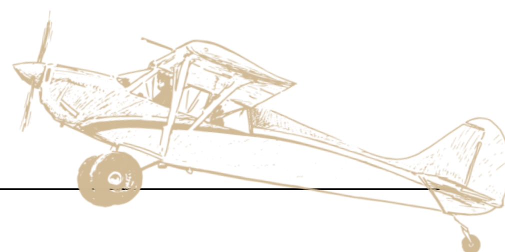
No One in the Pilot's Seat



This paper provides a critical examination of developments in irrevocable life insurance trust management and oversight that erodes the protections afforded to trust beneficiaries. It also provides recommendations for grantors and beneficiaries to help protect their interests in light of the current environment. Although the paper will focus on life insurance in the estate planning context, the majority of the discussion items and solutions are applicable in non-estate planning situations as well.

Can you imagine waking up in-flight to find there's nobody in the pilot seat, and you have no way to take control of the plane? Sure, it's a bit outlandish, but it's exactly what the owners and beneficiaries of many life insurance policies are facing today. If we think of life insurance in the estate planning context as a vehicle to accomplish plans for the client, it can be likened to a long aircraft flight that gets estate assets to a specified destination (the intended beneficiaries). There are numerous parties involved in the pre-flight planning, yet the ultimate success relies on the guidance and expertise of the pilot flying the plane. Unfortunately, there is a disturbing trend occurring that threatens to undermine the best laid plans: the absence of a pilot once the journey is underway. The abandonment of life insurance policies by the very people who are supposed to be managing them and ensuring they stay on course over time will undoubtedly cause irreparable harm to beneficiaries should it be left unchecked.

Life Insurance: A Long Term Asset That Differs From Other Assets Significantly

In the management of a client's investment assets, there is contract and active monitoring and reporting. Assets are reviewed periodically and rebalanced and adjusted based upon performance, economic considerations, and client goals and objectives. The consequences of an underperforming investment portfolio aren't typically dire and corrective actions abound. Contrast this to a life insurance policy, where underperformance can terminate the entire asset and where corrective actions are limited (see Table 1 at the end of the article). This creates a much more challenging environment for the ILIT trustee.

Life insurance policies purchased for the purpose of providing long term death benefits often span multiple decades. Few other assets owned as widely as life insurance have such a lengthy duration and such a material financial impact to beneficiaries. Life insurance policies are complex financial products that require ongoing monitoring and maintenance. Compared to other financial instruments, life insurance is also much less liquid due to barriers to entry and exit that may be financial, health, control or tax related. Thus, life insurance requires an uncommon combination of upfront due diligence, pre-policy planning, monitoring and adaptation within a sometimes confining set of boundaries.[i]

"Life insurance requires an uncommon combination of upfront due diligence, pre-policy planning, monitoring and adaptation."

Where Does The Most Risk Exist?

The buying knowledge of the consumer has increased tremendously in the last decade when it comes to pre-purchase product due diligence. Much has been written about the selection and structure of life insurance policies. Often professional continuing education sessions are offered concerning life insurance as well. As such, it is likely that at least one of a client's professional advisors (attorney, trustee, financial advisor, or accountant) has some exposure to the life insurance acquisition process. They typically assist in the purchasing process to some degree. Unfortunately, this tends to be where the practical assistance ends, and the policy owner is often left to manage a strange and complicated asset on their own.

The problem with this approach lies with the timeframe where risks are most prevalent: after policy purchase. For example, prior to purchase great care is often exerted to ensure a proper balance of carrier strength, diversification, policy funding, and policy ownership considerations. Undoubtedly, these issues warrant significant time and attention. But what risks may manifest after a policy has been issued? Figure 1 shows some of the policy administrative risks that exist over time.

Figure 1 – Life Insurance Post-Purchase Policy Administrative Risks

- Premium timing
- Ownership change
- Beneficiary change
- MEC (and look backs)
- Assignments
- Cash rich contracts (1st 15 years)
- Loan strategies (APL, Index, Variable)
- Shadow account challenges
- Address change
- Trustee change
- Billing changes
- Suitability
- Expiration of term conversion rights
- Termination of term policies
- Non-enacted planned changes
  - Investment options
  - Increasing to Level DB option
  - Premium suspension
  - Loan repayment
  - Non-forfeiture/APL
  - Dividend option
  - Rider removal
  - Death benefit reductions
  - Utilization of riders/features
  - Policy distributions
- Tax implications
  - Gift
  - GSTT
  - Income
  - Estate
  - Transfer for Value
  - 101j non-compliance
  - Phantom income

What are the implications if these risks manifest and aren't addressed properly over time? The risks may be financial in nature or have other less recognized consequences. The most obvious implications are increased out of pocket premium requirements, reductions in death benefit, lower cash values and loss of coverage prior to death. When these things go awry it may have companion impacts such as incurring gift or income tax. In cases where coverage is reduced or terminated and the life insurance was a key foundation in a planning strategy, it could have wide ranging consequences such as the inability to properly transfer business interests, unequal estate distributions to heirs, lack of liquidity, or forced sales of assets that were not intended to be sold such as a family vacation home.

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The Trustee May Not Be Liable For What Happens

Just as a plane is impacted by internal and external forces, so is a life insurance policy. The grantor of an irrevocable life insurance trust can't manage the policy. The agent, attorney, and accountant have no legal or contractual duty after the policy sale. So, who is sitting in the pilot seat managing the policy and reacting to these external forces? The burden rests solely in the hands of the trustee. The trustee (whether professional or non-professional) has to guide the policy through everything thrown at it to a destination that is 30, 40 or even 50 years into the future. The Uniform Prudent Investors Act ("UPIA") provides a fairly detailed set of standards to describe what the trustee should be doing as well as specific duties to measure if they are exercising adequate care over the assets (a life insurance policy in this situation).

Given the well-established fiduciary standard of a trustee, one would believe that a policy would be managed professionally and with great care. However, a disturbing trend has emerged in recent years that should concern grantors and trust beneficiaries. There has been a movement that effectively provides a parachute for the trustee to escape the plane unscathed. The trend, either by statute or trust provision, exculpates the trustee from the responsibilities to the trust beneficiaries regarding the outcome of the life insurance policy (excluding outright fraud or criminal acts). As of 2012, at least 13 states have enacted statutes exculpating a trustee from any losses sustained with respect to life insurance held by a trustee.[ii] Similar statutes have been or are currently proposed in other states. In addition, attorneys may draft trusts provisions that afford a similar protection to the trustee. Similar protections may be afforded to trust advisors as well. While this language might be a reasonable request coming from a family member or friend acting as trustee, the inclusion of such language for professional trustees seems incredulous when clients entrust their assets to such parties and pay them a fee for professional trustee services. A February 2014 article in Trusts & Estates poses an interesting question to attorneys: "How many of our settlors would proceed with their trusts if they really understood that their beneficiaries had no enforceable rights in the event of gross negligence or even reckless misconduct of the trustee, or of any misconduct, incompetence or negligence of the non-fiduciary advisor, short of outright fraud?"[iii]

Even absent these parachutes, two court cases (Figure 2) seem to set a very low bar of standards the trustee must satisfy to avoid liability for the outcome of their actions. In Cochran v. KeyBank[iv], it was deemed sufficient that the trustee "examined the viability of existing policies and at least one other option" (in regards to the replacement of an existing policy by a new policy with a 65% lower death

Figure 2 – Case Highlights

Cochran v. KeyBank

- 1987 Cochran purchased $4.75MM Universal Life and Whole Life insurance portfolio
- 1999 stock market was racing and insurance agent replaced existing policies with Variable Universal Life and increased death benefit to $8MM
- 2001 stock market decline and panic ensues
- 2003, $8MM policy was exchanged to $2.5MM Guaranteed Universal Life policy
- Cochran died 7 months later

French V. Wachovia Bank

- French ILIT owned two Whole Life policies with $5MM death benefit and $2.2MM cash value
- 2004 Whole Life policies and cash value exchanged for $5MM Guaranteed Universal Life with $0 premiums saving trust $620K premium. However, cash value decreased to new policy type and sizeable commission.
- French upset that the insurance agency, Wachovia Insurance Services earned over $500K commissions; claimed "self-dealing" and failing its duty of loyalty by putting is own interest ahead of the beneficiaries

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benefit and after incurring $107,764 in surrender charges). In French v. Wachovia[v] Bank, the trust documents gave the trustee the discretion to "retain, invest and reinvest in any property…regardless of any risk, lack of diversification or unproductivity involved;…to continue as trustee and to deal with any trust hereunder without regards to conflicts of interest". This allowed the trustee to engage in self-dealing by purchasing new life insurance from the bank's insurance brokerage affiliate and collecting approximately $500,000 in commissions on the new policy.

Consider these examples where a trustee could conceivably avoid any liability:

- A trustee pays the premium late or early either of which may result in a higher required premium or loss of policy guarantees.
- A trustee fails to change investment allocations and leaves the money in the money market account even though the policy requires an earnings rate approaching 8% to sustain itself.
- A trustee initiates a policy distribution prior to maturity of an earnings segment causing forfeiture of 5 years of index policy gains.
- A trustee deactivates the dollar cost averaging feature which results in permanent termination of the policy's guaranteed death benefit provisions.
- A trustee isn't aware of a looming policy lapse because of failure to secure periodic re-projections of policy performance.
- A trustee fails to recognize upcoming declines in the policy death benefit and/or significant premium increases because of reliance upon abbreviated policy information provided by the carrier.

Given the apparent proliferation of trustee escape hatches, what confidence can be gained by employing a trustee? Does this mean that every trustee will abandon their duties? Certainly not. Most trustees take the fiduciary responsibility very seriously and some national banks have taken stances to forbid self-dealing and chosen to employ outside third party fee based reviews of life insurance policies. However, given the irrevocable nature of an ILIT, it is something that absolutely has to be addressed. The grantor has no assurances that the chosen trustee will remain trustee until the end of the flight. The beneficiaries have no assurances that their interests will be cared for in the future. Therefore, additional actions need to be taken to ensure proper protections of a policy over time.

Ensuring There Will Always Be a Pilot

It is clear that life insurance is an asset where one cannot make the assumption that someone is looking out for what may happen down the road and taking the necessary steps to give the policy the best possible chance of achieving the desired outcome. What can be done to make sure the policy is being regularly monitored and managed over time?

Step 1: The Policy Management Statement

The first step is to develop a flight plan for the life insurance. For a life insurance policy, this takes the form of a life insurance policy management statement. It is necessary to understand the environment and constraints under which policy related decision making should be taken. Why was the policy established? Are there targeted policy earnings levels required to sustain a policy? Is there a reason for a concentrated carrier position rather than a portfolio of policies from multiple carriers? Are there finite limits on grantor contributions to the trust for premium payments? Are there any events or developments which should trigger specific actions including consideration of

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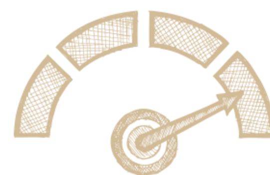
alternative policies? Has the need for the policy changed or the Grantor's desire to fund premium gifts changed (a common situation today with the higher current estate tax exemption amounts)?

A written policy management statement can document these considerations and many others which can then be used to manage the life insurance policies. Consider incorporation of trust language related to the use of the policy management statement (including provisions for periodic updating of standards as necessary). With such a document, all involved parties will be better informed and have managed expectations. The written policy management statement also provides the foundation upon which to judge any proposed new policies or replacement policies. It facilitates comparative analysis of how well existing and proposed new policies fit within the established standards for the trust.

Although the policy management statement is most commonly used for trust owned policies, there is no reason such a document can't be crafted for non-trust policies as well. It would seem prudent for any policy owner to have such a document if for no other reason than to serve as an easy to find reference of policy expectations.

Step 2: Ongoing Policy Management and Monitoring

While it is impractical for every individual trust to have a specialized policy service system or process, it is not impractical for a grantor to insist that any policies be managed by a party employing such a system. A robust policy management process or software system can provide functionality such as basic policy reporting, premium reminders, status checks, measurement against standards set forth in the policy management statement, carrier financial reporting, and even document storage capabilities. While this step may require a fee to be incurred, there are too many things that can go wrong in the future with policies that rely on ad-hoc reporting only. For new coverage being purchased, consider only agents that employ (and can demonstrate it real time) a system or process with such capabilities. Consider incorporating language into the trust document that requires the trustee to employ such a system or process whether internally or via outsourcing to a qualified third party. It would be prudent to employ such a system for non-trust owned policies as well.



Step 3: Written Contract with a Competent Flight Crew

As noted herein, trust language and location can relieve trustees of some of their fiduciary responsibilities. Some trust companies may require inclusion of special trust language in order for them to administer an ILIT. Discuss the obligations and responsibilities of the trustee with your legal counsel. If you are uncomfortable with the language, search around for a trustee willing to provide the services without shirking fiduciary responsibilities. It may require greater administrative fees or a change in trust situs, but those may be reasonable accommodations for the resulting peace of mind that somebody is likely to be flying the plane.

It is insufficient to rely on policy annual statements as a life insurance management tool. Policy statements are snapshots of a point in time and usually do not accurately re-project the expected policy performance into the future. Include language in the policy management statement requiring periodic in-force illustrations (annually, bi-annually or tri-annually) to be obtained. However, it is necessary to ensure the data can be properly interpreted and acted upon. For example, if you haven't been trained in reading an EKG, merely having a printed EKG does little to

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aid in decision making regarding your health. You need someone capable of interpreting the results, identifying any potential problems, and developing any necessary plan of action. Given the complexities and nuances of life insurance, steps should be taken to ensure the data is interpreted properly and acted upon as needed. Thus, reporting is most useful when coupled with consultation with a qualified third party who can provide interpretation and advice related to the information as well as the ability to act on any required modifications. What if there needs to be explanation and discussion with trust beneficiaries or grantors? Who is willing and capable of the task? Many third party reporting solutions fail to provide the crucial element of interpretation and consultation…stopping only at report generation.

It is equally important that any policy management services also include some level of "fulfillment" services. Analyzing, planning, and adapting are important to the long term success of a life insurance plan, but any changes must be implemented properly. Is the agent still around? Is the agent willing to assist? (Remember they have no obligation to service the policy.) What if modifications require careful timing and coordination due to legal, tax or accounting considerations? Who is managing the implementation properly? Consideration should be given to the ability of policy managers to coordinate and manage the implementation of any requisite modifications such as those shown in Figure 1. "Reporting only" service providers may leave trustees flying solo when it comes to implementing changes.
Ideally, the agent is willing to commit in writing to provide a given level of policy service and can provide the policy management system, necessary reporting, interpretation, consultation and implementation. A simple policy service contract can outline the services the agent is willing to provide for the policy. There may be an annual fee associated with the management activities, but it is money well spent in order to give the life insurance coverage the best possible chance of achieving the desired outcome over time.

In absence of a written policy management contract with the writing agent, many trust companies and other professional trustees are now delegating some duties to third-party, fee-based policy management and monitoring firms. Generally, this has resulted in the trustee increasing fees to their clients. Section 9 of the UPIA specifically addresses Delegation of Investment and Management Functions. Under Section 9, the trustee may reduce risk while providing a best practices approach to the management and monitoring of ILIT policies.

Conclusion

Life insurance is a complex, long term financial instrument. It requires specialized knowledge for proper implementation, monitoring, and management. Rather than developing the necessary information, insight, processes or systems, it seems many states and trust companies are relying on statutes and trust language which effectively allows ILIT trustees to avoid responsibility for the very assets they are tasked with supervising. Recognition that the traditional life insurance management process is inherently flawed and modification of behavior will help circumvent the challenges during flight. The steps suggested herein can provide additional assurances to grantors, beneficiaries and trustees that the flight has the best possible chance of reaching the intended destination. In the end, such additional steps will result in aligned interests, more managed expectations, better communication, peace of mind, and improved chances of a successful flight.

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Table 1 – Differences in managing investment portfolios and life insurance

Trust Investment Portfolio	ILIT Life Insurance Policy
Under-performance results in lower portfolio balances.	Under-performance may result in loss of the entire policy and may have tax implications
Near limitless investment options and strategies to recover from portfolio underperformance including: change allocations, find lower fees, change managers, change durations, add more money, or increase risk exposure.	Investment choices (if any) and options to recover are dictated by the type of policy, policy funding limits, and other factors. It may not be possible to change allocations, lower fees, add money, change durations or alter the risk exposure.
Easy to quantify cost to put an investment strategy back on track.	May be difficult or even impossible to quantify the ultimate cost to put a life insurance strategy back on track.
An investment portfolio might have lower expense levels over time as the asset base grows.	Many policies have significantly escalating expenses over time.
It is simple to change the risk profile or time horizon of an investment portfolio.	A policy may not allow a change in the investment risk profile or the investment time horizon.
Borrowing or distributions from an investment portfolio can be easily quantified and modeled under a variety of assumptions and fact patterns.	The full impact of a loan, partial surrender or distribution from a life insurance policy may not be easily determined prior to execution or even disclosed in some policy types.
Relatively easy to diversify a portfolio at any time without inordinate increases in associated expenses.	Available underwriting offers and product types may result in significantly higher costs for carrier diversification and is available up front only.
The trustee may unilaterally choose to liquidate one or more investment positions.	While a trustee may surrender a policy outright, he may not execute a life settlement without consent of the insured.
There is significant breadth and depth of research and insight on investment strategies and portfolios.	Sound research and insight on life insurance policies is difficult to find. What information is out there is often plagued by omission or supposition of fact patterns or actions.
Many trustees are very knowledgeable on investments and investment strategies.	Few trustees are experts on life insurance.
Some investments may have barriers to exit such as income taxes, capital gains taxes, back end loads, surrender charge periods, notice requirements, or lock up periods.	A life insurance policy has barriers to exit that may include income taxes, surrender charges, forfeiture of earnings, notice requirements, lock up periods, and delays for receipt of surrender proceeds.
Some investments may have barriers to entry such as minimum investment requirements.	Life insurance policies have significant barriers to entry including willingness and consent of the insured party to undergo underwriting, health worthiness of the insured, a pricing structure that escalates with age, and restrictions on minimum and maximum allowable premiums.

[i] Two white papers are available for additional insight: 1) Repercussions of a Sustained Low Interest Rate Environment on Life Insurance Policies, and 2) A Matter of Choice which discusses life insurance company selection.
[ii] AL, AZ, DE, FL, NC, ND, OH, PA, SC, SD, TN, VA, and WY
[iii] Bove Jr., Alexander A (February 2014), The Death of the Trust, Trusts & Estates, 51-55
[iv] In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009)
[v] French v. Wachovia Bank, N.A., 2011 U.S. Dist. LEXIS 72808 (E.D. Wisconsin 2011)

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