Whose Policy Is It Anyway?
The Management of Insurance Policies for ILITs
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Topic: The fiduciary duty of a trustee in the ownership and management of insurance policies as part of an irrevocable trust.

Synopsis
Life insurance policies held in irrevocable trusts (ILITs) are one of the most common wealth transfer techniques in planning for intergenerational transfers. A trustee who is responsible for selection and configuration of a policy for which he/she has little knowledge of or guidance in its true purpose. In the real world, it is often not clear where the responsibility for the selection and ongoing maintenance of these policies lies. The standards set out in the Uniform Prudent Investor Act apply to trust-owned policies. By adhering to a clearly defined process, trustees will also be in compliance with a new standard that is developing in this area of the law.

Duties of the Trustee
The trustee of an irrevocable trust is under the same fiduciary obligations and duties as the trustee of any trust. He or she serves to protect the interests of the beneficiaries of the trust and to manage the assets of the trust for their benefit. The legal standard of that duty was known as the Prudent Man Standard. The trustee must exercise his or her duties for the benefit of the trust beneficiaries in all areas, including the selection and management of all trust assets, including life insurance policies. This duty has been modified somewhat under the Uniform Prudent Investor Act of 1994 (UPI); however, the overarching standard continues to be prudence. The new standards allow the trustee to delegate some investment responsibility to professional advisors.

The Problem
Cash value life insurance represents a complex financial instrument. For a life insurance policy to perform properly, there must be special attention paid to its design and selection pre-implementation, as well as the ongoing maintenance of the policy post-implementation. The grantor is making decisions on trust funding while the trustee is responsible for actual policy management issues.

Trustees discovered, much to their dismay, that they were caught between a rock and a hard place. Going forward, trustees must give greater attention to how the policies they manage are selected, the assumptions that are used in their construction and the actual systematic monitoring of the policies once purchased. Trustees can work with
grantors and their insurance advisors to create a process that assures the life insurance policy will accomplish what it was intended to do: mature at the death of the grantor.

**What Is the Standard?**

The trustee is acting as a fiduciary. “A Fiduciary is under a duty to the beneficiaries to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property. A breach of this duty may subject the trustee to liability for loss to the principal of the trust even if they acted in good faith.\(^{11}\)

While the Prudent Man Standard promoted the preservation of principal, it ignored two significant risks to trust assets. First, the focus on principal ignored inflation risk. The second significant deficiency of the Prudent Man Standard was the exclusive focus on preservation of principal. This strategy eliminated most assets that offer the best long-term potential for appreciation. Beneficiaries were harmed under this standard because it caused the trustee to focus on short-term value, not long-term results.

In 1992, the American Law Institute published the *RESTATEMENT (THIRD) OF TRUSTS* and significantly altered the standards by which trustees are judged.\(^{16}\) The National Conference of Commissioners on State Laws adopted this new standard now known as “The Prudent Investor Rule.” It has now been adopted into law by approximately 40 states.\(^{17}\) Even in those states that have not yet formally adopted the Uniform Prudent Investor Rule (UPI), there exists strong precedent requiring trustees to balance the need for principal preservation with that of long-term appreciation.

**The Standard of Trustees: The Uniform Prudent Investor (UPI)**

The UPI requires that a trustee acting in his or her fiduciary capacity demonstrate a process for selecting and managing all assets held in the trust. The trustee can no longer exonerate him or herself by merely demonstrating maintenance of principal. The American Law Institute, in its THIRD RESTATEMENT, enumerates:

1. diversification of assets;
2. duty of trustee to analyze and make conscious decisions, balancing risk and return appropriate to the purpose of the trust;
3. avoidance of expenses that are not justified by the purpose of the trust;
4. conscious effort to balance the needs of income beneficiaries versus remainder; and
5. duty and authority to delegate where outside expertise is needed.\(^{18}\)

**Trust-Owned Life Insurance (TOLI)**

The trustee must understand and adhere to the fundamental issues that address the essence of his/her fiduciary duties. **Fundamental Questions** For what purpose is the insurance being purchased? What are the anticipated needs of the beneficiaries? What is the time horizon that the trustee is confronting? What funds will be required by the trustee to fund the trust?

3. What are the contractual guarantees? The most important of these guarantees
is a contractual assurance of a death benefit when premiums are paid, regardless of cash value performance. Failure to first establish the appropriate type of policy is almost certain to create confusion. All policy comparisons should be evaluated with minimum criteria and a common set of assumptions. These may include:

- Financial Strength
- Conservative Interest Rate or Investment Rate Assumptions
- Historical Data on Selected Policy Type
- Underwriting Classification

**Diversification**

The UPI requires trustees to diversify investments in the trust unless they can demonstrate compelling reasons not to do so. When this standard is applied to the purchase of life insurance, there is a demonstrable advantage of having considered more than one life insurance carrier in the selection process. Multiple policies decrease the risk that the total death benefits will be adversely impacted by the insolvency of a single insurer. Multiple policies also decrease the risk that a given carrier may arbitrarily increase costs of insurance and/or decrease the crediting rates it applies to its general account products. A notable exception would be where one carrier clearly offers a better underwriting classification or better guarantees than the others.

**A Documented Process for Selecting, Configuring and Managing Policies**

There are several major changes for trustees under the UPI that require the trustee to rethink the nature of the services offered to
the ILIT. The first is that the trustee is not liable for unfavorable results as long as he or she can point to a documented process demonstrating consideration of the aforementioned issues and careful decision making based on the facts. A seven-step process can aid the grantor and trustee called the TOLI Expert System.

- **Step 1: Quantify the Desired Result.** Establishes the purpose for the insurance, time horizon and needs of the beneficiaries, anticipated funding and the macro-economic assumptions.

- **Step 2: Select Policy Type and Create Specifications.** With these broad parameters established, the grantor could then create guidelines for the trustee to aid in the selection, configuration and management of the policy or policies. These parameters become minimum specifications that can be used to select the appropriate type of policy and then compare policies of the same type. At ValMark Securities, we use a document called The Life Insurance Design Questionnaire® to memorialize and quantify this process. It provides a discussion for the policy selection and policy configuration assumptions.

- **Step 3: Produce Written Policy Guidelines for the Trustee.** With data from the Life Insurance Design Questionnaire®, we then incorporate these guidelines into an expanded set of instructions to help the trustee make all of the decisions required in the acquisition and maintenance of the insurance. For those in the in-vestment
business, they will recognize this document as being akin to an investment policy statement for managing assets. In our practice, we call this statement, The Life Insurance Policy Management Statement™. These instructions also help the grantor address beforehand how any shortfall in policy performance will be reflected in the management of the policy(s). For example, if dividends on a whole life policy were lower than originally projected, the grantor might indicate a preference for a reduced paid-up policy as opposed to continuing the premiums for additional years.

- **Step 4: Market Search.** Only after these criteria are established is a market search undertaken. The trustee is comparing policies of the appropriate type under similar assumptions using the screens created in the Life Insurance Policy Management Statement™. It is also helpful if actual carrier underwriting approvals are secured so that the trustee can consider actual policies that can be issued on the insured as opposed to hypothetical illustrations.

- **Step 5: Written Service Agreement.** Given that the UPI allows delegation of some duties, it makes sense that the trustee obtain a written service contract with a skilled agent who will service the selected 26 policies post-implementation. Here, it is helpful to be specific about the role of each member of the estate planning team and their ongoing responsibility.
The insurance agent should be specific about the type and frequency of the reports. In evaluating who can best perform these duties, the trustee may want to request samples of the reports they can expect on a continuing basis. Other considerations may include:

- Spell out specific duties of trustee, insurance professional and investment advisor.
- Clarify how often the policies should be reviewed and by whom. This should include provisions for rebalancing sub-accounts, review of sub-account performance and new options in the policy.
- If significant events occur, such as the death of one of the insureds, divorce, change in tax law, significant market corrections or change in company ratings, extra care should be given by the trustee to ascertain the impact on the trust and its beneficiaries.

**Conclusion**

A properly implemented process for the irrevocable trust will protect both beneficiaries and trustees by giving enhanced guidance in selecting and managing life insurance policies. Insurance professionals and investment advisors will be able to demonstrate expertise and bring new value to all parties by facilitating the process of creating an Investment/Insurance Policy Statement for their client’s irrevocable trust as standard operating procedure.
ENDNOTES
1 FREDERICK K. HOOPS, FAMILY ESTATE PLANNING GUIDE (3d ed. 1982), at 231.
2 Id., at 232.
3 C.M. Rose, CA-5, 75-1 USTC ¶13,063, 511 F2d 259; G.G. Terriberry Est., CA-5, 75-2 USTC ¶13,088, 517 F2d 286; supra note 1, at 232.
10 Supra note 6.
11 Id., at 13.
12 Harvard College v. Amory, 26 Mass. 446, 9 Pick. 446 (1831).
15 Harry M. Markowitz, Portfolio Selection, J. FINANCE, Mar. 1952, at 77.
16 Supra note 13.
18 Supra note 14, at §227.
19 Supra note 7, at §2(a).
20 Supra note 7, at §2(c).
21 NASD Conduct Rule 2210 and IM-2210-2(b)(5)(c).
22 Supra note 14, at §227(b); supra note 7, at §3.
23 Supra note 9, at 36.
24 Supra note 7, at §9.
25 See “Fundamental Questions” section of this article.
26 Supra note 7, at §9.
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