Trust-Owned Life Insurance: Risk Management Guidance for Professional Advisors

If an ILIT trustee was aware of a policy's impending lapse (or the carrier's insolvency), is the trustee liable if it failed to take appropriate action?

And, if this trustee was a personal (unskilled) trustee who relied upon a professional advisor or life insurance agent for policy performance monitoring, would the advisor or agent have liability?

And, would insurance trust beneficiaries be advised to take action against a trustee if the trustee had actual knowledge of a fact and failed to take appropriate action based upon the trustee's ownership of the life insurance policy?

This special LISI report on Trust-Owned Life Insurance, **which should be carefully studied by every trust officer and every professional involved in implementing and maintaining Trust-Owned Life Insurance** was prepared by **E. Randolph Whitelaw and Dick Weber.**

EXECUTIVE SUMMARY:

Trust-Owned Life Insurance (TOLI) and its unmanaged liability has been the subject of many cautionary articles since 1992 when the prudent investor rule replaced the prudent person rule to accommodate contemporary investment management strategies. "Flexible premium" non-guaranteed death benefit policies have become the TOLI "product of choice." Yet surveys show that most TOLI fiduciaries have not established any prudent and traditional risk-based practices, much less "best practices".

This special LISI commentary will address past practice rationales that usually defy logic and common sense. A check-and-balance process has always existed between grantor's attorney and trustee to assure appropriate product suitability determinations and trust operation procedures. Contemporary TOLI risk evaluation tools and products ARE available to achieve an insurance trust's objectives. They just need to be used.

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NO SAFETY IN THESE NUMBERS

Consider the warnings from a recent survey of professional trustees and recent articles:

- 84% had no guidelines and procedures for handling TOLI.
- 96% had no policy statements on how to handle life insurance investments.
- 71% of personal trustees had not reviewed their trust's life insurance policies in the past 5 years.
- 95% had no policy statements on how to handle life insurance investments.
- Flexible premium policies now approximate 35% - 40% of inforce TOLI policies as compared to less than one percent 25 years ago.
- The average TOLI policy death benefit is $1.5 million.
- Larger death benefit policies tend to be flexible premium non-guaranteed death benefit policies purchased in the past 25 years.
- More than 50% of inforce TOLI policies warrant remediation due to their under-performance of policy acceptance benchmark values. Adjust this statistic for guaranteed policies and it is likely 100% of non-guaranteed policies warrant remediation and, possibly, restructure!
- Over 90% of TOLI policies are "orphans" without an assigned servicing agent.

The responsibility for policy management rests solely with the trustee who, upon acceptance of the insurance trust, affirmed his/her/its expertise and capabilities to serve in this role.

DISTURBING QUESTIONS:

These statistics beg the obvious question – ***who is safeguarding the interests of the beneficiary?***

Trustees who elect to "do nothing" and rely upon hold harmless and exculpatory language protection are especially vulnerable to lawsuits instigated by beneficiaries. In general, a trustee is liable to the trust beneficiaries for any losses sustained if:

- The trustee had actual ***knowledge*** that a TOLI policy was either not suitable for the purposes of the trust or not performing competitive with more productive alternatives readily available, and/or
- The trustee failed to exercise reasonable diligence in the discovery of potentially damaging trust information that was ***knowable*** and commensurate with his fiduciary obligation to monitor trust assets.

TODAY'S TOLI FIDUCIARY ENVIRONMENT

Appropriate fiduciary conduct must be demonstrated, documented and affirmed. A trustee is not legally obligated to accept a trust or a trust investment it is not competent to manage. But once a trustee takes on that duty, acceptance affirms the Trustee's implied declaration it has the requisite skill, care and expertise. Hence, trustees contractually perform their duties in a "guilty without proof of innocence" environment. The introduction to the enhanced duties of the Prudent Investor Rule emphasized that "a major purpose of Restatement Third was to make sure fiduciaries could not escape liability for inadequate investment strategies."

Fiduciary conduct is evaluated against a process standard, not a performance standard. The Prudent Investor Rule places the emphasis for liability protection on the establishment, documentation, and implementation of prudent decision-making policy. Over time, trust objectives, tax law, economic and

market conditions, risk management practices, and life insurance product features change.

A trustee of an irrevocable life insurance trust may elect to "do nothing" and rely on "hold harmless" and exculpatory language protection. However, since all incidents of ownership were conferred on the trustee in order to keep the proceeds out of the grantor's estate for federal estate tax purposes, the trustee is the ONLY party who has the power to act to protect the beneficiaries' interests!

Irrespective of the limited protection afforded by hold harmless language or state legislation, the beneficiaries could argue that the trustee, at a minimum, has a duty to notify the parties-at-interest and do what is required as owner to protect their interests.

OPERATION OF IRREVOCABLE LIFE INSURANCE TRUSTS

The creation of an insurance trust usually results from a broader analysis of wealth preservation, estate liquidity, and income planning objectives. This economic analysis, prepared by the grantor's legal and/or tax advisor, evaluates the cash flow, liquidity timing, and tax trade-offs of different planning options.

Life insurance has evolved as the preferred option because it offers both cost and risk transfer advantages that are ideally suited for trust ownership. The economic analysis also confirms both the level of expected trust return (death benefit proceeds) and the expected level of risk (premium adequacy).

FIDUCIARY DUTY WITH RESPECT TO FINANCIAL OUTCOME:

The basic duty of a fiduciary is to maximize the probability of a favorable outcome to the trust estate. A trustee can elect to acquire a guaranteed death benefit policy and transfer all premium adequacy risk to the underwriting carrier.

Alternatively, a trustee can retain premium adequacy risk by accepting an indeterminate "flexible premium" non-guaranteed death benefit policy and actively manage policy values. Acceptance of premium adequacy risk implies grantor approval to do so, premium evaluation and active policy value management expertise, and affirmation by the trustee to manage the insurance investment consistent with the trust's objectives.

If a trustee lacks TOLI risk-based procedures or credible premium evaluation expertise, the trustee must recommend restructure to a guaranteed death benefit policy to affirm its limited scope of services and document an appropriate product suitability determination. This is especially true of a personal (as contrasted to an institutional) trustee.

PRE-ACCEPTANCE COMMUNICATION IS ESSENTIAL:

Pre-acceptance communication between the trustee, grantor and grantor's attorney must document product suitability decisions and affirm the expected trust operation including premium gifting strategy, Crummey Notices and tax returns. Further, it should document that the grantor's attorney is not acting as a professional life insurance advisor in order to avoid potential conflicts or interest and assumed suitability judgments.

Pre-acceptance communication should set forth premium management guidance for policies that do not have defined premiums and affirm what happens if:

- The policy incurs higher than expected expenses and/or lower returns than suggested in the simplistic sales illustration that establishes benchmark values for policy acceptance?

- The grantor can't or won't increase the gift. Should the death benefit be reduced to keep the policy in force?
- The policy is no longer suitable due to changed trust objectives. Should a policy exchange or a life settlement be considered?

In transitioning to a "best practices" TOLI risk management process, a trustee should adopt contemporary practices appropriate in today's corporate governance environment, and not maintain conventional status quo thinking.

For example, a trustee must overcome embedded TOLI administration practices such as the following that are no less than an invitation to litigation by beneficiaries:

1. Focus on a carrier's size and ratings when product suitability and premium adequacy are the more critical and immediate issues to be evaluated.
2. Assume carrier sales and inforce illustrations are credible for determinations of premium adequacy risk management.
3. Assume the interests of the agent, carrier, grantor, beneficiary, and trust are aligned.
4. Approve acceptance of a policy without formally confirming all trust operation issues with the grantor's attorney who drafted the trust document.
5. Approve acceptance of a non-guaranteed policy without <u>formally</u>:
    a) Affirming the product's suitability with the grantor and the grantor's attorney,
    b) Evaluating the adequacy of the premium to sustain the policy for the insured's lifetime, and
    c) Confirming that the policy will be managed consistent with the insurance trust's Investment Policy Statement.
6. Approve acceptance of any policy assuming that the death benefit will unequivocally become an asset under management when the insured dies.
7. Approve acceptance of a policy without identifying the necessary compensation to be received for the risk-appropriate management of the policy.

TOLI PRODUCT SUITABILITY PRIMER

Life insurance has experienced a product revolution over the past 30 years and has become a sophisticated self-design risk transfer mechanism. To maximize the probability of a successful outcome to the trust estate, the prudent investor rule instructs a trustee to design and carry out a reasoned investment strategy that will fit within the trust's unique purposes and the expectations of the beneficiaries to make the trust property productive.

Following is a TOLI product suitability matrix based on the current generation of life insurance policies.

TOLI Product Suitability Matrix

Trustee Acceptance Considerations Policy Management Features	Guaranteed Products: Whole Life	Guaranteed Products: No Lapse Guarantee Universal Life	Guaranteed Products: Level Premium Term	Guaranteed Products: Yearly Renewable Term	Non-Guaranteed Products: Adjustable Life	Non-Guaranteed Products: Universal Life	Non-Guaranteed Products: Variable Universal Life	Non-Guaranteed Products: Variable Life
Premium Schedule	Fixed	Fixed	Fixed Period	Increasing	Flexible	Flexible	Flexible	Fixed
Specified Death Amount	Fixed	Fixed	Fixed	Fixed	Flexible	Flexible	Flexible	Fixed
Account Value Management	Carrier	Carrier	None	None	Policy Owner	Policy Owner	Policy Owner	Policy Owner
Asset Allocation Required	N/A	N/A	N/A	N/A	No	No	Yes	Yes
Illustration Credibility	Yes	Yes	Yes	Yes	No	No	No	No
Actuarial Evaluation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Volatility Simulation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Trustee Management Requirements								
Investment Policy Statement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
TOLI-Specific Procedures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product Suitability*	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Premium Adequacy Risk	No	No	No	No	Yes	Yes	Yes	Yes
Monitoring Cycle	N/A	N/A	N/A	N/A	Annual	Annual	Annual	Annual
Carrier Solvency Risk	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Asset Allocation Review	N/A	N/A	N/A	N/A	N/A	N/A	Annual	Annual
Conversion Review	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A
Rating and Rider Review	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Regulatory Review (Institutional)	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Professional Advisor Annual Verification								
Product Suitability*	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Premium Adequacy	N/A	N/A	N/A	N/A	100%	100%	100%	100%
Death Benefit Adequacy	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes
Carrier Solvency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Investment Performance-Rebalancing	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Yes
Term Conversion	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A

*implicit with each premium payment

TRUSTEE'S DUTY TO CONSIDER LEVELS OF RISK AND AVOID UNJUSTIFIED LEVELS OF FEES AND EXPENSES

A trustee has a duty to "make conscious decisions concerning the levels of risk" and to avoid fees and expenses that are not justified. For over 20 years, academic studies have debated the pros and cons of traditional and low load policies, and articles have chronicled the long-standing compensation system debate between commission-based agents and fee-based planners.

It is not the author's intention to suggest one approach is more favorable than the other. Policy sales compensated by commission are perfectly appropriate if the agent is providing both professional pre and post sales services to the trustee.

A policy delivery letter must avoid factual omissions and provide full disclosure of the policy's assumptions relative to the trust's objectives, its guaranteed and non-guaranteed features, its initial sale charges and estimated ongoing policy costs, the trustee's ongoing risk management responsibilities, and the agent/planner's commitment to his/her policy service role.

ACTUARIAL EVALUATION

Actuarial evaluation must be used for all premium adequacy policy acceptance, management and restructure determinations involving "flexible premium" and non-guaranteed death benefit policies. Actuarial evaluation uses common standards, impartial analysis, and objective data to assess a

non-guaranteed policy's premium adequacy until contract maturity and/or an assumed life expectancy. If a trustee elects a premium adequacy risk tolerance less than 100% probability to sustain the policy to contract maturity, actuarial evaluation can suggest the risk-appropriate premium amount.

If an existing TOLI policy is under-performing its acceptance benchmark, actuarial evaluation can assess the needed premium adjustment.

If under-performance poses a risk that the policy may lapse, actuarial evaluation can estimate the insured's age at the earliest probable lapse in order to compare this age to the insured's assumed life expectancy.

If a policy warrants restructuring, actuarial evaluation facilitates a credible analysis of restructuring options, including comparison to the fixed premium for a guaranteed death benefit policy.

Because of an actuarial evaluation's long-term time horizon, periodic reassessment is appropriate to take into account actual policy experience.

TOLI ILLUSTRATION PRIMER

Trust files filled with non-guaranteed carrier illustrations and illustration-based performance reports are evidence of an imprudent process. The reason is that flexible premium, non-guaranteed policy illustrations:

- Do not evaluate premium adequacy,
- Do not provide predictive value (they in fact disclaim it),
- Are not appropriate for policy comparisons, and
- Do not assess the reasonableness of agent-controlled policy design or carrier-controlled crediting rate and expense charges assumptions.

It is difficult to imagine that a professional familiar with contemporary life insurance practices would assert that non-guaranteed illustrations and illustration-based methodology are meaningful for predicting policy performance, much less evaluating the adequacy of the premium adequacy, in light of the following:

(1) In 1992, the Society of Financial Service Professionals introduced the Illustration Questionnaire ("IQ") and clarified, "illustrations have little value in predicting actual performance or in comparing products and companies. So the risks associated with the possible inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policyholders."

(2) Also in 1992, the Society of Actuaries published an extensive examination of illustrations and illustration practices associated with the purchase of life insurance, and concluded that there are two major uses of illustrations:
    - Type A usage is intended to show the consumer the mechanics of the policy being purchased and how the policy values or premium payments change over time. The emphasis is a matter of how and what rather than how much.
    - Type B usage tries to project likely or best estimates of future performance and compare cost or performance of different policies. It attempts to show how much on the premise that the hows and whats are comparable enough for this to be meaningful.

The 1992 report of the Society of Actuaries report went on to explain, "Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future,

and that knowledge has been used to create the illustration…To summarize, the Task Force endorses the use of illustrations for Type A purposes. We do not believe they are appropriate for Type B purposes."

Over the years, various "predictive" systems have been developed that rely upon carrier illustration data. **Ben G. Baldwin**, author of the **CTFA Life Insurance Reference Guide**, comments in his book, **The New Life Insurance Investment Advisor**: "predictive illustration-based methods are doomed to failure because the numbers used in illustrations are filled with assumptions that are not comparable company to company and that are more and more flawed, and less and less reliable, as they project further into the future." TOLI requires credible determinations of premium adequacy for ten to 50 years.

'SECOND OPINION' SAFEGUARD

As noted earlier, outside intervention is needed to protect beneficiaries. The logical step, before engaging a forensic specialist, is obtaining a credible "second opinion" that the TOLI fiduciary is providing the expected standard of care.

WHAT MUST BE CONFIRMED ANNUALLY:

Common sense recognizes that a policy death benefit cannot be paid unless scheduled premium payments are adequate to sustain the policy for no shorter period than the insured's life expectancy (and generally to age 100 or contract maturity). We are saying that a life insurance trust beneficiary should expect ANNUAL affirmation that:

(1) scheduled premiums are adequate to sustain the policy to the insured's life expectancy as a minimum, and preferably to age 100 or contract maturity,

(2) the policy is performing consistent with its policy acceptance benchmark values and/or current trust objectives, and

(3) the carrier's third-party financial ratings are unchanged (or modestly changed) and meet trustee criteria.

If such affirmation is not provided annually for a flexible premium non-guaranteed policy, the trustee needs to immediately obtain a credible "second opinion." The remediation options for a policy with a 50% to 75% probability of sustaining to insured life expectancy are much more attractive than having 30-60 days to resolve a lapse notice.

RED FLAGS INDICATING THE NEED FOR SECOND OPINION:

Following is a partial listing of the TOLI red flags warranting a second opinion:

- A limited duty trustee arrangement.
- Corporate or personal trustee arrangement unable to furnish:
    - a) TOLI-specific risk management procedures,
    - b) Affirm premium adequacy evaluation capabilities,
    - c) Provide the trust's current investment policy statement,
    - d) Affirm benchmark values used for performance monitoring, and
    - e) Affirm 100% premium adequacy.

- Trust ownership of a variable universal life policy where the trustee cannot affirm:

a) The asset allocation strategy,

b) Criteria for fund selection and performance monitoring, and

c) Criteria for periodic fund rebalancing.

- Trust ownership of a variable universal life policy purchased to replace a guaranteed policy. Why is replacement is the best interests of the beneficiaries?
- Trust ownership of a "no lapse guarantee" universal life policy purchased in the past 3 years to replace a VUL policy. Why is replacement in the best interests of the trustee?
- Any TOLI policy lapsed or surrendered in the past 5 years due to insufficient premium payments.

A "second opinion" should always be obtained for any exchange, replacement or restructure recommendation before a medical exam is taken in anticipation of policy replacement. A replacement analysis must document the specific reasons why replacement is in the beneficiaries' best interest and be supported by a credible restructure evaluation. Further, it should:

- Disclose surrender charges to be incurred by replacement of an existing policy;
- Disclose new policy tax and sales charges plus higher insurance charges;
- Document internal exchange options discussed with the existing carrier and why an internal exchange is less favorable than pursuing external replacement.

A credible 'second opinion' should not be confused with comparison of an inforce policy illustration to a new policy sales illustration. Such comparisons, often described as "shell games," are akin to the comparison of an apple to a socket wrench.

LIFE INSURANCE: A REAL WORLD PRIMER

Because flexible premium, non-guaranteed policies anecdotally represent at lease 35% of inforce TOLI policies and because trustees have accepted the contractual responsibility to actively manage the risk of premium adequacy, trustees and the professional advisors to the grantor's beneficiaries must understand the nuances of a policy that does not have a defined (i.e. guaranteed) premium.

Universal, variable universal, and adjustable life insurance products are prime examples of flexible premium policies, meaning the policyowner has a contractual right to pay essentially "what he wants, when he wants" into the policy to maintain a positive account balance. All such policies have a guaranteed schedule of insurance charges but allow the insurer to charge *less* than the guarantees when the insurer's management deems it appropriate to the carrier's experience, marketing and profit goals. Some policies (universal and adjustable life) have a guaranteed interest crediting rate, while allowing the insurer to credit *more* than the guaranteed rate when management deems it appropriate to the carrier's experience, marketing, and profit goals.

Most trustees do not have the tools to reasonably calculate the needed premium schedule to affirm 100% premium adequacy at the time of policy acceptance and to evaluate premium adequacy thereafter. Mistakenly, they rely on the policy illustration for this calculation. The dilemma, though, is that the illustration assumes *constant* interest rates or investment returns and a *current* "scale" of insurance charges, whereas market volatility dictates *actual* interest/investment returns and *actual* insurance expense experience and changing profit targets dictate future cost of insurance charges.

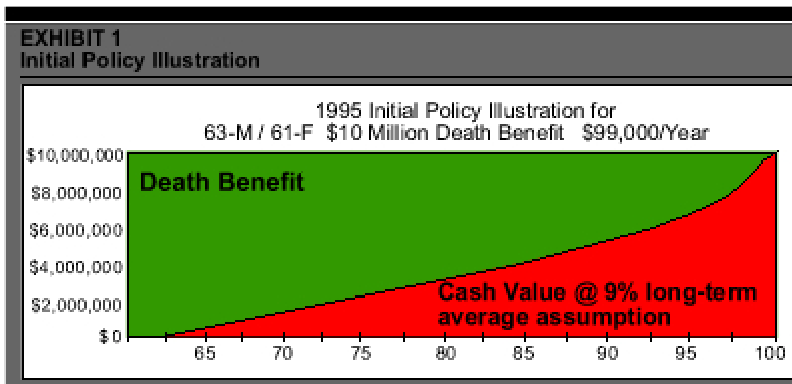
Consider the trend of interest rates over the past 25 years and the resulting portfolio income of a life insurance company. Ten-year government bond rates (a reasonable proxy for an insurer's investment

portfolio supporting this type of policy) peaked at 15.32% in September 1981 and bottomed at 3.33% in June 2003. As a result, in-force universal life crediting rates have generally declined from a high of 14% in the early 1980s to guaranteed minimums of 4% in 2004 and 2005.

Relating this trend to premium adequacy, assume that a *flexible premium* was calculated in 1982 at an assumed 14%. If the *flexible premium* amount was not recalculated and increased as rates dropped, the *flexible premium* could not possibly sustain the policy as originally illustrated. Most *flexible premium* policies sold through the late 1990s under an illustration system that calculated a "just sufficient" premium based on current assumptions will now reflect an account value inadequate to sustain the policy even to the insured's life expectancy unless the premium is increased.

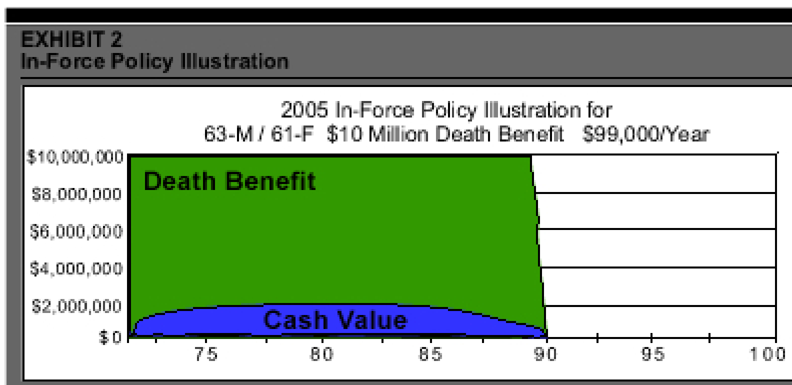
SAMPLE CASE EXPECTATION VERSUS REALITY

The carrier illustration for a level death benefit $10 million Variable Universal Life policy purchased in 1995 and underwriting a 63 year old male and his 61 year old wife calculated an annual scheduled premium of $99,000 to sustain the policy to age 100 and beyond, based on a "conservative" 9% long-term investment return for an all-equity allocation (See Exhibit 1).



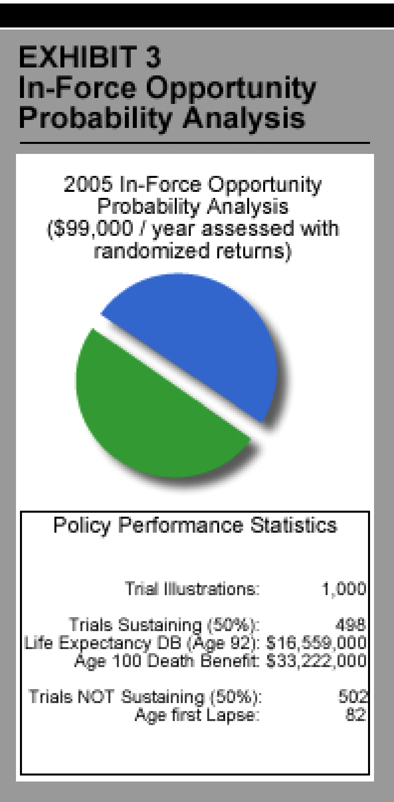
While investment returns often exceeded this 9% benchmark from 1995 through 1999, the all equity allocation suffered significant negative returns between 2000 and 2003. As a result, the 2005 Accumulation Account Value is $300,000 less than the originally illustrated $1,309,058. Since the $10 million death benefit is defined as the accumulation value plus whatever amount of *net amount at risk* is necessary to equal the death benefit, a decline in account value causes an automatic increase in pure insurance accompanied by the associated increase in insurance expense charges.

This combination of lower investment returns and increased insurance costs can cause the policy to lapse in as few as five years at ages 75+. An *in force* illustration calculates that the policy should still sustain into the couple's late 80s (See Exhibit 2). However, joint lives mortality tables indicate, in more than 50% of similar-aged couples, at least one spouse will still be alive into his or her 90s. Anticipated improvements in medical care could extend practical life expectancy another 3 to 8 years. Corrective action is needed.



Further, a corporate Trustee accustomed to managing fixed income and equity investments as well as using credible portfolio modeling knows that investment returns are *never* constant. Considering the volatility of an all-equity portfolio over the last 40 years, the policy only has a 50% probability the policy will successfully sustain to age 100. The earliest age predicted for lapse, based on a series of 1000 randomly generated trial illustrations, occurs at the wife's age 82 (See Exhibit 3).

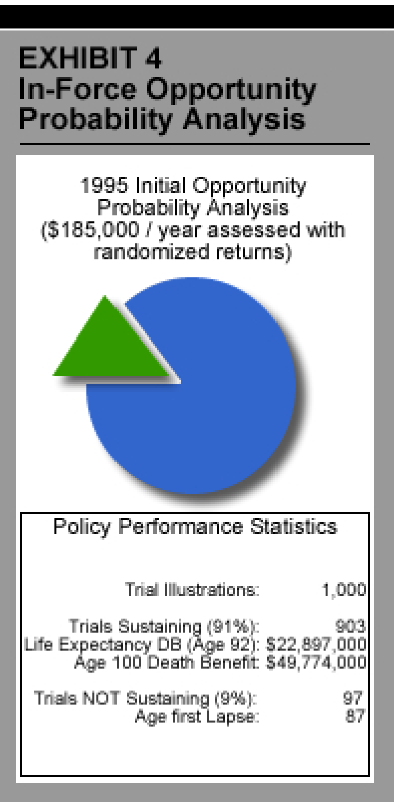
Because the policy was purchased to be sustainable at least to age 100, most trustees, grantors, beneficiaries, and their professional advisors would consider a 50% chance of failure to be an unacceptable risk. We find that most fiduciaries use 90-100% as a preferred probability of success and 75-80% as a minimum before considering restructuring. To achieve a 90% probability to age 100, the annual premium commencing 2005 should be increased to $185,000 (See Exhibit 4).



This unpleasant surprise (and its unfortunate gifting implications) can be avoided by clarifying the grantor's premium risk tolerance, by confirming the trustee's evaluation standards at the time of trust and policy are accepted, and by calculating the risk-appropriate premium. If this methodology had been used in 1995, the scheduled annual premium would have been approximately $130,000 and would likely have required little - if any - modification in 2005 because "down market" experience was factored into the forecasting model at the outset.

ONE MORE TIME – THE FIDUCIARY'S DUTY IS TO MAXIMIZE PROBABILITY OF FAVORABLE OUTCOME!

As we stated before, the basic duty of a fiduciary is to maximize the probability of a favorable outcome to the trust estate. The following exhibit shows the value of determining a risk-appropriate premium and the importance of active premium adequacy and policy value management.



Over time, the higher premium projects death benefits and cash accumulation in excess of initial death benefit. If down market conditions are experienced, the risk of premium adjustment is reduced, and any adjustment amount that is necessary should be lower. If the policy performs consistent with its policy acceptance benchmark but the excess death benefit is not needed, the death benefit option can be changed and/or scheduled premiums reduced. These routine active policy management considerations require credible evaluation of premium adequacy, which is not available using carrier illustrations.

POLICY RESTRUCTURE - TOLI "RESCUE"

Because of the mistaken reliance on carrier illustrations, most flexible premium policies are significantly under-performing their policy acceptance benchmark. To replenish the accumulation accounts of these policies, scheduled premiums must be recalculated using actuarial evaluation and a premium adequacy risk tolerance approved by the trust beneficiaries.

Policy restructure should also evaluate contemporary policy options considering the age and health of the insured and current trust objectives. For example, assuming trust objectives are unchanged, it may be more premium/gift efficient to exchange account values into a "no-lapse" guarantee universal life policy. At best, no-lapse guarantee policies provide the advantage of a low guaranteed premium that may well resolve the immediate ***crisis*** of a failing policy but it may also create a longer-term policy management problem.

Such policies are likened to level premium term insurance because they accrue little or no cash value, and are not likely to develop any more death benefit than the stipulated death benefit. Because they build up little or no cash value, it may not be possible to exchange into the next generation of "new and improved" policies. Finally, because the "secondary guarantees" may produce a strain on the carrier's reserves, only insurers with very strong financial strength ratings should be considered. Hence, these trade-offs require disclosure to the trust beneficiaries and confirmation of current trust objectives so that a properly informed product suitability determination can be documented.

Using the facts of our earlier sample case, the 2005 exchange value of $1,009,058 will secure a guaranteed $10 million death benefit for a guaranteed annual outlay of roughly $120,000 - $140,000, assuming both insureds can be favorably underwritten. Based on an informed product suitability determination, restructuring requires less premium and eliminates the need for active policy management.

LIFE SETTLEMENTS AND PREMIUM FINANCING

On the other hand, trust objectives can change and a TOLI policy may no longer be needed. For insureds age 65 and older, a life settlement should be considered as an alternative to policy surrender or continuing premium payments. A life settlement involves the sale of a life insurance policy for fair market value in the secondary market. The proceeds of a life settlement can be reinvested in traditional fixed income and equity investments or can be used to purchase a new life insurance policy, or a combination of both.

Cash flow for premium payments is usually the constraint in insurance trust planning. Third-party premium financing of a guaranteed death benefit policy should be considered as long as recourse is limited to trust assets, the lender affirms its concurrence with the exit strategy analysis, and all terms and costs are fully disclosed. Properly structured, a life settlement combines attractively with premium financing of a new guaranteed death benefit policy to achieve the trust's current objectives.

Finally, TOLI "rescue" must prioritize larger death benefit flexible premium policies that were originally purchased based on spreadsheet comparison to select the lowest illustrated premium. Enlightened common sense suggests the ***lowest*** premium has the ***highest*** probability of under-performance. Enlightened common sense also suggests that using an illustration to fix a problem created by illustrations simply "adds fuel to the fire."

CONCLUSION

If a trustee is aware of a carrier's impending insolvency or a policy's impending lapse, is the trustee liable if it failed to act? Corporate governance standards today are well-known, as are the basic life insurance, fiduciary duty, and regulatory compliance market conduct issues and the expectations of grantors, beneficiaries, and their advisors.

Today's investment savvy generation of advisors and trust beneficiaries understand how to obtain second opinions as well as engage a forensic specialist to assess and resolve disputes. Hence, a trustee's "wait-and-see" dispute settlement strategy seems an expensive alternative to simply implementing a legally defensible, administratively feasible, and cost-efficient "best practices" TOLI risk management program.

A "best practices" program must include TOLI-specific risk identification and management practices and credible policy evaluation capabilities. It should include contemporary risk mitigation and wealth management products and services. A TOLI policy is typically purchased to span a ten to 50 year time horizon and, hence, it is expected that trust objectives, tax laws, insurance products and insurance management services will change over time. Life settlements and third-party premium financing programs

are examples of “best practices” insurance management services that can maximize the probability of a favorable outcome to the trust estate.

Finally, grantors, beneficiaries and their advisors must expect to pay for “best practices” active policy management, no different from fixed income and equity investments. Family member personal trustees and “family office” staff members should ensure access to these services.

HOPE THIS HELPS YOU HELP OTHERS!

RANDY WHITELAW DICK WEBER

Edited by Steve Leimberg

CITE AS: Steve Leimberg's Estate Planning Newsletter #891 (November 16, 2005) at http://www.leimbergservices.com. LISI provides fast, frank, and authoritative information and analysis on recent cases, rulings, regulations, and legislation of interest to financial services professionals. Click on http://www.leimbergservices.com for a free look or to sign up for membership.

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