Advanced Markets Blog

Checkups for life insurance – the importance of ongoing policy review for clients and trustees

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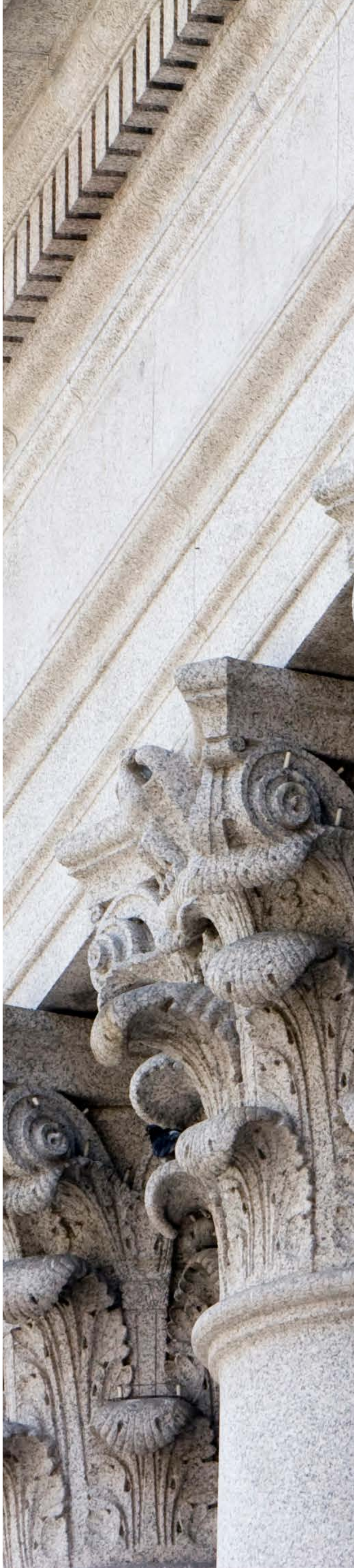

Clients are used to getting checkups — an annual physical, a periodic inspection of their car or a trip to the dentist. But what about checking up on their life insurance policy? All too often, life insurance policies are purchased and largely forgotten. For personally owned policies, this can lead to insufficient coverage, paying too much for coverage, familial discord when beneficiary designations are not up-to-date, and more. For trust-owned life insurance (TOLI), the stakes may be even higher. Not only can failing to proactively manage and administer an underlying trust-owned policy potentially frustrate planning goals, but if a policy does not perform as expected, the trustee may be held personally liable for breach of fiduciary duty to the trust beneficiaries.

Life insurance, like any financial asset, must be routinely evaluated and managed to ensure it reflects changing planning objectives and market conditions. Financial professionals can help clients and trustees conduct these policy reviews and, in doing so, may uncover gaps in coverage and identify key planning opportunities.

Policy review basics

The first step in any policy review is to understand why the insurance was purchased and determine if the existing policy is still meeting that purpose today. This includes reviewing beneficiary designation changes at least every two to three years — or sooner if there has been a change in life circumstance, such as a business start-up, marriage, divorce, birth of a child or a death.

The second step is to determine if the policy is still performing as intended by reviewing the underlying policy and investments. There are a variety of reasons a policy can fail to perform as initially illustrated. For example, older whole life or universal life policies may be performing poorly due to a combination of factors, including a low interest rate environment and changes to a carrier's cost of insurance charges. Timing of premium payments and/or inadequate funding of the policy can also be an issue. This may be particularly so for trust-owned policies where the trustee may be dependent on yearly gifts to the trust and does not have other assets that can be used to pay premiums.

In some cases, particularly where poor policy performance and/or large loans against the policy cash value puts the policy at risk of lapse, increasing the premium or reducing the death benefit may be needed. In other cases, a tax-free 1035 exchange of the policy may be advisable. For example, if an older mortality table was used or if the insured's health has improved, a new policy may mean lower premiums. Replacing the policy can also allow the client to address holistic planning goals, such as adding long-term care protection.

Managing trust-owned life insurance (TOLI)

In the context of TOLI policies, routine policy review by the trustee is especially critical.

Trustees have a fiduciary duty to the trust beneficiaries, meaning they are required to manage trust assets with the best interests of all beneficiaries in mind, while maintaining an objective standard of care. When life insurance is owned by the trust, the trustee's fiduciary responsibilities include facilitating the ongoing payment of premiums and income tax management as well as providing notice to Crummey beneficiaries.[1] Trustees also have important investment duties to the trust beneficiaries that must be upheld. These duties, as outlined by the Uniform Prudent Investor Act (UPIA) and further defined by case law over the years, require that trustees today take a more proactive approach to managing trust-owned policies.

The UPIA, which was adopted in 1994, details the "prudent process" a trustee must follow with regards to financial assets owned by the trust.[2] The UPIA requires that trustees follow the Prudent Investor Rule in making or retaining trust instruments and focus on the overall investment strategy of the trust, including keeping costs low and maximizing returns in relation to all trust assets and weighing an income beneficiary's right to income with the remainder beneficiary's right to principal.

Over the last several years, there have been several notable cases where beneficiaries have sued the trustee for breach of fiduciary duty related to life insurance management. These cases provide clarity for understanding how the courts may interpret the UPIA and should provide guidance for trustees when executing their fiduciary responsibilities.[3] The first UPIA case, and the marquee of all the TOLI cases, *Cochran v. Key Bank*, clarified aspects of the UPIA's "prudent process" standard for determining suitability of trust-owned assets.[4]

Namely, *Cochran* highlights that trustees must:

1. Continuously monitor the suitability of trust investments, including developing a documentation/record-keeping process and bringing in third-party investment advisors as needed.
2. Investigate the strengths and weaknesses of the underlying policy in light of the overall investment strategy and trust objectives/grantor intent.
3. Take proactive steps to manage trust investments, including life insurance, to minimize cost and risk.

TOLI — a ticking time bomb or a golden opportunity?

The TOLI litigation of the last decade has impacted both corporate trustees as well as nonprofessional trustees, such as family members or friends. While corporate trustees such as financial institutions theoretically should be well versed in trust law and should have institutional policies and procedures in place to ensure their trustees are complying with the UPIA, that is not always the case.

For nonprofessional trustees, which account for roughly 90% of ILIT trustees, the situation may be even more dire.[5] The unfortunate reality is that many nonprofessional trustees may be unaware of their responsibilities regarding ongoing insurance and investment management, or even if they are aware, they are less likely to have expertise in understanding the mechanics of life insurance policies.

This general lack of trustee preparedness — coupled with the fact that 39% of inforce nonguaranteed universal life and 34% of inforce variable universal life are illustrated to lapse during the insured's lifetime or within five years of life expectancy[6] — could result in an uptick in litigation against both professional and nonprofessional trustees who have failed to fulfill their fiduciary responsibilities with regard to the policies.

Simply looking at an annual statement is not enough to determine the health of the policy. A dynamic review process should be implemented and revised routinely. Because life insurance policies are complex financial instruments, many trustees may need to engage a third-party administrator or other independent entity to evaluate the health of the policy and to fully understand how it is performing so they can make an informed decision on behalf of the beneficiaries. Delegating the investment responsibilities to a third-party is also a factor courts have considered when determining if a trustee has met their fiduciary duties to monitor, investigate and manage the policies.[7] Financial professionals can help trustees with their ongoing policy review responsibilities and those who do so may be well-positioned to uncover opportunities to help trustees accomplish trust goals.

Financing considerations

As it is common for large premiums to be paid via bank loans (commonly referred to as premium financing) or through intra-family loans, regular policy reviews are also critical for trust-owned policies because often the policy's cash value is needed to secure and/or repay the borrowed funds. A regular policy review will help determine whether the policy is on track to allow repayment of the loan given increases or decreases in the policy's crediting rate or the loan interest rate — and can help uncover opportunities for additional insurance. Addressing these key elements could also help ensure the trustee is not subject to liability as discussed above.

How John Hancock can help

At the root of the need for regular reviews are life insurance policies that have not performed as expected and were not managed to address those issues. As discussed, factors that impact policy performance, such as interest rates and the timing of premium payments, can change over the life of the policy and tracking and understanding those changes historically has been difficult for clients and trustees. In some cases, these parties may only become aware of these issues when the policy is on the brink of collapse. To address this ongoing issue and help clients and trustees make proactive, informed decisions, John Hancock developed LifeTrack, the first-of-its-kind policy management solution that helps clients stay on track to meet their insurance goals. With LifeTrack, which is offered free-of-charge and is available on many of our new and inforce products, premium notices are adjusted each year based on actual policy performance and updated assumptions about the future. If there are changes to the policy in a given year that may affect long-term policy performance, LifeTrack allows clients and trustees to take a more gradual approach to addressing the needed policy changes. Moreover, if the client engages in the John Hancock Vitality Program, their LifeTrack premium will be recalculated according to the Vitality Status achieved, which may result in lower premiums and, for trust-owned policies, reduced gifting.

Takeaway

With so much general uncertainty in the world, clients are likely more focused on their protection needs than ever before. Now is an excellent time to reach out to your clients to assist with a policy review. Financial professionals may find that taking the initiative helps to build trust and strengthen client relationships, while also providing an opportunity to potentially identify new insurance needs.

Additionally, financial professionals should consider reviewing their book of business for trust-owned policies. If the trustee can be identified, reaching out to that individual to assist with policy review and help develop an ongoing process for policy management can help to facilitate the grantor's planning intent and ensure that the trustee is fulfilling their fiduciary responsibilities.

Lastly, to help with ongoing policy management, financial professionals should explore John Hancock options such as LifeTrack and Vitality and educate new clients and trustees about the benefits of these options.

Links:

What a Trustee Should Know BYA

Beneficiary Designations BYA

JH Tools to help manage in-force policy performance

For more information, please call *Advanced Markets*
at *888-266-7498, option 3 AMC* or *option 4 Attorney*

1. For gifts to ILITs to qualify for the annual exclusion from gift tax, gifts must be "present interest" gifts. Contributions to an ILIT can typically qualify as "present interest" gifts if the beneficiary has the right to withdraw the contribution for a period of time. Ensuring the formalities of these withdrawal rights, known as "Crummey powers," are followed is a key responsibility of an ILIT trustee. See Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).
2. Many states have adopted a form of the UPIA or provisions of the Restatements of Trusts — clients/trustees should consult applicable state law.
3. See Cohran v. Key Bank; French v. Wachovia; Paradee v. Paradee; Rafert v. Meyer.
4. Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Ind. Ct. App. 2009).
5. E. Randolph Whiteclaw and Henry Montag, "The Life Insurance Policy Crisis," American Bar Association (2017).
6. Trust Owned Life Insurance (TOLI) Issues. (January 11,2017) Shenkman Law, https://shenkmanlaw.com/blog/2017/03/17/trust-owned-life-insurance-toli-issues/
7. In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Ind. Ct. App. 2009).