WRMarketplace
An AALU Washington Report

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The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: A Trustee's Best Friend: Best Practices in Administering Life Insurance Trusts.

MARKET TREND: Given the technical and tax complexities of ILIT administration, combined with fewer options for experienced, corporate trustees, litigation targeting trustees of irrevocable life insurance trusts ("ILITs") for breaches of fiduciary duty continues to rise.

SYNOPSIS: ILITs present unique fiduciary challenges in terms of administration and asset management. The growing complexity of life insurance products, along with the administrative requirements to preserve an ILIT's intended tax treatment, can make ILIT trust administration far more complicated than anticipated, particularly for non-professional trustees. Following certain best practices, however, can help establish trustee independence and evidence that the trustee is acting in the ILIT's best interest.

TAKE AWAY: ILIT trustees have significant fiduciary duties that can result in serious liability if breached. To properly perform their duties and minimize exposure, ILIT fiduciaries should act independently, conduct or obtain regular, independent evaluations of the ILIT and policy performance, document their deliberations and decisions and, as appropriate, disclose and obtain waivers or consents from ILIT grantors and/or beneficiaries. Life insurance producers can add value by offering post-sale services, like policy monitoring and annual reviews of trust-owned life insurance products, as ways to support ILIT trustees in carrying out their duties.

PRIOR REPORT: 16-25.

ILITs have the ability to address a wide spectrum of financial and estate planning needs for individuals at all wealth levels, making them increasingly popular. ILIT administration, however, presents unique fiduciary challenges, given the complexity of today's life insurance products and tax laws, leading to greater ILIT litigation. In light of this trend, WRMarketplace No. 16-25 discussed the importance of selecting suitable trustees for ILITs. Yet, selection is only the first step. Once appointed, ILIT trustees must satisfy a wide array of fiduciary and administrative duties. Below we identify some best practices for ILIT trustees to help evidence compliance and minimize potential liability.

KNOW THE OBLIGATIONS

An ILIT trustee must fulfill several fiduciary duties imposed by both state law and the trust instrument, as breaches can result in serious liability. These critical duties often include:

ILIT FIDUCIARY DUTIES
• Administer the trust solely in the beneficiaries' interests and avoid dealing with trust property for the trustee's own profit or engaging in transactions in which the trustee has an interest adverse to a beneficiary.
• Deal impartially with multiple beneficiaries and when investing, managing, and distributing trust property.
• Administer the ILIT according to the trust agreement and keep the beneficiaries reasonably informed of the trust and its administration.
• Control and protect trust property and keep it segregated from trustee's personal property.
• Manage and monitor trust investments in compliance with the trust agreement and any applicable prudent investor rule, including the diversification of trust investments. For ILITs, this may specifically include reviewing policy design, assumptions, performance, and alternative options (as newer policies are developed), as well as the insured's health and liquidity.
• Act reasonably when exercising discretionary powers.

Apart from the fiduciary duties, trustees must perform several administrative functions, such as:

ILIT ADMINISTRATIVE DUTIES
• Pay life insurance premiums on a timely basis.
• Ensure proper designation of owner and beneficiary on ILIT policy.
• Send Crummey withdrawal notices to the beneficiaries to qualify ILIT contributions for annual exclusion treatment.
• Manage any split-dollar arrangement used to fund the policy and track annual economic benefit costs or split-dollar loan payments.
• Prepare annual accounts and reports for beneficiaries.
• Pay the trust's expenses.
• File trust's income tax and/or informational returns.

As discussed in WRMarketplace No. 16-25, although financial institutions have the experience and infrastructure to handle ILIT administration, due to shifts in the marketplace, many are no longer willing to serve as ILIT trustees. With more clients forced to appoint non-professional trustees, ensuring their understanding and compliance with fiduciary and other administrative obligations has become increasingly critical. These trustees are often unfamiliar with state trust laws, technical trust concepts, and trust administrative protocols, and also lack the errors and omissions coverage that could protect them and the trust beneficiaries in case of a breach, leaving little recourse for the ILIT. Clients appointing non-professional or inexperienced trustees should anticipate the ILIT's need to hire administrative, legal, and investment services to help fulfill these duties.

EVIDENCE OF TRUSTEE INDEPENDENCE

Significant conflicts of interest can arise when a trustee maintains too close of a relationship with the grantor and takes actions that prioritize the grantor's interests over those of the trust. For example, a grantor may be concerned about providing trust information to beneficiaries, particularly if they are younger. A friend or family member ("FFM") who is appointed as trustee may defer to a grantor's wishes to limit accountings or other reports to ILIT beneficiaries, even though required by the trust and/or state law. Further, a grantor may appoint a FFM as trustee but perform all the required trustee tasks himself in an effort to minimize the burden to the FFM and to ensure that the ILIT and policy is managed as the grantor desires. This makes the FFM a trustee in name only, potentially undermining the client goals for the trust and exposing the trustee to claims of breach.

Ensuring independence in fiduciary actions and decisions, particularly with regard to ILIT grantors and non-beneficiaries, may help mitigate the potential risk exposure. Steps trustees can take to evidence independent actions include:

- Appoint an Unrelated/Professional Co-Trustee. Appoint an unrelated or professional co-trustee (such as an attorney or other advisor), which can establish independence of administration and support inexperienced trustees who may find it difficult to maintain separation from the insured/grantor.

- Hire Independent Consultants/Service Providers. Use experienced outside consultants as an alternative to, or in lieu of, appointment of an independent trustee to conduct independent reviews or analysis of investment options and decisions, including with regard to changes to, or exchanges of, the ILIT policy. The consultant could be a disinterested person with no financial stake in the outcome.

- Conduct Regular Evaluations. Regularly (e.g., annually) evaluate and document the trust's insurance investments and their performance as part of the trust's administrative protocol. Regular compliance audits (e.g., every 2-5 years) to ensure compliance with the unique administrative requirements discussed above also should be considered, and may require the assistance of outside legal counsel. Again, clients should anticipate that the ILIT will incur additional expenses to engage these experts.

CLEARLY DOCUMENT DELIBERATIONS & DECISIONS

Even trustees that follow the above rules may still be targets for liability if they fail to properly maintain trust records, including the reasoning behind their decisions. Actions for breaches of fiduciary duty often occur years after the alleged violation, when few will be able to remember the actual details or reasoning for the decisions. A clear and significant record of the deliberations and the reasoning underlying the fiduciary's decisions may provide protection to ILIT trustees and is especially critical if the trustee chooses not to follow expert recommendations.

MAKE DISCLOSURES & OBTAIN WAIVERS

An important but frequently overlooked issue is the trustee's duty to provide annual accounts and/or other information to trust beneficiaries, whether imposed by state law or the trust agreement. For example, state law may require the trustee to inform a beneficiary of the existence of a trust when he or she attains a certain age and prevent the trust agreement from waiving this duty. Trustees should confirm and comply with both state law and trust requirements.

Also, when appropriate, currently advising ILIT grantors or beneficiaries of trustee deliberations and actions may avoid future challenges or at least start the running of any applicable statute of limitations with regard to such actions. The type and amount of disclosure will depend on the particular circumstances of the ILIT and state law requirements. Obtaining consents and waivers also may be a good administrative practice, particularly if a potential conflict of interest exists or the trust agreement offers limited protection.

HOW THE TRUST AGREEMENT CAN HELP

The ILIT agreement can expand or restrict a trustee's duties (subject to any limitation imposed by applicable state law), including eliminating a trustee's duty to monitor and track policy performance, to diversify investments, or to avoid self-interested transactions. Thus, existing ILITs should be reviewed to determine the scope of the fiduciary's protections and duties, while grantors of new ILITs can customize the powers and duties of their trustees. In many cases, the grantor will want the ILIT agreement to give the trustee the broadest possible investment discretion and waive any duty to diversify, where consistent with applicable state law.

Note that some states, like Delaware and Florida, have passed statutes that minimize certain fiduciary duties with respect to life insurance policies. To take advantage of these laws, however, the ILIT would need to designate that state's law as its governing law and have a sufficient nexus to that state (e.g., has a resident trustee).

OPPORTUNITIES FOR POST-SALE SUPPORT

Life insurance producers should define their role with regard to ILIT polices post-sale. Producers can provide additional value to clients and trustees by offering to monitor trust-owned life insurance policies, provide annual reviews to the ILIT trustee, secure in-force ledgers, etc. Most policyholders do not receive this information automatically or even know that it exits. A producer could provide this policy information to the ILIT trustee as part of an annual policy report to remain in contact with the client and trustee and ensure they receive regular updates.

TAKE AWAYS

- ILIT trustees have significant fiduciary duties that can result in serious liability if breached.
- To properly perform their duties and minimize exposure, ILIT fiduciaries should act independently, conduct or obtain regular, independent evaluations of the ILIT and policy performance, document their deliberations and decisions and, as appropriate, disclose and obtain waivers or consents from ILIT grantors and/or beneficiaries.
- Life insurance producers can add value by offering post-sale services, like policy monitoring and annual reviews of trust-owned life insurance products, as ways to support ILIT trustees in carrying out their duties.

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