet the criteria. Also, life insurance products continually change in response to consumer demands. The selected sales agent can play a continuing role with the trustee.

Conclusion

ILIT insolvency can be easily avoided. An ILIT trustee is responsible for maximizing the probability of a favorable outcome to the trust estate. The life insurance investment(s) is typically purchased for a 10- to 50-year duration period. The selection of a life insurance product consistent with the appropriate risk tolerance and management responsibilities allows the trustee to purchase the policy(ies) with the desired return and select among fixed and flexible premium payment options. Hence, the development and implementation of a prudent and reasoned investment management process are essential to safeguarding the interests of ILIT parties, maximizing the outcome to the trust estate, and avoiding breach of trust allegations. ●

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Endnotes

- (1) Reliable data concerning life insurance policies owned in irrevocable life insurance trusts (ILITs) is

unavailable. Since 1993, TOLI risk management articles have suggested that unskilled trustees administer up to 90% of in-force TOLI policies. 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% of in-force universal and variable universal life products are carrier illustrated to lapse prior to the insured's estimated life expectancy or within 5 years of the insured's estimated life expectancy. Further, approximately 12 percent of whole life and guaranteed universal life policies have compromised guarantees.

- (2) E. Randolph Whitelaw, "How to Relieve the Plight of Unskilled Irrevocable Life Insurance Trust Trustees Unfamiliar with Their Duties," *Journal of Financial Service Professionals*, March 2014.
- (3) Skeptics are likely to question this suggestion, believing that the sales agent will always consider the consultant to serve in an adversarial role. There is a trust insolvency crisis that demonstrates the need for collaboration in order to maximize the probability of a favorable outcome to the trust estate.
- (4) 12 CFR 9.6 (a) (b) (c) OCC 2008-10 Bulletin. This bulletin also provides excellent guidance concerning the basis for an effective investment review process necessitating policies and procedures that provide clear standards for scope, documentation, and exception reporting and tracking.
- (5) *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.* Restatement (Third) of Trusts, §227b. Duty to Conform to Fiduciary Standards.
- (6) See companion article for a more in-depth discussion of fact-based policy evaluation and the importance of avoiding illustration-based analysis and subjective ratings.

- (7) Carrier illustrations for flexible premium nonguaranteed death benefit policies, by policy contract provisions, carrier illustration disclaimers, and FINRA regulation for predictive value calculations or policy comparisons are neither credible nor appropriate for predictive value determinations.
- (8) Restatement (Third) of Trusts, §90(c)(3) 1992.
- (9) *USB Financial Services, Inc. v. Thompson.*

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appeared in the March 2014 issue of the *Journal of Financial Service Professionals*. (If you haven't read that article yet you really need to do so. In my humble opinion, it is one of the best articles I've ever read.)

Randy's article for this newsletter, "The Need for a Fresh Look at Irrevocable Life Insurance Trust (ILIT) Fiduciary Practices," was written as a companion piece to the article that appeared in the *Journal of Financial Service Professionals*. This remarkably practical article goes into exquisite detail about the exact fiduciary requirements, roles, and best practices for the attorney, trustee, and life insurance sales professional. More importantly, it examines the collaborative nature of these roles and the need for the trustee, whether skilled or unskilled, to delegate appropriate duties to independent third-party consultants with expertise in trust-owned life insurance (TOLI) risk management and administration and life insurance product evaluation when the trustee does not possess these skills or capabilities. As pointed out in the

article, the TOLI consultant role is not adversarial with respect to the life insurance sales agent or broker. Rather both the TOLI consultant and life insurance professional are working toward the same goal of a successful outcome with the life insurance policy(ies) for the trust beneficiaries. In fact, the TOLI consultant provides independent verification of the choice of the life insurance product by the agent/broker.

Frankly, this article is just as excellent as Randy's article that appeared in the March 2014 issue of the *Journal of Financial Service Professionals*. You will find it immensely informative, enjoyable, and practical!

On a personal note, this issue of the newsletter marks two years that I have served as editor. This leaves me 10 more years to catch up with the tenure of my good friend and previous editor Ron Caballero. We'll see if I can make it. However, whether I make it or not, I just want you all to know what a pleasure and honor it is to serve as your editor for this *Estate Planning* Section Newsletter. ●



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