ILIT Trustee Protection & Policy Audits

- Words of Wisdom from Mike Tyson -

Mike Tyson said "Everyone has a plan...until they get punched in the face". Since most of us aren't boxers, these words may not immediately resonate. However, if you have worked with clients on their planning for more than a year or two, you have surely been on the receiving end of a few haymakers.

Sometimes you see a windup before the punch is delivered. Sometimes, you don't see it until you are on the canvas, getting the ten count.

Life insurance has long been an integral part of people's estate planning. Unfortunately, right now a lot of life insurance planning is resulting in the equivalent of a punch to the face. And, just like the description above, some of them won't be recognized until you or your client are in the ten count, such as:

- A 1035 exchange takes place for a policy set up to provide lifetime tax-free income. Unexpectedly, the exchange violates guideline premium limits, making the new policy a MEC (Modified Endowment Policy). The entire future income stream is taxed as ordinary income.
- Poor policy performance causes someone to cancel a policy rather than pay premiums that have increased 100%. He then finds out he has a medical condition which shortens his life expectancy, prohibiting him from replacing the lost coverage.
- A business owner sues because the firm's SERP (Supplemental Executive retirement Plan) caused a greater amount of tax liability for him personally than the total of accrued benefits for the plan's participants.
- A planning review discovers that although premiums were diligently paid on time, coverage for your healthy 85 year old client will likely lapse before she dies because one premium was paid ***early.***
- Filing a death claim only to learn that the carrier has no record of who the rightful beneficiary is.
- Acting in good faith as trustee for a friend, client, or family member, only to be sued by the trust beneficiaries because a greater amount of death benefit could have been received for the premiums paid by the trust.

Even though you may not have advised the clients above, you may still be dragged into their nightmare.

The growth in potential life insurance related catastrophes has been of exponential proportion, since the financial crisis of 2008. What is worse is that policy owners, and often their advisors, are in the dark with regard to identifying and quantifying the problems.

Two recent surveys illustrate the magnitude of misunderstanding and neglect that is helping to exacerbate problems, allowing them to remain undiscovered. Here are a couple of the findings:

- A Harris Poll survey (May, 2014) indicated that 60% of respondents believe their policy benefits are guaranteed forever.
- The Elder and Special Needs Law Journal (Vol. 24/No. 1) reported that 83% of Professional Trustees surveyed admitted to not meeting Uniform Prudent Investor Act guidelines.

Root Causes of Problems
Problems with life insurance policies are nothing new. However, the types and number of problems has risen dramatically since 2008 and will probably continue to do so for many years to come. Why?

- Carriers reduced expenses by employing smaller policy service staffs or automated service systems.
- Older agents are retiring and fewer carriers are hiring and training agents.
- Products are more complex and have a shelf life of only about 24 months.
- Annual policy statements for increasingly complex policies are becoming more cryptic and almost useless at evaluating performance.
- Under-funding at policy onset, relative to needs and life expectancy considerations.
- Underperformance due to unrealistic interest and dividend projections.

ILIT Trustee Concerns
The number of lawsuits against trustees of ILITs (Irrevocable Life Insurance Trusts) is rising. Hold harmless clauses of trusts and liability limits legislated by states to protect trustees are being challenged.

Most private trustees have accepted their role to help a friend, family member or client. Typically, the only responsibilities discussed with non-professional trustees are those of managing assets for the beneficiaries, *after* the death of the grantor. Rarely are lifetime policy management responsibilities explained by the grantor or the drafting attorney. This isn't surprising given that even professional trustees admit to falling short on their responsibilities, as mentioned earlier.

Private trustees in most states are required to follow the guidelines of the Uniform Prudent Investor Act (UPIA). UPIA compliance is determined by establishing and following a prudent process, not by the performance of the trust's portfolio. The Act provides guidance on the components of a prudent process. Essentially:

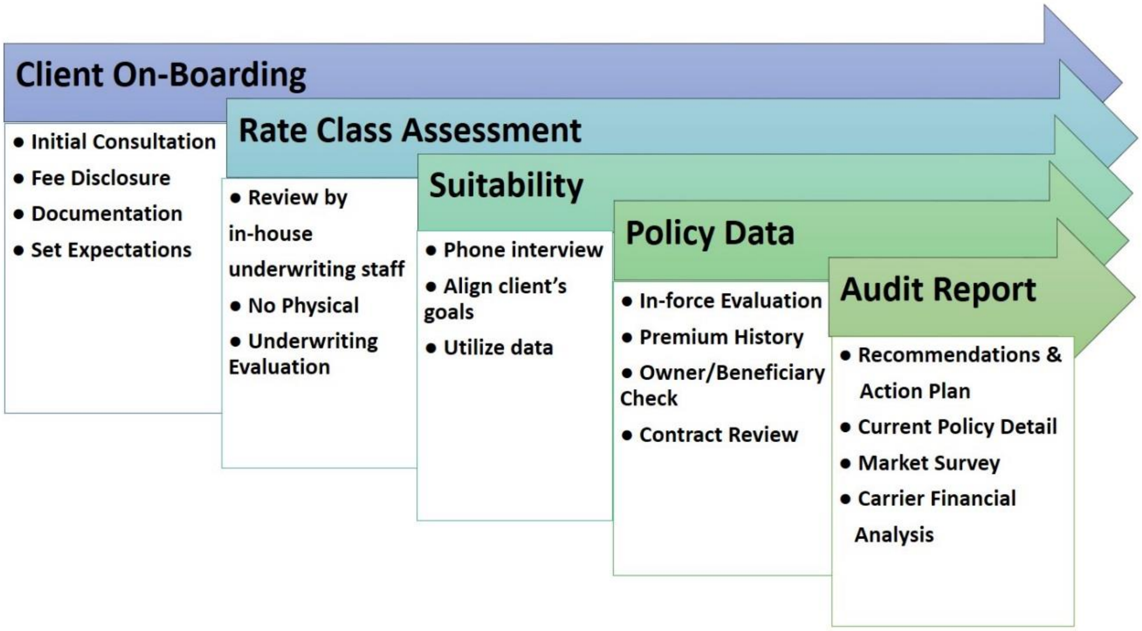
- Monitor performance of trust assets.
- Investigate appropriateness of holdings.
- Manage assets to minimize costs and maximize benefits.

Is there a single process that can help to meet the requirements of the UPIA? Could this be a documented dispute defensible process? Is it possible to use this documented process to avoid potential disputes? Yes, yes, and yes!

The Dispute Defensible Process: A *Comprehensive* Policy Audit

The life insurance failings listed at the beginning of this article are all true. Fortunately, such catastrophic outcomes are being avoided by a process that is continually uncovering even more potentially disastrous issues.

Comprehensive Policy Audit Process



A process that meets the primary fiduciary responsibilities of the UPIA goes a long way toward establishing a defense in the event of a dispute. A *comprehensive* policy audit, updated periodically, fulfills this obligation. More importantly, if shared with trust beneficiaries, policy audits may help to avoid disputes. Following are the benefits derived from the primary elements of a comprehensive policy audit. Note how they align with the UPIA's guidelines:

- Performance review—Establishes sufficiency of premiums for desired objective.
- Suitability review—Assures policies are appropriate to meet objectives of beneficiaries.
- Underwriting-based market survey—Provides cost and benefit comparative analysis based on client medical and financial underwriting assessment. Also provides benchmarking of returns versus alternative investment opportunities.
- Carrier financial review—Ratings and data from reactive and proactive rating services for the in-force carrier and those utilized in the comparative analysis.

Actionable Information

Most of what is commonly referred to as a policy "audit" is nothing more than a policy "review". For a policy "review" to rise to the level of a true "audit" it needs to incorporate all elements above. It needs to do this in a format providing actionable information. Without actionable information, a "review" cannot be meaningful in a dispute.

The policy your client thinks they have, may not be the one they actually own. Without a comprehensive policy audit, including actionable information, this situation may never change.

The best way to handle a punch to the face is to see it coming, before the ten count, and avoid being hit.

The best way to handle life insurance failings and being dragged into client nightmares is to see and correct the problem before it's unavoidable, through a comprehensive policy audit.

Thanks to Gary DeVicci, MSFS, CFP, AEP ® for his contribution of this article to *Technical Alerts*.
Gary can be reach at garyd@cpicompanies.com or at (856) 874-1250