Trust-owned life insurance and the Uniform Prudent Investor Act

RBC Wealth Management

What trustees need to know

Irrevocable trusts containing life insurance are popular estate planning tools, because they help financially successful people and families accomplish their intergenerational wealth transfer goals. If trustees do not fulfill all of their fiduciary responsibilities, however, the trust may fail to meet its objectives, leaving the trustee personally exposed to lawsuits filed by the beneficiaries.

Compliance with the Uniform Prudent Investor Act (UPIA) is one aspect of managing trusts containing life insurance that many trustees are unaware of. Over the last decade, state legislation, standards set by the Office of the Comptroller of Currency (OCC) and regulatory trends have raised the standard of care to include monitoring and reviewing life insurance asset performance as requirement of UPIA.

Scope of the issue

Studies published in *Trusts and Estates* indicate four out of five professional trustees (84%) had no guidelines and procedures for monitoring and reviewing Trust Owned Life Insurance (TOLI).[1] And 19 out of 20 professional trustees (95%) had no guidelines and procedures for reviewing and monitoring asset allocation for variable life TOLI.[2]

Equally concerning, figures as high as nine out of ten TOLI policies are cited as having no current servicing agent.[3] With no servicing agent, trustees may have no one to consult when searching for reliable information and advice concerning the TOLI they manage.

Four fiduciary impacts

The UPIA sets standards for trustees to act "as any prudent investor would" as they manage and invest trust assets. Some of these standards are especially relevant for life insurance.

- Assessing risk tolerance, taking into consideration "the purposes of the trust and the relevant circumstances of the beneficiaries"
- Taking into consideration general economic conditions and expected tax consequences of investment decisions or strategies
- Adequately diversifying trust assets
- Considering an asset's special relationship or special value, if any, to the purposes of the trust

Three noteworthy perils

There are three perils that may expose trustees to legal liability when managing TOLI.

- **Poor investment decision making —** Trustees have been sued for investment decisions, loans or other decisions that have failed to achieve the goals of the trust.
- **Poor/improper life insurance design —** Trustees have been sued when policy premiums or cash values do not live up to the expectations of the policy design, requiring additional gifts to pay premiums.
- **Poor vendor selection —** Trustees have been sued for failing to meet OCC standards of documenting the due diligence for why a particular carrier and agent were selected.

Note: Gross negligence in maintaining the insurance policy may be grounds for civil action. However, the courts rarely have found against the defendant (trustee). Most reputable trustees would never excuse any form of professional negligence.

Six possible hazards

There are six hazards that may increase your risk exposure to civil lawsuits.

- **Policies not performing as illustrated —** Changes in markets and interest rates may result in cash values and death benefits lower than illustrated. For example, if the policy was written when 10% was the going annual rate of return, the policy may be underperforming in lower interest rate environments.
- **Policies insufficient for current needs —** A client's needs may have evolved since the policy was written and a different death benefit may be warranted. For example, the grantor may have additional or fewer beneficiaries to consider in his or her estate.

- **New products offering cost efficiency —** Many carriers have been able to reduce costs because of gains in life expectancy, better underwriting and streamlining expenses.
- **New products offering better guarantee —** Recent product innovations may offer secondary guarantees with potentially more security compared to the products available when the policy was written.
- **New riders offering more appropriate features —** Relatively new ways to customize policies, such as return of premium riders and guaranteed death benefit protection riders may offer trustees more flexibility to design a policy for their client's specific needs.
- **Policies scheduled for a jump in premiums —** Whether it is intentional, such as in an older graded premium policy, or the result of poor design, a jump in premiums can be especially sensitive. Because of the longer paying period or higher premium required to maintain coverage, the grantor may not be in a position to make increased or extended gifts. For example, the death of a spouse may reduce a grantor's income and decrease by half the grantor's annual exclusion gifting power.

How to maintain compliance with the Uniform Prudent Investor Act

Trustees managing TOLI may wish to monitor and review the six hazards (listed previously) on a regular basis and on two levels.

First, on a strategic level, to determine if life insurance is an appropriate tool for the trust and beneficiary goals — similar to how an investment professional might evaluate the asset allocation of a portfolio of securities.

And second, on a tactical level, to determine the suitability of the underlying life insurance policy(ies) — much in the same way an investment professional might evaluate the individual securities within a portfolio of securities.

Many experienced, highly competent professional trustees may not have the time, focus or knowledge to review and monitor TOLI on these two levels. For a complimentary consultation with an experienced life insurance specialist who can help you make well informed decisions, contact your RBC Wealth Management® financial advisor.

1. Harris and Prince, "The Problem with Trusts Owning Life Insurance," *Trusts and Estates* (May 2003):62

2. Ibid.

3. Whitelaw and Ries, "Managing Trust Owned Life Insurance Revisited," *Trusts and Estates* (April 1999): 38, citing statistics on page 39.

