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“Best Practices” TOLI Risk Management

Life insurance is ideally suited for trust ownership and risk management. Contemporary tools are readily available for fiduciaries to cost-efficiently manage trust-owned life insurance policies with the same prudent process employed for fixed income and equity investments. The failing TOLI policy crisis and its resulting litigation has caused professional fiduciaries, advisors, and insurance trust beneficiaries to implement defensible TOLI risk management standards and monitoring procedures.

This Q&A reviews typical questions concerning a ‘best practices’ TOLI risk management process. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting legal counsel.

A ‘Best Practices’ TOLI Primer

1. *Is life insurance conducive for risk management?*

Yes. Life insurance is a risk transfer mechanism ideally suited for trust ownership and risk management, if the fiduciary understands the risks to be identified and managed. The economics of a life insurance policy are fairly straightforward - payment of death benefit proceeds is conditioned upon the policy being in-force at the time of death.

Product suitability is a trustee’s critical policy acceptance and management determination. A trustee can purchase a guaranteed death benefit policy and transfer premium adequacy and policy performance risks to the underwriting carrier or purchase a non-guaranteed death benefit policy and retain contractual responsibility to manage these risks. From a risk identification and management perspective, acceptance of a non-guaranteed death benefit policy requires defensible premium adequacy evaluation expertise. Also, a trustee is well-advised to obtain grantor confirmation of the Investment Policy Statement and to communicate policy performance results to beneficiaries annually.

2. **If a skilled trustee accepts an insurance trust, is the trustee accountable to demonstrate a prudent TOLI-specific risk identification and management process?**

Yes. The basic duty of a fiduciary is to maximize the probability of a favorable outcome to the trust estate. The Prudent Investor Rule instructs a trustee to design and actively carry out a reasoned investment policy that will fit within the trust’s unique purposes and the needs of the beneficiaries.

The prudence of a fiduciary's conduct is evaluated against a process standard, not a performance standard. The Prudent Investor Rule's General Requirements of Care and Skill comments: "...if the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill. So also, if a trustee, such as a corporate trustee or professional fiduciary, procured appointment as a trustee by expressly or impliedly representing that it possessed greater skill than that of an individual of ordinary intelligence, or **if the trustee has or represents that it has special facilities for investment management, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill or of those specialty facilities (emphasis added).**"

A 'best practices' TOLI risk management process should avoid liability for: (1) holding unsuitable life insurance policies, (2) failing to evaluate premium adequacy of non-guaranteed policies, (3) failing to take appropriate action if trust objectives change or policies are under-performing their acceptance benchmark values, and (4) failing to annually provide beneficiaries with a performance monitoring report.

3. What purpose is served by a TOLI Investment Policy Statement?

A TOLI Investment Policy Statement (TIPS) serves an essential roadmap purpose for institutional and personal trustees, especially family member trustees who rely upon professional advisors and/or third-party experts for all trust operation matters. Properly used, TIPS should safeguard the interests of all insurance trust parties, demonstrate a prudent risk management process, and avoid fiduciary breach of trust exposure.

Based on the economic analysis justifying creation of the insurance trust and the trust agreement, the TIPS sets out the key issues for trustee management, beneficiary understanding, and professional advisor awareness. It is a dynamic document that can provide guidance in the event that trust objectives or grantor funding capacity or tax laws change. It clarifies annual reporting and performance monitoring expectations. Finally, it facilitates credible and cost-efficient delegation of functions necessary for informed decision-making. In summary, TIPS demonstrates a reasoned investment strategy and prudent investment management process.

4. How is premium adequacy evaluated for indeterminate premium (universal life, adjustable life, and variable universal life) non-guaranteed death benefit policies?

Actuarial evaluation demonstrates defensible policy acceptance, management, and restructure determinations based on the trustee's premium adequacy risk tolerance. If an in-force TOLI policy is under-performing its acceptance benchmark, actuarial evaluation can calculate the risk-appropriate premium adjustment. If under-performance poses a risk of lapse, actuarial evaluation can calculate the earliest possible lapse age for comparison to insured assumed life expectancy. If a policy warrants restructure, actuarial evaluation facilitates credible analysis of restructure options, including comparison to a fixed premium, guaranteed death benefit policy.

5. Do carrier illustrations for indeterminate premium policies evaluate premium adequacy risk?

No. The purpose of an illustration is educational to depict how a policy works. Carrier illustrations do not predict future policy values, do not evaluate premium adequacy, and are not credible for policy comparisons.

Beneficiary Safeguards

6. *Should an insurance trust beneficiary expect annual policy performance communication?*

Yes, especially in today's UTC and failing TOLI policy environment. The trustee is managing the trust for the benefit of the beneficiaries. The frequency and form of communication is usually set out in the trust agreement and clarified in the Investment Policy Statement. A beneficiary should receive an annual performance report confirming that the policy (ies) is/are performing consistent with the trust's current objectives and each policy's benchmark values. The premium adequacy evaluation for indeterminate premium policies should be actuarially certified.

7. *What are the red flags suggesting the need for third-party expert assistance?*

Approximately 15% to 20% of in-force TOLI policies are predicted to lapse prior to or within five years of the insured's life expectancy. The following red flags warrant third-party expert assistance:

- An irrevocable life insurance trust without a TOLI Investment Policy Statement (TIPS) that confirms the trust's objectives, clarifies the scope of annual beneficiary communication and accounting, and sets out guidance for ongoing policy management, including selection and monitoring criteria for third-party TOLI consultants and/or administrators.
- A limited duty trustee arrangement.
- A trust agreement that does not permit delegation of periodic policy evaluation.
- Institutional and personal trustees that do not provide annual policy performance monitoring report to beneficiaries.
- Annual performance reports for non-guaranteed policies that are not defensible (see question #4).
- Annual performance reports for variable policies that do not volatility-test premium adequacy based on the policy's asset allocation strategy.
- Any policy replacement recommendation.

8. *Should beneficiaries obtain 'second opinions'?*

Yes, if necessary and appropriate for the circumstances. A trustee represents the interests of the beneficiary and, hence, a beneficiary should not be reluctant in obtaining a second opinion and/or clarifying the trustee's scope of services. With any of the red flags identified above, a beneficiary should seek a credible second opinion. Life insurance is a sophisticated risk transfer mechanism but it is not self-managing. Indeterminate premium non-guaranteed policies have been the TOLI policy-of-choice over the past 25 years, yet few institutional or personal trustees employ defensible risk management procedures and premium adequacy evaluation capabilities. As a result, the policy-of-choice is now a candidate for lapse or replacement when credible premium adjustment may be the more appropriate action.

Trustee Standard of Care Considerations

9. *Is a TOLI Investment Policy Statement (TIPS) appropriate for an irrevocable life insurance trust?*

Yes, especially if the trustee is a family member, attorney or accountant. An Investment Policy Statement is basic to any trust arrangement as it documents the fiduciary's reasoned in-

vestment strategy, prudent decision-making process, and beneficiary communication expectations. A TIPS should provide trust administration and policy management guidance recognizing that some trustee functions may necessitate delegation to third-party providers to appropriately demonstrate "care, skill, and caution".

10. *Is a trustee expected to take corrective action if a TOLI policy is unsuitable for the trust's objectives and/or underperforming its acceptance benchmark values?*

Yes. The Duty to Conform to Fiduciary Standards comments, "*The trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved. The trustee's compliance with these fiduciary standards is to be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment. 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.*"

11. *Can a fiduciary rely upon the insurance agent to sell a life insurance policy suitable for the trust objectives and to thereafter monitor policy performances?*

No. The responsibility for policy acceptance, management, and restructure decisions rests solely with the trustee. An insurance agent generally takes direction from the fiduciary at the time of policy purchase and, unless otherwise affirmed, does not have a duty to provide service after policy delivery. Agents retire and leave the insurance business. Also, agents are not able to provide policy service to larger corporate trustees that consolidate TOLI monitoring in another regional location.

12. *Can a trustee rely upon an insurance agent for credible policy restructure recommendations?*

No, without adequate disclosure. An "agent" contractually represents a life insurance company so that a trustee should request clarification of such limitations. Depending on the circumstances, a trustee should consider a Request for Proposal process involving multiple agents and brokers. Also, some carriers and broker dealers restrict their representatives from discussing 'life settlements' so that, again, clarification should be requested and credible alternatives pursued.

13. *Do variable policies require special policy acceptance and performance monitoring capabilities?*

Yes. Acceptance of a variable policy warrants establishment of an asset allocation strategy and periodic investment subaccount performance monitoring process as set out in a TOLI Investment Policy Statement. Further, scheduled premiums should be volatility-tested and actuarially certified in documenting policy sustainability to contract maturity or insured life expectancy, as a minimum.

14. *Do fixed premium guaranteed death benefit policies warrant annual monitoring?*

Yes. A product suitability determination is implicit with each premium payment. Trust objectives, tax legislation, a grantor's gifting capacity, and life insurance products frequently change. Scheduled premiums can be reduced if the insured receives a more favorable risk classification.

A TOLI Investment Policy Statement usually provides for annual monitoring and beneficiary review. An irrevocable life insurance trust typically requires an annual accounting to trust beneficiaries. For regulated trustees, an annual review of all assets in each trust account is required by compliance regulations. Further, it is not unusual for a guaranteed death benefit policy to have non-guaranteed features that warrant monitoring to assure policy acceptance benchmark values are achieved. Finally, non-guaranteed policies now offer a "no lapse guarantee" rider as long as certain conditions are met, and such conditions should be annually confirmed.

15. *If a trustee 'delegates' (outsources) the policy monitoring function to a third-party vendor, is the trustee responsible for the scope of services provided by the vendor?*

Yes. The Duty to Delegate is specific in setting out the screening and performance monitoring duties of the trustee. A trustee should avoid engagement of an illustration-based vendor for a non-guaranteed death benefit policy. Such vendors (1) often develop proprietary risk descriptions and numeric grades that are not explainable, much less defensible, and (2) employ policy comparison methodology "known" to be inappropriate. Some vendors profess to evaluate policy suitability, yet they do not have access to the trust agreement, its Investment Policy Statement, and the trustee's risk management criteria.

16. *Is a trustee responsible for evaluating costs?*

Yes. A trustee has a duty to only incur costs in investing and managing trust assets that are appropriate and reasonable. As a result, a trustee should request confirmation of agent compensation (placement and renewal commissions) as well as projected policy costs. Further, competitive low load and non-commissionable products are available and should be considered. Cost disclosure is especially important in evaluating policy restructure options for recommendation to trust beneficiaries.

17. *Should a successor trustee undertake a credible policy evaluation before accepting an insurance trust?*

Yes. A successor trustee may incur liability for failure to correct the wrongful acts of its predecessor. An exoneration provision in the trust instrument may not effectively insulate the successor from such liability. Therefore, prudent practice dictates that a successor trustee ensure that the predecessor has complied with applicable fiduciary standards.

18. *Does exculpatory language safeguard a trustee?*

Yes and No, depending upon the circumstances. 'Hold harmless' protection remains a topical issue because the trustee is the only party to an irrevocable life insurance trust with decision-making responsibility and power. Such protection would not prevent trust beneficiaries from alleging breach of trust. Uniform Trust Code Section 1008 states: "*A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it: (1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor. An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.*"