



istockphoto/photo illustration: Andrew O. Alcalá

ILIT Trustees Bridge Out Ahead . . . Lock in Your Navigation System Now

By Melvin A. Warshaw

The irrevocable life insurance trust (ILIT) has been a popular estate planning tool for many years. Whether passing large amounts of policy death benefit to heirs or providing estate liquidity, trust-owned life insurance has been a fairly tax efficient estate planning tool for wealthy clients and their advisors.

Due primarily to the recent economic downturn, clients and their advisors are increasingly scrutinizing all the client's assets, including trust-owned life insurance policies. Because such policies often represent a concentrated investment in an often hard to understand asset, management of trust-owned life insurance presents some unique challenges to a trustee.

Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA), which sets "default" standards for trustees in managing trust assets and in determining their fiduciary responsibilities to the trust and its beneficiaries, has now been adopted by 48 states. The UPIA generally applies to all trusts, even "old" trusts that were created before the state adopted the UPIA.

The UPIA applies to trust-owned life insurance and specifies basic standards that should be considered a minimum threshold for trustees. A client's lawyer can always add language to a newly drafted trust that holds a trustee to a higher or lower standard.

Under the UPIA, an ILIT trustee may not be able to justify

Melvin A. Warshaw is General Counsel of Financial Architects Partners, LLC, in Boston, Massachusetts.

continuing a "buy and hold" strategy for the life insurance policies owned by the trust. Merely acting as a passive custodian of trust-owned policies is no longer adequate for a trustee. Today, an ILIT trustee must do more than pay the premiums and send out annual *Crummey* notices to beneficiaries.

The UPIA requires that an ILIT trustee must proactively monitor trust-owned policies to ensure that they are appropriate for the purposes of the trust. The ILIT trustee must reaffirm that the current policies remain in the best interest of the trust beneficiaries. Underperforming policies must be evaluated and monitored by the trustee. In fulfilling its duties under the UPIA, an ILIT trustee should always scan the marketplace to determine whether newer, more cost-effective policies are now available that would increase the total return of all ILIT assets or decrease the risk of loss to the trustee.

An ILIT trustee should recognize that the following principles laid down by the UPIA are to be integrated into the trustee's administration of trust-owned life insurance:

- The modern investment portfolio principles of the UPIA apply to trust management of life insurance.
- The prudent investor standard of the UPIA requires that a trustee must use reasonable strategies to grow the trust assets.
- The policies held in trust should be managed together as a single portfolio.
- Unless there are special circumstances, trust assets (including life insurance policies) should be diversified.
- A trustee can hire professionals to help in making decisions.

Ultimately, the ILIT trustee's performance will be evaluated on whether he or she developed a prudent management process for the trust. Future lawsuits will focus on the adequacy of the management review process, not selection of a particular policy within a portfolio.

Investment Policy Statement

The UPIA and the Prudent Investor Rule impose on a trustee the practical requirement to implement a written investment policy statement (IPS) for the ILIT, the same requirement imposed on a trust holding portfolio assets. A well-written IPS serves as a guide to the trustee in making decisions about product suitability, the purpose for the insurance (providing estate liquidity, for example), the needs of the beneficiaries, and the time frame for the insurance. The IPS also can clarify the objectives and purposes of the ILIT in relation to the insured's overall estate plan. Each IPS is unique and must be customized for the specific trust and beneficiaries involved. The IPS should be reviewed and updated periodically by the trustee, grantor (insured), and beneficiaries.

If the IPS process is reasonable and has been followed, an ILIT trustee should be able to demonstrate compliance with the UPIA, and a grantor (insured) or beneficiary is less likely to succeed in any challenge of the trustee's actions.

Monitoring Policy Performance

Regular auditing of the policies held in an ILIT is critical. Reliance by a trustee on outside professional help may be required. By making the inquiries described below, the ILIT trustee begins to fulfill his or her responsibilities under the UPIA to regularly evaluate the performance of the policies held in trust:

- *Performance.* Compare in-force illustrations to the original illustrations when the policies were purchased to determine performance trends. Be mindful, however, that the original illustrations for many "nonguaranteed" policies (that is, traditional whole

life and universal policies) may have assumed the lowest possible premium using the most optimistic "nonguaranteed" carrier investment earnings and may have further assumed that such carrier earnings remain unchanged and are not subject to normal investment volatility over long periods of time. Use of Monte Carlo simulations with randomized carrier returns (including lapse experience) will likely produce a more realistic expectation of likely policy performance. Some policy illustrations may have little value in predicting actual performance, and an ILIT trustee must be satisfied that the illustrations it is relying on are credible.

- *Carrier Financial Due Diligence.* Because of the recent economic turmoil, carrier balance sheets have softened. Reviewing carrier ratings and trends is critical.
- *Current Status of Insured's Health.* Health changes of the insured can affect policy decisions. Improved health of the insured coupled with carrier-mandated use of the most recent U.S. Census in calculating life expectancy can improve new underwriting offers. Deteriorating health of the insured and advancing age might suggest consideration of a sale of a policy in a life settlement transaction.
- *Funding.* Does the original funding strategy still work? Should a split dollar plan or AFR loan be considered to leverage the gift and GST tax reporting costs? Can the premium payments (presumably "level pay" over life) be restructured to improve the investment rate of return (IRR) and net present value (NPV)?
- *What if Current Crediting Rate on Policy Declines/"Cost of Insurance" on Policy Increases (on "Nonguaranteed" Whole Life or Universal Policies)?* To reflect the declining returns earned on their predominantly bond portfolios, even the highest rated carriers have been steadily reducing their dividend crediting rates on the "nonguaranteed" whole life and

universal products (known as the "current crediting rate"). The "cost of insurance" is the monthly charge the carrier deducts for the death benefit amount in excess of cash value. Most carriers project policy expenses, which include charges for "cost of insurance," using *current* assumptions of favorable claims and lapse experience. "Nonguaranteed" policies, however, specifically authorize a carrier to charge a higher *maximum* "cost of insurance" charge (up to a ceiling), which the carrier may impose on such policyholders in the future. If a carrier's actual expenses increase following issuance of a "nonguaranteed" policy and the carrier's primary state insurance regulator agrees, a carrier may be able to pass along to its whole life and universal life policyholders the carrier's rising administrative costs by increasing the "COI" charges on the policy.

Diversification

UPIA § 3 requires an ILIT trustee to diversify the trust assets unless the trustee determines the objectives of the trust are better served without diversifying. The rationale for diversification is that any one particular investment may fail to perform as expected. When applied to a trust-owned portfolio of life insurance policies, there is always a risk that a particular carrier might default on its contractual promise to pay the death benefit.

For a trust portfolio consisting solely of "no lapse guaranteed" policies, diversification among, say, 5 to 10 different carriers may be appropriate, depending on the overall size of the portfolio. For variable policies in which the cash value is held in a separate account and the policyholder is responsible for making investment decisions, an ILIT trustee must adequately diversify among the various sub-account options as with any other trust-owned investment portfolio.

Standards of Care

UPIA § 2(c) lists eight circumstances a trustee must consider in managing trust assets. Some are more relevant to

trust-owned life insurance than others. For example, the "possible effect of inflation or deflation" is highly relevant to most ILITs. The projected impact of inflation over life expectancy means that a policy death benefit may be adequate to satisfy the insured's estimated estate tax liability based on his or her *current* net worth but may be inadequate to satisfy the insured's estimated estate tax liability based on *future* net worth at life expectancy. Moreover, the ILIT trustee has a responsibility under the UPIA to grow the assets of the trust for younger generations. Accordingly, the ILIT trustee must adopt a process to periodically review not just the performance but also the projected suitability of the trust-owned policies in satisfying the purposes of the trust.

Additional Duties of National Banks Serving as ILIT Trustee

The U.S. Office of the Comptroller of the Currency (OCC) has published regulations that apply to national banks serving in a fiduciary capacity. National banks not only must comply with applicable state UPIA law governing an ILIT but must also comply with sections 9.6(a), (b), and (c) of the OCC regulations. See 12 C.F.R. § 9.6.

Section 9.6 of the OCC regulations requires a national bank to conduct certain types of reviews of fiduciary accounts, including ILITs. These additional requirements imposed on national banks serving as ILIT trustees pose some very practical dilemmas.

Like others asked to serve as an ILIT trustee, a national bank may face a difficult decision as to whether to serve as trustee, knowing it will be responsible for managing a life insurance portfolio. The trustee of an ILIT is often not consulted about the trust terms before being asked to serve. The initial ILIT trustee often does not participate in the process of selecting the policies to be owned by the trust. An independent trustee has no control over whether new funds will come into the ILIT to pay future premiums.

The OCC requires a national bank to conduct a "pre-acceptance" risk analysis of the policies, which includes assessing their suitability as well as

assessing the profitability of this block of trust business to the bank.

Once the policies are issued, the OCC requires national banks to conduct an "initial post-acceptance review" of the policies to confirm that the policies are appropriate for the purposes of the ILIT and are acceptable risks.

Finally, the OCC requires a national bank serving as ILIT trustee to conduct an annual review of the policies to evaluate whether they remain appropriate for the trust. If the bank lacks internal expertise in assessing the risk of premium adequacy (for "nonguaranteed" policies) or the policy fails to meet the bank's risk criteria, the bank is required to tell the interested parties (the grantor and adult beneficiaries and representatives of beneficiaries who are minors) and recommend restructuring the policy. Under section 9.6(c) of the OCC regulations, the grantor and beneficiaries of an ILIT can assume that, at all times during which a national bank serves as trustee, the bank is satisfied that the premiums are adequate to sustain the policy over the insured's life expectancy and that the product and carrier are suitable to carry out the ILIT's objectives.

***In re Stuart Cochran Irrevocable Trust:* A Wake-up Call for Corporate Trustees of ILITs Under the UPIA?**

In what appears to be the first reported case of how the UPIA applies to an ILIT, in *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009), the Indiana Court of Appeals reviewed claims of breaches of fiduciary duties against a corporate trustee of an ILIT.

The court found that under the Indiana UPIA "compliance with the 'prudent investor rule' is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." *Id.* at 1138. The court concluded that the corporate trustee's actions in exchanging two variable universal life (VUL) policies for a guaranteed policy with a significantly reduced death benefit were "eminently prudent, reduction in death

benefit notwithstanding." *Id.* at 1138. The corporate trustee in *Cochran* likely protected itself from liability by engaging an outside consultant to help determine that the two existing VUL policies remained appropriate investments for the ILIT.

Despite escaping fiduciary liability, the corporate trustee in *Cochran* was found by the court to have performed the minimum acceptable management duties in that case. The court concluded that "while [the corporate trustee's] decision making process and communication with the Beneficiaries was not perfect, it was sufficient." *Id.* at 1141.

Although *Cochran* is technically limited to corporate trustees, often professionals such as lawyers, accountants, and family office executives are asked to serve as the trustee of an ILIT. The combination of adoption of the UPIA in nearly all states and the recent trend finding judicial tolerance of more third-party lawsuits against professional advisors could mean that professional advisors to an insured may have a *continuing* duty to the ILIT trustee, extending well after the trust has been established. The professional advisor often has reason to know that the friend or relative of the insured serving as ILIT trustee lacks technical know-how about estate planning and life insurance products. The insured's professional advisors know that such nonprofessionals acting as ILIT trustees typically rely on the insured's lawyer or accountant to provide accurate and thorough information to determine whether the ILIT will fulfill the insured's estate planning objectives.

Avoiding UPIA's Standards in New ILITs

The management of trust-owned life insurance is challenging for any trustee. The typical ILIT initially holds few assets other than life insurance policies. The initial assets of a typical ILIT generally represent a "concentrated" position in one investment class, and very often the life insurance investment is not diversified among a variety of different types of life insurance products. Trustee compensation is often minimal. For most corporate trustees, serving as an ILIT trustee is often done as a "loss leader" or client accommodation, with the expectation of future profitability from the account once cash is available

for investment. Some insureds expect to continue to actively manage and participate in decision making of their own trust-owned life insurance, notwithstanding the trustee's responsibility to manage the policies in the best interest of the trust beneficiaries.

Recognizing these challenges faced by ILIT trustees, some states have enacted laws allowing a grantor to insert exculpatory language into a new ILIT that effectively reduces or eliminates the local Prudent Investor Rule (and UPIA) applicable to trust-owned life insurance. Delaware, a non-UIA

state, has enacted 12 Del. Code § 3302. Pennsylvania, North Dakota, and West Virginia have enacted similar statutes. Florida has enacted Fla. Stat. § 518.112(2), which permits a trustee to delegate investment responsibility for an ILIT.

Some Practical Guidance About Permanent Life Insurance

What type of life insurance policies works best for a particular ILIT depends on the trust's unique objectives. A policyholder must weigh a variety

of considerations that will affect the decision-making process. No one size fits all.

Assuming a decision has been made that there is a lifelong need for trust-owned life insurance protection (that is, coverage through life expectancy), below is a table setting forth some generalizations about the attributes of different types of permanent life insurance:

This table, and the other best practices outlined in this article, should help ILIT trustees navigate through the complexities of trust-owned life insurance in meeting their fiduciary duties. ■

	Traditional Whole Life	Universal Life	No Lapse Guarantee Universal Life	Variable Universal Life
Price (premium outlay)	Highest	2nd Lowest	Lowest (age & carrier sensitive)	2nd Highest (heavily dependent on policyholder investment acumen)
Cash Value Creation Opportunity	Highest	Modest (dependent on carrier investment performance/policy crediting rate)	Nominal	Modest (heavily dependent on policyholder investment acumen)
Potential to Increase Death Benefit at Life Expectancy	Highest	Limited (unless intentionally overfunding premiums within permissible statutory corridors)	None	Limited (unless policyholder's investment acumen results in surpassing general investment return norms)
Flexibility of Premiums (alternatives to "all pay"—equal payments over life expectancy)	None	Yes	Yes	Yes
Risk of Increased Premiums Due to Declining Carrier Dividend Crediting Rate	Yes (on "nonguaranteed" portion of policy)	Yes	No	Yes
Risk of Increased Premiums Due to Mortality (COI) Charges on Policy?	Yes	Yes	No	Yes
Age Bias (works best if policy bought at this age)	30-48	40-60	55-80	30-48
Need to Diversify Across Carriers	2nd Lowest	2nd Highest	Highest	Lowest