IRREVOCABLE LIFE INSURANCE TRUSTS, INSURANCE TYPES and TRUSTEE FIDUCIARY DUTY

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The Irrevocable Life Insurance Trust is a mainstay of those seeking to (generally) to use insurance pay estate taxes upon death. The use of insurance fits perfectly in most situations since the leverage element of a policy allows one to pay considerably less in the early years for the perceived ‘benefit' and yet still reap viable economical coverage if one lives a long time. This is obviously a recap of what everyone knows. The problem arises with the type of insurance that is used in such trusts.

It is necessary to initially address what insurance is supposed to do and then relate it to current practice. I submit that insurance is simply a tool developed over centuries to reduce the risk of potential loss. In the strictest sense, it is not to provide large sums of money in excess of value. That is to say that you (supposedly) cannot insure a barn worth $2,000 for $2,000,000. Human life value is more esoteric but will still be limited by the facts of the individual. That is the essence for most insurance trusts- coverage for current and perceived future estate taxes. But note that all I have addressed so far is the word ‘insurance'. The literal interpretation is coverage for the loss, not for internal buildup of other value that may provide additional appreciation and/or the ability to cease premium payments at some subsequent point in time. The term ‘may' is the key since the use of such policies with extra fees and reliance upon extraneous factors (economics, investment manager expertise) can cause additional risk to the insurance coverage itself since the policy could simply run out of money. And it could be very costly- far in excess of common sense when related to the underlying need. With that I refer to cash value policies of almost all types and certainly to any of the variable products.

Pundits will note the vast number of products that have been marketed and sold to the public to facilitate all sorts of (convoluted and unimaginable) technical positions. All too true. But note the term, "marketed". That is what agents are taught to do. But the ability for such techniques to switch cash values in and out to do who knows what is a machination of the real reason for insurance for the normal and reasonable consumer. It is true that certain elements may work. But it is also true that the policy may fold before death. If one wants to add risk to a policy via types of cash value buildup, ‘special' split dollar- so be it. But it's no longer pure insurance coverage which is the need within 99% of Irrevocable Life Insurance Trusts. Further, such risks must be clearly explained to the client in writing up front. Certain illustrations with universal life show part of the problem but still are relatively unintelligible. Illustrations for variable policies show nil in regards to risk.

Readers will be aware of the reduction in interest rates during the mid 1980's that caused a huge hue and cry among consumers as more and more company notices were sent out demanding more premiums for universal policies. The initial illustrations showed high rates that were unsustainable. It is not the issue that certain rates in the illustrations may have appeared viable- it is the issue that the policy was focused on something other than static premiums to maintain the policy no matter what (whole life will be addressed later). The reliance on internal returns can work, quite obviously, but the element of risk must be considered. Rarely are they. And one must clearly recognize that none of the economics are static. A reliance in a policy that interest rates from now on will either go up or down is a "bet" pure and simple. That therefore becomes a risk in the policy. Most consumers may rationalize the use of such policy (though generally made by the agent) for retirement, college funding et al, but the underlying performance cannot be determined with certainty. Perhaps not even close when one considers the decades when the policies might be needed. So, was such insurance needed in the first place?

When one looks to the various variable life policies, the issue may well be far, far worse. Further, few (if any) illustrations cover the volatility of the returns through a type of Monte Carlo analysis and hence such sales almost assuredly violate fiduciary standards via prudent man rules (identified below). One cannot use a flat rate of return in an illustration with any degree of viability at all.

The point is that in cases where some internal type of cash buildup is required to maintain sustainability, risk has been inserted into the policies viability. While this issue may be addressed separately outside of an Irrevocable Trust, I submit that the absolute reason for insurance to pay estate taxes should have very little reason of default at any point in time. The idea that an elderly insured will be notified of the inability of a major policy to remain in force without a substantial increase in premiums and/or lump sum is simply bad planning from inception. (I am not willing to even remotely think of a widow expecting $20,000,000 in insurance to be told at age 73 the policy has run out of money or the face value must be significantly reduced. That should not happen with an ILIT.) One must also recognize that additional monies may no longer be available. If the insured feels that the policy was misrepresented- certainly the beneficiaries- then a suit must/will be filed.

This then becomes another issue- since the policy lasted so long, the agent, estate planning attorney and the trust officer may no longer be in business. But the trust company (and the estate planning attorney/firm) will still be held liable for not recognizing the inherent problem from inception.

The problem may originate from all types of insurance and securities agents with various licenses and credentials but the problem of default for independent trustees of an irrevocable life insurance trust cannot be eliminated by focusing on the (faulty) responsibility of others. The trustee has a fiduciary duty to not only analyze the initial policy type and illustration, but must also review any policies on a continual basis to assure that it will perform for the lifetime of the insured. I submit that many current policies will be in default over time if not almost from inception (consider 2000- 2002). That they may separately end up with large sums of money is extraneous to such risk of default.

Current Insurance Review

Per an article in National Underwriter several years ago noted, "One 2004 survey noted that among professional trustees, fully 83.5% indicated they had no guidelines and procedures for handling trust owned life insurance.

For non-professional trustees, 71.2% indicated they had not reviewed their trusts' life insurance policies in the last 5 years.

Both groups did not focus closely on handling the subaccounts for variable life. Among professional trustees, 95.3%, had no guidelines for handling the asset allocation components of VL. Among non-professionals, 94.7% indicated they had no procedures in place for the allocation component of VL. (Noted below, one must have an advisor with the requisite skills in investment risk and reward as well as insurance costs and risk of default.)

Another pair of surveys indicated that anywhere from 70%-95% of all trust owned policies do not have a life insurance agent servicing the contracts." (Even if so, what is the point? An agent offering "risk" insurance may be clueless to the underlying issues. A trustee may have some legal offset for liability in the use of an agent (with limited skills) but it begs the issue did the trustee attempt to confirm what needed to be done or what capabilities that the agent needed to have to begin with. They all have a responsibility to find someone who can actually do a meaningful analysis.

"One professional trust owned life insurance service firm indicated that as many as 92% of existing TOLI policies could be restructured to provide 20% greater value. In fact, that same firm concluded, after a survey of policies, that 74%-87% of these contracts could be restructured to provide either a 40% increase in death benefit, or 40% reduction in premium."

I concur but focus as much on the ability of the policy to last. Even if a new policy offered nothing more than certainty rather than risk, all other issues remaining equal, that element itself demands the change. The risk in insurance should be minimized for almost all ILITs. ILITs are designed to last for a lifetime(s). If the advisors are negligent in the obvious, they will be held liable upon default of the policy or a mere indication that more funds are needed. Actually, they are liable initially where a proper analysis would have showed such risk could occur. Of course, such liability will be determined in court but I submit that an initial default rate of over 5% should be met with a claim.

There are those that do not accept that position. In an article in National Underwriter, attorney William Ries says the full weight of the Prudent Investor Rule rests on the trustee, and not on the insurance agent, for monitoring and reviewing insurance policies within trusts. He notes that the types of class-action lawsuits against insurers and agents concerning so-called vanishing premium policies could someday be carried over into trust management. He stressed that life insurance poses significant risk of liability to a trustee because most producers and agents are not held to professional standards of care since the selling of life insurance is not legally deemed to be a profession. This fact imposes more duties and responsibilities on a trustee holding life insurance contracts since insurance producers and their agents have no duty to advise an insured on the adequacy or suitability of his insurance. Nor is there a duty on the agent to advise a client on the provisions of policies previously purchased from another insurer. There also is no duty to investigate the solvency of an insurer authorized or licensed to do business in a particular jurisdiction; and after the sale of a life insurance policy, there is no duty to monitor the continuing solvency of the issuing carrier.

Further, he wrote, once a policy has been issued, there is no continuing duty on the part of the agent or insurer to determine that the coverage remains appropriate.

“While insurance producers may be relieved to hear this, there are reports, although only one could be confirmed, that insurance agents are being sued by banks for non-performance of policies.”

EFM commentary- It is generally conceded that the duty of an insurance agent is to the company, not the client. That said, I do believe that the essence of a ‘professional' will/should force a change in the entire process, including the courts. From all I have read, estate planning attorneys have also supposedly escaped the responsibility for doing some investigation. Or for that matter having to know anything about insurance to begin with. Not good enough. That said, my MSFP major was in estate planning and while I attempted to find some classes that truly addressed the sophistication of insurance for use at any level- certainly for estate issues- there was nothing. And these classes were taken from the College for Financial Planning where one might assume that they had a significant insight to insurance (never has been true). I have found very little in independent education during the last 15 years either. But it is patently absurd to remotely infer that any entity involved in as critical an item as personal life insurance could hide behind a veil of ignorance much less that of the law. That it maybe hard to do, so be it. That's just the way some things exist and one cannot rationalize away the effort to learn the product and its uses where so many lives are at risk for it working correctly.

The knowledge can be learned- it's just hard.

Insurance uniqueness

What makes insurance unique? "Insurance policies are different from other products because there exists a "special relationship" between the insurance company and the policyholder. The special relationship consists of a combination of elements, including:

(1) the fiduciary duties insurance companies owe to its policyholders;

2) the public service nature of insurance;

(3) the imbalanced bargaining position between an insurance company and its policyholder;

(4) the information imbalance between insurance companies and its policyholders;

(5) the present payment of money in exchange for a promise to pay the costs of a future event which may or may not occur;

(6) the financial motivation for the insurance company to delay or deny delivery of its promise, and;

(7) the duty of good faith and fair dealing inherent in every insurance policy between an insurance company and its policyholder.

EFM- Statements 3 and 4 are most notable. The courts will tend to sway certain language to the benefit of the consumer because of the imbalance. That said, it requires a very knowledgeable advisor to ferret out the implications of the contract so the courts can hear of the inequity.

As regards statement 4, it is simply not the imbalance of information between the company and the consumer but the lack of information for the agent ‘working' both for the company as well as for the benefit of the consumer. About 15 to 20 years ago, insurance companies offered a lot of training for its agents. With the element of disintermediation and the loss of profits, product training became financially unfeasible and is generally not provided by the insurance companies any more or only to a very limited degree. Some training may be offered by the brokerage firms but it is mainly sales and marketing. Also recognize that this training is usually taught by licensed agents whose background in limited as well. Unless the instructor is a unique entity- certainly the ability to use a calculator and think independently- the training remains universally suspect. Product and usage knowledge and expertise is essentially the sole effort of the agent. Again, this is not meant to be a diatribe- it's just the way things are.

The point with this commentary is that while the industry recognizes some of its duty to consumers, it is not going out of its way in any manner to provide true knowledge to anyone (including is agents) to understand how a particular product would work for a consumer- nor if it would work at all. The illustrations- particularly as defined for variable annuities and variable life insurance- bear little resemblance to the real world. It is within that context that I feel that the rest of the offerings (basic universal and whole life) invariably fit within the same lax duty to inform the public of why they are selling what they are selling. They know full well that agents are bereft of knowledge and judgement for the astronomical offerings that proliferate every day. The trustee cannot fall into the trap of ‘ignorance'.

From an article by Jordan Stanlzler, "Susequent U.S. Supreme Court decisions reemphasized the "specialness" of the insurance industry and of the persons who work within the insurance industry. Similarly, Dean Roscoe Pound wrote:

[W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public.

Another commentator has noted:

The insurers' obligations are . . . rooted in their status as purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public's interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements. . . . [A]s a supplier of a public service rather than a manufactured product, the obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary. Insurers hold themselves out as fiduciaries, and with the public's trust must go private responsibility consonant with that trust.

Similarly, the American Insurance Association stated:

The insurance industry is imbued with the public interest . . . insurance is essential to commercial activity and necessary to daily living. We focus the spotlight on ourselves. We convince others of the leading role insurance plays in society. We encourage them to expect superior performance from us.

Legal Liability/Prudent Man:

"In ordinary cases the standard of care is whether or not the accused behaved as an ordinary, reasonable prudent person would have behaved under the circumstances. When acting as a professional however, the required standard of care changes. Such individual is required to use any special knowledge he may have obtained through education, training or experience. Therefore, if a person or entity offers professional services to the general public, it is presumed that the person possesses some degree of special skill or knowledge. A professional negligence case imposes a certain level of skill and knowledge on the accused whether or not he actually possesses that skill or knowledge. This is a standard of minimum professionally acceptable conduct."

EFM-Trustees are generally not aware of the real world of insurance and this must be put into context when selecting an entity to review ILITs, the innumerable products along with unsubstantiated software modeling. Estate planning attorneys are also caught in this conundrum. They just can't make up documents and then simply select a ‘friend, associate, et al' to fulfill the major part of the trust with a product that won't work much of the time. Where is the professional responsibility? As stated, just because something is hard to do, it is, in these cases, a mandatory action that cannot be relinquished to others where any reasonable (prudent man) investigation would show a significant lack of knowledge on the part of the agent right to a level of incompetency. And, as should be obvious, simply because the trustee or attorney got/gets a number of referrals does not relinquish the responsibility to do appropriate research. Admittedly, that's how this whole system works- but it does not mean by any stretch of the imagination that a fiduciary duty is being upheld.

As such, I do have a difficulty with the definition of ‘professional'. This is a common phrasing for those in the financial industry that have just a license to transact business. The fundamentals of investing have never been taught to a broker. There are no requirements that an insurance licensee understand an illustration. In fact, an illustration review of any type is not required for licensing. The term ‘professional' cannot be used without a corresponding minimum of knowledge and experience. One must have at least 10 years of experience in both securities and insurance; corresponding licenses and a degree in some financial area. Even here there are a lot of caveats but it is a place to start. (A person with 20 years of ‘experience' may simply have taken one year's worth and repeated it 20 times.) A trustee or attorney must deal only with agents at the highest level if they wish to avoid legal claims. That the number of suits so far have apparently been limited, I believe they will escalate significantly in the next five years. And the consumers should win since they put their faith in those that should have known better.

Software

Here is yet at another stumbling block to the exercise. Who can perform the function of independent review? I don't know. I am sure there are some with the appropriate backgrounds and disciplines, but this commentary refers not just to a "simplistic" cash universal policy but to a variable policy wherein there must be capability with risk and reward with investments and the added background in the various types of insurance coupled with the ability to delve into both areas simultaneously. That's tough enough, but the person must also be able to search for some software that can provide some of the statistical (Monte Carlo) analysis to determine the odds of the policies success.

I will comment on the last element first. I have worked with another Analyst for well over a year in an attempt to 1) Get trustees to recognize their professional and fiduciary duty and 2) Find a software program that can offer a competent review of a variable policy.

As to the first effort, since there were just two of us, the marketing of such an effort was both beyond our skills and our funding. It was not economically viable to attempt such an effort. It also appeared that the trustees were not yet prepared to recognize the huge exposure they had so the point may have been moot in any case. There had not been too many court cases where the breach was obvious (though perhaps they were settled out of court where no info was available). However, the issue of ILITs overall has become far more questioned in the last three years and a fiduciary duty will be forced on many unsuspecting trustees (and Estate Planning attorneys).

Secondly, the issue of software was equally frustrating. There was in depth discussion with a firm that had written a software package that had some statistical merit. We discussed the current platform and what could be added. The cost was going to be several hundred thousand dollars. But the effort was futile to begin with. In the past, the company had sold just a couple hundred insurance programs. Their effort with their “financial planning” software was very successful and without a need for a specific insurance review being addressed by the financial planning and brokerage industry, it was not economically feasible to take on a very large project incorporating maybe half a million dollars for a sales effort that would not even pay for the subscriptions anticipated.

Additionally, we found it problematic that a broker or insurance agent would have the proper knowledge and insight to use a product that would allow/require some input. If they had not been taught risk nor Monte Carlo simulations (neither addressed for a broker or insurance agent in licensing training), then the final review would be probably futile- and probably wrong. If no input was allowed- everything preprogrammed- the lack of these insights would almost assuredly lead to an unacceptable analysis. It was, obviously, the same problem- perhaps more so- in developing a singular product for a trustee or estate planning attorney. There are too many moving parts and even less insight on how any of it worked. (As a comment- think about the understanding of correlation with asset allocation. A very limited number of those in the securities industries would understand the implications.)

I do use the program since I know of nothing else. It has its limitations as noted. But I can use it because I am reasonably aware of what those limitations are and can adjust my reports accordingly. It's not perfect, but there is nothing else out there to work with.

Licenses, Designations, Knowledge

In order to do a competent report on investments, one must know securities, mutual funds et al and the associated risks. Brokers per se are not capable. While that may seem like a diatribe, the accompanying resume shows that I taught the securities licensing exam preparation for many years. This includes the basic series 7 license as well as the series 24 for supervisors. The fundamentals of investing have never been taught- diversification, alpha, correlation, standard deviation et al. Certainly some have attained some outside knowledge, but it is not mandatory nor can the separate knowledge base be generally verified. Therefore if risk is not stated in full, there is a breach of duty. That the entities are unfamiliar/clueless to the statistical problem will not be an excuse in court. If one accepts the responsibility as a fiduciary, they will be held to such standards.

As regards designation- the only ones that are of any distinction are the CFP, ChFC and the CFA. I am a CFP and took two years of the CFA classes. I am familiar with the ChFC. Neither the CFP nor the ChFC have the requisite background to properly address risk. Nor has the use of any current mainstream software covered it correctly- including that of Monte Carlo. (There are no mandatory continuing education courses in risk. Hence, nothing to directly contribute to a designations understanding of the true problem). The CFA has no background in insurance though they can validate the variability of investments in an account and the necessity of a Monte Carlo analysis. The CFP background in insurance is about nil.

No matter, any trustee/designee involved with investments who has taken upon themselves the responsibility of investment review has had to run various Monte Carlo simulations and/or clearly addressed the risk of loss to the clients. Monte Carlo software has not been utilized by the investment community until the computers became powerful enough to handle such computations. However, prior to that time, a trustee had to address the losses sustained in 1973/74. There was a loss of 45% in less than two years. There was a real world of risk that was clear to all. Of course, a lot of the statistical sense was lost in the 1990s where so many stated that the world economics had changed irrevocably to one with no business cycles, nor market downturns, nor recessions .... But insurance agents, investment brokers, estate planning attorneys, trustees et all can't allow this emotionalism to permeate the requirements of an ILIT.

That's all well and good but trustees simply do not have the background in both disciplines. And in order to facilitate a correct analysis of this policy with its limited payments, the trustee must engage an advisor familiar with both elements of investing and insurance and with the commensurate licenses. It is NOT sufficient to use solely an investment advisor. It is not sufficient to use solely a life insurance agent. Admittedly, even such individual must have access to software modeling that incorporates both and they are limited both in number and sophistication. But this commentary is addressing what a professional trustee must do and simply because the activity may be hard, there is not offset for doing it.

In order to at least find some element of competency, the advisor must be insurance licensed for at least 10 years. A ChFC or advanced degree in planning is a minimum requirement. A CFA has no background in this area and a CFP has effectively nothing of value. They have always been weak in insurance and this is no place to allow them to start.

There will need to be a combination of the two elements for a variable product. And familiarity with some type of software that can provide some reasonably analysis of the risk of investments over time.

Unfortunately, state licensing may provide some of the answers while also being very restrictive. In California for example, only a Life and Disability Insurance Analyst can provide such research for a fee. But there are only about 33 in the state and only a very few with investment background as well. There are similar licenses in about another 35 states- they must be checked out first before looking elsewhere. A trustee must deselect any of these for cause before moving to unlicensed individuals for the analysis.

Unfortunately, and as should already be clear, the state and federal licensing entities have not been instructing its agents in any sophisticated elements of insurance or investing. The problem is that the industry has done nothing either. The legal profession has no insight to the issues nor do professional trustees save for the fact that they have become aware that putting their heads in the sand and hoping no one else notices the problems of default of ILIT products is not going to work. I do not have any specific direction for the trustees in seeking out exceptional advisors save for those that have advanced degrees and are properly licensed. As stated, it is going to be rare to find those with both elements of competency- investments and insurance- and have some grasp of industry software.

The Uniform Prudent Investor Act and Other Standards of Care
http://www.ifa.com/Media/Images/PDF%20files/UniformPrudentInvestorAct.pdf

Just as a trustee might monitor the assets in a trust, reviewing whether the individual investment performance is meeting expectations, a trustee should also consider monitoring and reviewing the life insurance assets in trusts for which they are responsible. Does this mean removing or replacing policies on a regular basis? No. But it does reflect that a change of an old policy might be fortuitous since most premium prices have come down. Or almost mandatory if the wrong type policy was used to begin with. A greater level of care is required than just looking at an illustration that is rarely understood. (A non licensed trustee is not an acceptable entity for the review.)

Several key areas addressed by the UPIA are noted below. While these always have not influenced court decisions in cases involving a trustee's judgment over life insurance, the themes and considerations are very similar.

It is important to keep in mind that the UPIA sets a basic standard that may vary from state to state. It is possible for trustees to set exculpatory clauses in order to reduce liability but that is failing. Frankly, I find this will not hold up under scrutiny. A basic understanding of risk and reward cannot be wished away by pleading ignorance nor the statement that others- picked without scrutiny- are the ones at fault. A trustee has a fiduciary duty to do some homework. No or weak effort is not acceptable.

Life insurance is not strictly defined under the UPIA but it will be covered in any case where a variable policy is concerned since the investment side of a policy will clearly involve the entire product/policy.

The sections particularly relevant for life insurance with my comments are:

• Assessing risk tolerance, taking into consideration "the purposes of the trust and the relevant circumstances of the beneficiaries."

EFM- I am focusing on an ILIT. Someone will be hard pressed to validate that the life insurance designed to pay potentially millions of dollars of estate taxes has a significant potential of default.

Under an assumption that the (non professional) beneficiaries do wish to utilize a variable policy for the cash buildup, a short questionnaire can be used to protect the (professional) trustee. How many stocks must be held in a portfolio in order to insulate it due to unsystematic risk? (More colloquially, how many stocks must one have to be properly diversified). They will not be able to answer that (50 to 350) and it's even more involved once you add in the element of correlation). Or ask the advisor they are using. No answer there either since it is rarely taught and few advisors are really careful about risk. You have therefore covered your liability since you have assured yourself that neither entity understands the first element of investing- diversification. You can let them go forward with the effort but you will have to document the irrationality in writing each and every year till the policy potentially implodes.

Never allow any analysis verbally. Everything must be documented in writing. An illustration is not acceptable without a corresponding separate commentary from a knowledgeable and licensed advisor.

• Taking into consideration (1) general economic conditions; (2) expected tax consequences of investment decisions or strategies.

EFM- The tax strategies are fairly obvious for an ILIT. (I am dismissing an attempt to take out a loan from an ILIT.) But if a standard universal or variable life policy is used, the national and international economics can reek havoc on interest rates and even more so on the underlying allocations of funds in a variable policy. That is not an easy task to figure out and even harder to document if one is not conversant with the fundamentals of investing. But it is a non issue with a No Lapse policy

• Adequately diversifying the trust assets.

EFM- Generally the focus is on the allocation of various funds, ETFs and perhaps some stock. Very involved, hard to validate if something goes wrong. On the other hand, if one uses a No Lapse policy, there (generally) is no issue

That said, once you get above, say, $25 to $50 million in insurance, it may very well be correct to use more than one company for the insurance. It's doubtful that a major company might default unilaterally but it is also simply a wise decision to spread the risk as necessary. Remember, most insurance companies will reinsure the risk anyway, but it is still valid to seek even additional diversification.

Congress has also imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . ."

While the reference is to ERISA, therein lies a defense since a prudent man would not have a clue to how a standard insurance policy should work and would be even further removed from the statistical elements of a variable policy. But a professional trustee is deemed to have the requisite skills to understand that more formal analysis is required. Then again there is the defense that there are very few analysts who can cover both elements of insurance and investments in a single policy. I am aware that ERISA does not cover insurance per se, but any attorney would apply such rules to a trustee who has not conformed to a formal investigation of investments and/or insurance.

Clearly, the trend is toward setting standards relative to the monitoring of life insurance, and assuring that there is both a pre-purchase and ongoing review of the policies.

While the following may be a moot point for professional trustees, it is necessary to validate the implicit fiduciary duty. From material I wrote several years ago with added current comments -

"In the handling of money and when one acts as a corporate or individual trustee, there is a fiduciary responsibility owed to the principal party. It is defined as a relationship imposed by law where someone has voluntarily agreed to act in the capacity of a "caretaker" of another's rights, assets and/or well being. The fiduciary owes an obligation to carry out the responsibilities with the utmost degree of "good faith, honesty, integrity, loyalty and undivided service of the beneficiaries interest."

The duties include:

1. Utmost Care- The agent is bound to the higher standard of a professional in the field which extends the standard of duty to investigate within the means of the profession, to ensure the maximum protection and information be provided the principal.

EFM- This is a tricky area. Most trustees may not know where to look nor what to ask. That's because the agents that have or are being considered for use are woefully undertrained through licensing nor from any mandatory training thereafter- particularly referencing variable products. But the trustee will have to show the effort- who was contacted, what was discussed and a myriad of other areas to show valid intent to find a knowledgeable and capable independent entity. And any analysis will have to be in writing.

2. Integrity- Defined as the soundness of moral principle and character. It means the agent must act with fidelity and honesty.

EFM- Just so we are clear: there are people in the industry who are referred to as "dumb honest". They may actually believe what they are offering is correct. But they also possess so little understanding of the implications of the product or their efforts as to make their attempt for competency pointless and useless. I again reference the effort that has to be expended by the trustee. The mere acceptance of a CFP or CLU et al is not to going to be accepted in court.

3. "Honesty and Duty of Full Disclosure" of all material facts, either known, within the knowledge of or reasonably discoverable by the agent which could influence in any way the principal's decisions, actions or willingness to enter into a transaction

EFM- The position of ‘reasonably discoverable' will be key in court. I repeat- the mere acceptance of a designation with no other formal review will not/should not be accepted in court.

4. Loyalty- An obligation to refrain from acquiring any interest adverse to that of a principal without full and complete disclosure of all material facts and obtaining the principal's informed consent. This precludes the agent from personally benefitting from secret profits, competing with the principal or obtaining an advantage from the agency for personal benefit of any kind.

5. Duty of Good Faith- includes total truthfulness, absolute integrity and total fidelity to the principal's interest.

EFM- Not good enough. If you do not know what you are doing, none of the above has been covered. Most trustees will/are clueless to insurance. So are most insurance agents.

One may ask if such duty is truly required. From various texts, "While life insurance trusts had been exempted from recently imposed standards-for-care, the Uniform Prudent Investor Act (UPIA) now requires that trust-owned life insurance policy holdings be 1) monitored for performance, 2) investigated for suitability, and 3) managed to minimize costs and maximize benefits relative to risk, just like all other investment trusts."

Duty to investigate

Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment/insurance (emphasis mine)

"The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional.

I repeat the element of a professional in such insurance cases. What level of care will a trustee be held to? No matter the overall knowledge of insurance, the trustee must engage an insurance professional for any universal life policies that are held. However, if there are variable policies, the trustee must engage a professional versed in both statistical analyses of investments (and Monte Carlo) as well as knowledgeable how such investments can and cannot work within such polices (again relating to Monte Carlo or the like.)

These are vexing problems for the trustee. While the commentary clearly addresses the need for analyses, trustees (and estate planning attorneys et al) do not possess the skills or experience to recognize the inherent difficulties of the use of the various policies. But it does not get easier in the selection of those capable of providing a competent review. This is not a diatribe of the industry- just the real life review of current entities and services available. But no matter the person or company, they must have at a least an insurance license. And a minimum of 10 years experience. This is not a guarantee of expertise, admittedly, but a decent level of experience is needed. And they must have the personal capability with a financial calculator. We all know that there are software programs galore that (supposedly) do all sort of calculations. But very few are designed for specific insurance analysis. Even for those with some detail, the advisor will have to provide some separate individual input. Or, I repeat, do not engage anyone who cannot use a financial calculator. From an instructor for the College for Financial Planning several years ago, "I agree with you that if you can't use the calculator, you probably don't know what you are talking about. The process of using the calculator helps you learn what result to expect."

Duty to monitor

Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

EFM- Mandatory for life insurance whenever the risk scenario has been introduced. If a variable policy is used, a formal analysis must be made each and every year as to the allocation and, particularly, the risk of default.

A review is still necessary for No Lapse just to validate finances of company but, otherwise, the risk element has been deleted and very little additional review is needed.

Criteria for review.

1. The company must have reasonable expectation to pay the insurance value in the future. The point is that the trustee obviously is demanding high claims paying ability and will review AM Best, S&P and other rating services. That is critical but not necessarily for the obvious. Over the next 10 years- certainly 20 years and later- almost all major companies will be sold or merged into various other entities. Those with the best current financials are apt to fare better under these conditions. There can be no guarantees of absolute payments under all potential changes in the future, but if one starts with a top rated company, there is a reasonable expectation of servicing decades later.

2. Price of insurance/No Lapse Policies. Here I disagree with the few that have commented on various universal/variable life products that will offer ‘vanishing premiums' because of the internal buildup and will be "cheaper" in the long run. The issue for estate taxes is pure insurance that will be around (subject to 1. above) to pay upon the death of the insured. I am not directly ‘concerned' with the cash value buildup for any extraneous purpose. The point is that certain policies called No Lapse exist for periods of time (from age 100 to 130 depending on company) and are designed just for insurance purposes. There are no illustrations effectively necessary since the only thing that a trustee/agent/insured need be concerned about is the financial capability of the company to pay decades into the future. The cash value is irrelevant, the ability to take out a loan is irrelevant, et al. The main issue is that the concern by the insured/trustee/beneficiary is that the policy simply will pay the insurance as stated. And as long as the premiums are paid on time, that is exactly the only thing they have to worry about.

3. Older versus newer policies: The innovations in underwriting, competitiveness of companies coupled with increased mortality has led to substantial reduction in rates. In short, even though the insured is older, a new policy can offer benefits that may far exceed those of the previous and a much better rate. If there is any cash value, it can be transferred via a 1035 exchange and potentially provide a fully paid up policy with more coverage as well as extend the lifetime coverage for years longer.

Types of Insurance

This is not an attempt to define each and every type of insurance and use. It is a very simple commentary to address what a trustee needs to be aware of- that is till one gets to a variable product. These are extremely complicated as has already been identified.

Term Insurance: This pays insurance for a set period of time and then simply expires (though exchanges to permanent insurance may be offered). It is not valid for payment of estate taxes due to the termination of the policy well before death.

Whole Life: It's pretty much what it says- this is a policy that you pay for your entire life (caveats with older policies that do not extend beyond age 99) . While the guarantee of coverage is somewhat similar to the No Lapse listed below, it tends to be very expensive due to the imbedded additional costs for cash buildup. Older policies can also be very expensive as compared to new offerings. It may be preferable to switch to a newer policy depending on current age and health. The coverage can actually be greater. As such, the 1035 transfer to a fully paid up No Lapse policy in the ILIT may provide more value at a cheaper cost as well as covering for a longer period (up to age 130 if the insured/beneficiaries desire). A trustee must recognize this and review each and every whole life policy in this manner.

Universal Life: These were offered in the 1980's as a less expensive alternative to whole life. Its uniqueness was the transparency of costs - insurance, returns and company expenses. It allowed a tremendous flexibility to the product- starting and stopping the policy, taking out loans, etc. But flexibility is not a guarantee of continuing coverage. The returns varied tremendously between companies- some offering initial bonuses to collect new business. Further, they varied year after year depending on the operations and investments of the insurance company. Though it was anticipated at the time of inception that interest rates would stay high and support the policy illustrations well into the future, the subsequent lowering of rates through FED actions caused many policies to fail unless additional premiums were paid. Admittedly interest rates are now much lower overall and one might view these differently in this day and age. Recognize however that these are almost exclusively designed for internal growth for ‘some' purpose in the future- taking out loans for retirement, college, etc. But it should be obvious that if you want something beyond the strict coverage, the policy has to cost more than a pure insurance policy in order to get the money in there to grow in the first place.

Current prices have dropped due to new mortality tables.

With all policies, one can ask for an illustration that is based on guaranteed mortality, expenses and yield bust most will expire well before death. It is projected costs and yields that consumers (and agent) latch onto in the acceptance of the policy. But consider obesity. Will it force mortality down? What about a devaluation of the dollar? What about..................??

No Lapse: There have been policies around for decades in one form or another where the intent was solely to provide insurance- no internal growth, no mutual funds, no appreciation or anything of the like to speak of. They were covered under the traditional definitions of whole or universal life, but were unique to themselves. During the last few years, many more companies started offering these with the term "No Lapse" since, primarily, some of the previously highly marketed and sold variable products lost favor due to the market downturns of 2000- 2002. No Lapse policies are designed to simply offer coverage no matter then internal returns. Yes, they do project some internal growth but, for all intents and purposes, who cares??? Essentially the only time one might consider a loan would be to take out the cash value to terminate the policy. Otherwise, as long as one makes the premium payments as indicated, the policy will not lapse no matter if the internal values drop to zero.

There have been pundits concerned about the reserve requirements of the insurance companies to pay on policies that have no cash left in- in fact they may be well past the point of needed premiums.

First, the issue is what exposure does the company have in this area. If they had 100% of No Lapse policies, it potentially is a concern. But this is not about to happen. Actuaries at any company look to maximize profits with acceptable risk. I do not see an excessive exposure. Further, the NAIC is always reviewing certain items within the industry looking for defects. I do not see this a concern with any major company. Note I said major. Any top rated company is (supposedly) not going to allow itself an unacceptable exposure to risk (lessons learned from Executive Life). The risk exposure could come from outside issues such as obesity. If the mortality of the U.S. should shorten, the companies do not get to use the money long enough so profits might go down. How this might impact its No Lapse offerings is not possible to determine. But the impact will hinder its other policies as well.

Variable Universal Life: These are extremely complicated vehicles that were designed to (hopefully) provide large growth through mutual funds. The unfortunate element is that the use of securities has made the policy a very risky proposition at almost any stage of its use, particularly since the bulk of the policies were to limit/eliminate future premiums in the future (vanishing premium. Note that the premium never ‘vanishes'. It's the estimate that the cash buildup will be so great as to make such payments internally.) I make note of the Prudent Man Rule regarding the duty of a trustee, the element of diversification and more. It is all well and good but the material does not include the fundamentals of investing that must be addressed not only for the investments themselves but for the internal use inside of a policy.

In short, the risk of a variable policy remaining intact over almost any period of time is so imbedded with risk as to make a long term appreciation suspect. This, again, refers to a vanishing premium. If the insured was to continually make annual premiums, the policy would stay intact. But there would have been no point in buying a variable policy to begin with inside of an ILIT unless the intent was to do something far different than pay estate taxes. The entire focus of this report is for the use of an ILIT to pay estate taxes only. Other uses are not covered- and cannot be covered- here. That said, I refer once again to the use of investments per se. You cannot use a flat rate of return and if you do not know what diversification is by the numbers, the essence of the attempt may simply have failure written all over it.

Termination of Policy

Assume that, for whatever reason, a policy in an ILIT is no longer needed or wanted. With a No Lapse policy, it is easy to terminate- simply do not make the payments. Any cash accumulation can be accessed beforehand and that could be it.

But it isn't. In most cases, the trustee, estate planning attorney, agent or other advisor would find himself in court in short order. The reason is the use of a Life Settlement- the sale by an elderly person (say age 70 and above or younger with ill health) of an existing policy to purchasers who are willing to continue paying the premiums in the hopes of receiving a valid return when the insured dies.

It is not my attempt here to analyze all the issues that one might confront, but suffice to say they can and do work for such situations. One area however is that each insurance is unique in characteristics and the ONLY way a legitimate value can be ascertained is to shop the policy with at least six companies. The older one is, the sicker one is, the greater the sale value. It is therefore impossible to determine beforehand what one might get because each company and underwriter sees each individual differently, but I can also say that it is certainly worthwhile to examine the value. Further, there are no demands that one must complete the transaction so there is almost nothing to lose.

‘Almost' nothing to lose. Remember that the beneficiaries will no longer receive anything from the policy. The sale is an irrevocable transfer. But here is an example of a policy no longer needed, wanted or afforded but that should NOT be sold or terminated.

Assume an insured who is 70 years of age in ill health- not expected to live five years. He has a $5,000,000 policy with a $150,000 cash value. He can no longer afford it. We'll also say the beneficiaries cannot afford to maintain the policy either. He could terminate the policy and get the surrender value ($150,000). On the other hand, he could sell the policy for $400,000. It appears that is the way to go.

But it isn't. He stops making payments on the policy. The cash value is used to continue the annual payments and let's say it would be adequate for five years. He dies during that time. The beneficiaries get the $5,000,000 in death benefits (some liberties taken for complete accuracy of numbers but the essence is valid). Much better.

On the other hand, he does not die in the five years but is even more sickly now. The cash value has been used up and he must do something. And due to his advanced age and further health deterioration, he now can get $900,000 for the policy with a life settlement.

Most agents are now at least familiar with a life settlement. However, it is also the duty of a trustee to know about them as well since a termination for cash value that is less than a life settlement could lead to a lawsuit for a fiduciary breach for not knowing about the service.

Conclusion

Insurance is a minefield. It is impossible to remain knowledgeable about the industry unless one is licensed. There is no Morningstar service for insurance. The only way to stay current on product is to receive the volumes of Emails and regular mail and then follow up with additional review and the attendance of various industry seminars.

The added use of a mutual fund in a policy requires the formal knowledge of risk as outlined herein. But, as stated, such material is not taught as part of licensing nor for any designation save for the Chartered Financial Advisor- though rarely used in that arena as well.

The combination of the two disciplines is rarer still. And that is further topped off by the limited software products that can provide a real life view of the risk and rewards. All that said, that cannot stop a fiduciary from making a concerted effort to cover the problem. It is clear that the estate planning and insurance industries have a long way to go with education before the fiduciary duty is fully addressed and an accurate portrayal is conveyed to the public before purchase.

A No Lapse policy is the defacto choice for an ILIT and must be rationally dismissed before proceeding to another type. If so, the trustees, agent and insurance company must inform all impacted parties- insured, beneficiaries, company officers, wife/husband/children, et al of the possibility/probability of the default of a risk affected policy prior to death. Unless this is done in writing, the company, agent and trustees will remain liable for the default.

Even where the risk scenario is outlined, I submit that the trustee will still have an extensive liability for not requesting an outside advisor to review the problem and offer preferable alternatives.

An ILIT requires pure insurance and that is what should be provided.