Trusts&Estates

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The Problem with Trusts Owning Life Insurance

Most trustees fall short when it comes to monitoring, and beneficiaries are the big losers. Needed: a strong review process to prevent problems—including lawsuits

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It's getting more difficult for trustees to exercise prudent fiduciary responsibility in the life insurance arena. They must contend with developments affecting the policy's performance (including premiums that continue beyond the projected self-funding date and lower or negative rates of return), the availability of new products (with lower expenses, death-benefit guarantees, mortality changes and underwriting-standards changes) as well as changes in the law. And because for so many trustees, life insurance itself is a black box—something they don't understand very well—the trustee usually does not have the knowledge, experience or skill to do a proper analysis.

Trustees' failure to adequately administer life insurance can have a major, adverse impact on the death benefit paid to beneficiaries. Yet, in a telephone survey conducted last March of advisors to the very wealthy, we found most of those responsible for monitoring trusts had their heads in the sand about life insurance. A full 83.5 percent of the 297 advisors who reported acting as trustees also said that they did not have stated guidelines and procedures for handling life insurance. (See "Who's Minding the Trust-Owned Insurance?," page 63.) Given the lowered interest rates and market downturn, there is a very good chance that a number of the policies under their care are not performing as projected, which could result in a failure to deliver when the grantor dies. Yet the trustee might be blissfully unaware of the problem.

Such ignorance could be actionable—and expensive. A 1998 study of a large portfolio of TOLI policies held by bank trustees found that in 75 percent of the policies more than 5 years old, the death benefit could have increased by 40 percent without any increase in premium outlay. In 12 CFR (Code of Federal Regulations) 9.6, the Office of the Comptroller of the Currency (OCC) mandated that national banks have written documentation of the initial investment in a trust and of an annual review of the assets. Therefore, it behooves every trustee of an irrevocable life insurance trust (ILIT) to have a documented review process and appropriate experts as advisors to make sure the process is effective. Instituting guidelines and procedures significantly increases the odds that the life insurance policies will be effectively monitored and corrected when necessary.

THE PROBLEM

In March 2003, we conducted a 15-question telephone survey of 563 advisors—bankers, attorneys and accountants, all with annual income of $100,000 or more. More than half (52.8 percent) confirmed that they were trustees of life insurance trusts for affluent clients (not family or friends). Nearly all the bankers (97.9 percent) were trustees, while that was true of less than a quarter of the lawyers (22.8 percent) and accountants (17.5 percent). The trusts for which respondents were responsible were at least 5 years old and each owned $10 million or more worth of life insurance.

Among the 297 who are trustees, only 16.5 percent had a formal process for reviewing their trusts' life insurance policies. That is, they had stated guidelines and procedures for examining the life insurance to ensure it is working to meet the trust's objectives.

Only 4.7 percent of trustees had a life insurance-investment policy statement for their trusts, a document that spells out the benchmarks for purchasing and monitoring life insurance.

A life insurance-investment policy statement sets the parameters by which to judge the life insurance in the trust. The grantor may stipulate the purpose of the insurance, the performance goal for the insurance, the quality standards for the company or companies providing the insurance and the type of insurance to be used (for example, guaranteed death benefit, variable life) and, if variable life, the investment policy and hoped for rate of return.

We also conducted another study of trust-owned life insurance where a family member or friend was the trustee. This study, which consisted of 513 family members or friends who were asked 12 questions, also took place by telephone in March. All the trusts were at least 5 years old, with a minimum of $2 million in life insurance (the mean was $9.2 million, the median $2.7 million). The trusts' median age was 12.3 years, the mean age 17.1 years. On average, there were 2.4 life insurance policies per trust.

Slightly more than a quarter of these trustees (28.8 percent) had reviewed the life insurance policies within the past five

Instituting guidelines and procedures sharply raises the odds that the policies will be effectively monitored and fixed when necessary.

years. Only 5.3 percent of these trusts had a life insurance-investment policy. Another 37.4 percent of the trustees knew that the trust did not have a policy and the remaining 57.3 percent did not know.

THE REVIEW

Before starting the review process, the trustee should have an expert on his team. Because the requirements go beyond mere knowledge of life insurance products to expertise in funding concepts like split-dollar and estate-planning techniques, the field is limited. To find an expert with the appropriate expertise, look for professional designations such as chartered life underwriter (CLU) and accredited estate planner (AEP), as well as knowledge, experience and integrity, with a resume to match. (The trustee of a newly formed ILIT should have the same expert available, if not as a provider, than to offer a second opinion.)

First, determine if the trust is being properly administered according to its terms. Pay special attention to the Crummey notice provisions and records. Are gift-tax returns being filed, and if so, are they consistent with the terms of the trust?

BASIC STEPS WHEN REVIEWING LIFE INSURANCE IN AN ILIT:

1) Set goals.

2) Perform an analysis of the existing policy and a comparative evaluation.

3) Fix problems.

The first step calls for a review of the overall estate plan and determining the current health of the insured(s) and the client's current goals

IN THE EXISTING-POLICY ANALYSIS, REVIEW:

- the policy terms and riders;
- if variable life, the current investments;
- the policy funding method (in other words, where does the money come from to pay premiums? Is split-dollar being used?);
- a projection of the policy and funding method as it is currently.

FOR THE COMPARATIVE EVALUATION:

- consider alternate funding methods (including, for example, split-dollar or incorporating a Family Limited Partnership) for the existing policy;
- if variable life, devise an investment strategy;
- consider whether there are new policies available to the insured(s) that are more efficient;
- if a new policy would be more efficient and can be obtained, determine how it should be funded;
- surrender or sell the existing insurance if deemed necessary.

Fix any problems uncovered in the review process.

These steps should all be done on a regular basis, like a medical checkup. Even if the trustee is not a national bank, following the previously noted procedures prescribed by the OCC makes sense. At the very least, like a review of an estate plan, you should do this every three years.

Based on our study, the vast majority of life insurance trusts are not being properly administered now. As fiduciaries, the trustees are liable. And even if there is no legal action, the beneficiaries may be harmed. With the OCC regulation for national banks and the danger to all other trustees, it is time to take appropriate action. ▮

Endnote

1. William M. Arnold, Jr., Towers Perrin and Jeffery C. Harper, Tillinghast Towers Perrin, "Trust-Owned Life Insurance Poses Hidden Risks," *American Banker*, Feb. 3, 1998, p.17.

WHO'S MINDING THE TRUST-OWNED INSURANCE?

NOT **MOST PROFESSIONAL TRUSTEES**

OF 297 BANKERS, ATTORNEYS AND ACCOUNTANTS SURVEYED:

83.5%	Have no guidelines and procedures for handling trust-owned life insurance
95.3%	Have no policy statements on how to handle life insurance investments

NOT **FAMILY AND FRIENDS ACTING AS TRUSTEES**

OF 513 SURVEYED:

71.2%	Have not reviewed their trusts' life insurance policies in the past five years
94.7%	Have no policy statements on how to handle life insurance investments