# Fiduciary Pitfalls with Trust-Owned Life Insurance

***Christopher P. Cline, Esq.***
***Holland & Knight, LLP***
***111 S.W. Fifth Avenue, Suite 2300***
***Portland, Oregon 97204***
***(503) 517-2928***
***chris.cline@hklaw.com***

***Barry D. Flagg, CFP, CLU, ChFC***
***TheInsuranceAdvisor.com, Inc.***
***1301 West Fletcher Avenue***
***Tampa, FL 33612***
***888-908-8242 Toll-Free***
***BFlagg@TheInsuranceAdvisor.com***

The adoption by most states of the Uniform Prudent Investor Act ("Act"), has far-reaching effects on trust drafting and administration.[1] One of the often overlooked consequences of the Act is its effect on the administration of irrevocable life insurance trusts (or "ILITs"). The trustee's duty to appropriately select, purchase and monitor the insurance product that is often the ILIT's only asset has been brought to light by the Act, and it should be of significant concern to ILIT trustees, particularly in view of the fact that it has been estimated that between 70% and 95% of ILIT policies have no servicing agent, 83.5% of professional ILIT trustees have no guidelines or procedures for handling trust policies, and 71% of nonprofessional trustees have not even reviewed their policies within the last five years.[2]

This article will address the unique (and opaque) nature of life insurance as an investment and the effect the Act can have on trustee-owned life insurance (or "TOLI"). Part One reviews the theoretical underpinnings of the Act, and discusses the ways in which these theories can adversely affect the way trustees invest for particular families. It then explores the Act itself, and the types of drafting and administration issues it engenders. Part Two looks at the nature of life insurance as an investment, focusing on the factors that go into pricing insurance products and the effects that those factors have on policy performance. Finally, Part Three looks at trust administration of ILITs

---

[1] See, e.g., Hoisington, Modern Trust Design: New Paradigms for the 21st Century, 31st Annual Phillip E. Heckling Institute on Estate Planning, Ch. 6 (1997); Horn, Prudent Investor Rule, Modern Portfolio Theory and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust, 33 Real Property, Probate & Trust Journal 1 (Spring 1998); Wolf, Total Return Trusts—Can Your Clients Afford Anything Less?, 33 Real Property, Probate & Trust Journal 131 (Spring 1998).

[2] Teitelbaum, "Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make," J. of Financial Service Professionals 38 (July 2005).

## PART ONE: MODERN PORTFOLIO THEORY, THE RESTATEMENT (THIRD) OF TRUSTS AND THE ACT[3]

The Act is rooted in modern portfolio theory and the Restatement (Third) of Trusts ("Restatement"). The "prudent investing" concept was overhauled in 1992 with the publication of the Restatement. Academics, trustees and advisors sought to eliminate old, arcane trust investment rules in favor of "modern portfolio theory."[4]

### A. Modern Portfolio Theory and the Restatement.

Although this article is far too brief to cover the intricacies of modern portfolio theory, two crucial concepts must be recognized. First, the nature of risk must be considered. There is market risk, which deals with market volatility (e.g., the stock market); and non-market risk, which deals with the volatility of a particular asset (e.g., a company that may go bankrupt). If one accepts greater market risk (i.e., investments in stocks, which are riskier than bonds), the returns over the long term should be greater. However, non-market risk generates no additional return because one can avoid it by diversifying her investments. This concept of risk puts at least two burdens on an investor: (1) she should determine the level of volatility (the level of market risk) she will accept in exchange for the return she hopes to receive; and (2) she should diversify her portfolio in accordance with the chosen level of market risk to avoid non-market risk.

The second important concept is that of market efficiency, which assumes that asset information is disseminated efficiently and therefore all assets are priced more or less correctly. An investor's best strategy, in that case, is to invest passively through index funds, which should perform as the market does as a whole, because no investor should be able to consistently outperform the market. If markets are efficient, most active management (picking particular stocks, for example) generates additional management expense without a consistently higher return.

The Restatement, which applies investment principles to trustees of private trusts, incorporates modern portfolio theory. It adopts the concepts of risk,[5] distinguishing between market and non-market risk, and at least implies that a trustee breaches its fiduciary duty to preserve capital if it selects a level of return that allows inflation to erode the trust property's value. In other words, a trustee can get in trouble by playing it

---

[3] Portions of Part One are derived from Cline, "Prudent Investing, Reallocating Income and Total Returns: The Curmudgeon's View" 28 Tax Management Estates, Gifts and Trusts Journal 62 (May/June 2003), reproduced with the permission of Tax Management, Inc., a subsidiary of the Bureau of National Affairs, Inc., Washington, D.C. All Rights Reserved. An expanded version of these materials will be published as part of the future edition of TM 861, "Investment Issues for Fiduciaries," published by Tax Management, Inc., a subsidiary of the Bureau of National Affairs, Inc, Washington, D.C. All Rights Reserved.

[4] See, e.g., Macey, An Introduction to Modern Financial Theory (2d ed. (1998); Malkiel, A Random Walk Down Wall Street (6th Ed. 1996).

[5] See, e.g., Restatement (Third) of Trusts, § 227, cmts (b)(h) (1992).

too safe: it must accept a certain amount of market risk and avoid non-market risk by diversifying investments.[6]

The Restatement also adopts, to some extent, the efficient market theory.[7] Further, the Restatement specifically prohibits a trustee from incurring unreasonable costs in managing and investing trust assets.[8] In other words, the Restatement can be read for the proposition that passive asset management (for example, through the use of index funds) is generally a more prudent investment choice than active management. [9] Because the Act is based on the Restatement and modern portfolio theory, the Act also can be read as adopting the same concepts.

As an aside, the question whether markets are actually efficient may not be as settled as the Restatement implies. The equity value rollercoaster of the last five years has caused many to question the validity of the theory. An alternate view of market valuation is that of behavioral finance, which considers the psychology of investing.[10] Further, investor psychology (both individual and professional) is not given adequate consideration, even if market efficiency theory is correct. For instance, $1 invested in the S&P 500 in 1926 would have grown to $1,114 by 2005. However, if the same dollar was invested but the investor got out of the stock market during the 35 best months of the period (a total of 840 months), the dollar would have grown only to $10. Expressed differently, 99% of the growth during that period occurred during only 4% of the months in it. Miss those months, and you miss your appreciation. Investors, in other words, have to hang around for 96 unproductive months, waiting for the big one. This need to stay in a market for the long term demonstrates a need for continued guidance for many investors. If an investor takes comfort knowing the person or institution managing their money, that investor might maintain his investment strategy more consistently, resulting in less investment turnover and therefore higher returns.

## B. The Act

The Prefatory Note to the Act states that, relying on the Restatement, it makes five significant changes to the law of trustee investing. First, the prudence standard "is applied to any investment as part of the total portfolio, rather than to individual investments." Second, a trustee's primary consideration in investing is the tradeoff "between risk and return." Third, categorical restrictions on types of investments are eliminated; a trustee may "invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing." Fourth, investment diversification is incorporated as an integral part of prudent investing. Finally, trustees can delegate investment and management functions.

---

[6] Id. At § 227, cmt g.
[7] Restatement (Third) of Trusts, Ch. 7 (Introduction, pp. 6-7; Reporter's Notes, pp. 75-76) (1992).
[8] Id. At § 227(c)(3).
[9] *See, e.g.,*Horn, supra at fn. 2, pg. 17.
[10] Shefrin, Beyond Greed and Fear, 13 (Harvard Business School Press, 2000). This book synthesizes the work of several academics in the area of behavioral finance.

Under Section 1 of the Act, the prudent investor rule is a "default rule," which may be expanded, restricted or eliminated by the trust terms, but which must be followed if not overridden. Section 2 sets forth the trustee's standard of care: a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." In other words, a single investment approach for all trusts is inappropriate. Investments are judged, under Section 2(b), in the context of the trust portfolio as a whole and as a part of an overall strategy, after evaluating risk and return objectives. So, as the comments to that section point out, a trust "whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth." Section 2(c) lists some circumstances a trustee take into account when developing an investment strategy: general economic conditions, inflation, expected tax consequences, the beneficiaries' other resources, beneficiary needs for liquidity and an asset's special relationship or special value, if any, to the trust purposes. Finally, Section 2(f) states that a trustee with special skills or expertise has a duty to use them.

Section 3 requires a trustee to diversify trust investments unless, because of special circumstances, the purposes of the trust are better served without diversifying, such as holding an undiversified block of low-basis securities with built-in gain or retaining a family business. Under Section 4, a trustee must, within a reasonable time after accepting the trusteeship, review the trust assets and decide whether they are appropriate investments in light of the factors just discussed. In other words, a trustee cannot simply rely on the fact that a predecessor held these assets, even if the predecessor was the grantor.

Sections 5 and 6 set out the trustee's duties of loyalty to and impartiality among the beneficiaries. Section 7 states that a trustee may only incur costs in investing and managing trust assets that are appropriate and reasonable. Section 8 provides that compliance with the prudent investor rule "is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." As the comments point out, "[t]rustees are not insurers * * * . Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard."

Section 9 provides that a trustee who properly delegates investment and management functions is not liable for the decisions or actions of the agent to whom the function was delegated. This section reverses the former trust law that imposed a rule of non-delegation, and "is designed to strike the appropriate balance between the advantages and the hazards of delegation." Further, "the trustee must balance the projected benefits against the likely costs" of delegation, and "take costs into account." So, for example, if a trustee's regular compensation schedule assumes that the trustee will manage investments, "it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager."

## PART TWO: FACTORS DETERMINING LIFE INSURANCE PRICING AND, PERFORMANCE AND SUITABILITY

Now that the basics of the Uniform Act have been laid out, its application to life insurance as a trust asset will be considered.

### A. Some Crucial Facts About Insurance.

To begin any discussion of life insurance as an investment, it is important to understand how the various insurance products work. This, in turn, requires an understanding of the types of products available (see Exhibit A for a list of product types and a table of product characteristics for each product type), the way that they are illustrated and the expense structure behind them.

#### 1. Insurance Product Types.[11]

In its purest form, insurance is simply the insurance company pooling a sufficiently large number of risks (i.e., individual insured lives), which individually are unpredictable, but collectively become statistically very predictable. The insurance company calculates each year how much it must be paid for it to assume the risk that the insured will die in that year and that the company will then have to pay the stated death benefit to the insured's beneficiaries. The amount it must be paid, in the form of an annual premium, is determined based upon actuarial assumptions about the insured, including the insured's gender, age, personal habits (e.g., smoking and skydiving) and medical condition and history. An insurance company will accept a small premium from a 25-year-old healthy nonsmoker with no family history of illness; the annual premium on such a person for a $1 million might be $1,000. In other words, the insurance company is willing to accept a relatively small premium due to the statistical probability that it is very unlikely the insured will die in which case the insurance company keeps the premium. On the other hand, a 98-year-old smoker would have to pay an amount approaching $1 million for the same policy; that is, the company knows there is an extremely high probability that the insured will die that year, so they must collect a correspondingly large premium to be able to pay that death claim. This kind of "pure" insurance is called "term insurance," and it is used primarily to provide security for younger insureds (or for group insurance, with a large risk pool), because as the insured gets older, the premiums become prohibitively expensive. The calculation for this "pure risk" cost of insurance is discussed in Section B, below.

As an alternative to term insurance, most insurers also offer various products which can provide permanent coverage. The oldest form of "permanent life insurance" is "whole life insurance," the premiums for which consist of a term insurance component and an investment component. In the case of our 25-year-old above, the premium for a whole life policy with a $1 million death benefit might be twice as much, with $1,000 going to pay the cost of his term insurance and the balance (after the commissions are

[11] For a more complete discussion of the types of insurance products on the market, *see* Mezzullo, *An Estate Planner's Guide to Life Insurance*, (ABA 2000).

paid to the agent) going into an investment account regulated by the state insurance commissioner. This investment account grows over time, and can either become a part of the death benefit that is paid, or be used to reduce policy costs over time (discussed in more detail, below). For instance, if the cash value in the policy grows to $750,000 by the time the insured is age 50, the portion of the premium paid each year allocated to the term component of the policy gets smaller, because now the company is only insuring the insured's life for $250,000. The value of the investment account increases over time, so the premium never increases (as it does under term insurance). If the insured lives long enough (usually to age 100), the cash value in the policy increases to the point where it equals the death benefit, at which point the insurance company simply gives the money to the insured (or can continue to provide coverage without cost). The owner of the policy can withdraw the cash value in the policy at any time or can borrow against it; however, if the policy is left with too little cash it can lapse.

In response to the high interest rates of the late 70's and early 80's, the insurance companies developed "universal" life, which is similar to whole life, but provides flexibility in the amount of premium the policy owner pays. The policy owner can pay larger premiums in the early years of the policy and then lower premiums (or none at all) later on, always with the caveat that if the cash value in the policy drops below a given level, the owner will have to either contribute extra premiums to the policy or it will lapse.

With universal life, the policy holder gives up the certainty of a guaranteed premium in exchange for a lower current cost and premium flexibility. The insurance companies guarantee nothing more with universal life than with whole life. Rather, they allow this flexibility by transferring the premium sufficiency risk to the policyholder. If more money is needed because the interest crediting rate drops or mortality costs increase, then more premiums are due. If these additional premiums are not paid, the policy eventually terminates without value.[12] Because this risk may not be explained by insurance agents, many policyholders pay less than is needed to keep the policies alive, thinking that the quoted premiums are a promise of no future increases. As a result of this confusion, some believe that universal life has created a "legacy of disappointment and broken promises for policyholders and advisers alike."[13]

A decade later, after the significant rise in value of the stock market, policy owners grew tired of having the cash values of their insurance polices invested in "safe" regulated investments approved by the insurance commissioner (typically bonds and government-backed mortgages). The insurance industry responded with "variable life," which usually is a universal life product, but the cash value of which can be invested in one of several investment packages offered by the insurance company. For example, the company may offer mutual fund packages allowing investments 100% in stocks, or 50% in stocks and 50% in bonds. The policy owner is limited to the investment choices offered by the insurance company, which typically have higher than average costs associated with them. These higher costs may be offset, over time, by the fact that the growth of the assets inside the insurance policy occurs free of income tax liability. Note,

[12] Rybka & Jones, *J. of Financial Service Professionals*, 50, 51-42 (July 2005).
[13] *Id.* at 52.

however, that this investment flexibility can work both ways; if the policy owner decides to invest primarily in equities and the stock market is doing well, the cash value will build in the policy faster than expected, which means that the future premiums can be much smaller. On the other hand, if the stock market drops in value significantly, the policy owner may be faced with significantly larger premiums than were originally quoted to him or her.

As with universal life, policyholders tended to view the optimistic illustrations provided by agents as a promise that the product would perform and that premiums would not increase in the future. However, the significant fluctuation in values over the last seven years in the stock market have demonstrated that projections for premiums in variable life products are not reliable at all. Therefore, as with universal life, variable life products have proved to be a disappointment to many.

**2. <u>The Problem with Illustrations</u>.**

Another issue policy owners need to deal with, after the appropriate type of policy is chosen, is the illustration, or projection of premium payments, presented by the agent selling the policy. In the late '70's and early '80's, with the advent of universal life, insurance companies and agents were among the first to either own or have access to personal computers in order to run the illustrations for this more complex product.[14] Unfortunately, however, this technological advance became somewhat stratified, with the result that illustrations no longer adequately present purchasers with an appropriate picture of the risks involved. This is so because policy illustrations, even so-called "in force" illustrations, are constrained by both insurance regulation and industry tradition to projecting a constant return assumption.[15] So, for example, if illustrations are run showing an 8% return (the most that can ever be illustrated is 12%), the illustration will assume that each and every year the investments inside the policy generate an 8% return.

The problem, of course, is that no investment generates such a flat-line return. For example, suppose a 10% return is being illustrated. If $1,000 is invested and it generates an even 10% each year for five years, the value of the investment will be $1,611 at the end of the period. If, on the other hand, the investment earned, in each successive year, 10%, 20%, 0%, 30% and -10%, the average percentage return would still be 10% over the five years, but the investment would be worth only $1,544.[16] This fluctuation in values based upon the types of return can have great significance; in some cases, it can mean the difference between a policy being adequately funded by the premiums and requiring additional premiums in the future. A better way to illustrate, albeit one that is not commonly provided, is the "Monte Carlo" simulation, under which a computer enters a significant number of permutations, or "runs," of outcomes, all of which lead to the same average percentage return. This exercise will tell a potential

[14] Weber, *When is a Premium* Not *a Premium?* J. of Financial Service Professionals 34 (July 2005).
[15] *Id*. at 36.
[16] *Id.* at 35.

buyer of insurance the percentage likelihood that the policy will remain in force and will not require additional premiums.[17]

## B. Pricing Issues.

To manage any portfolio of life insurance products (even is just a single policy), trustees must first measure the factors underlying the product's pricing and performance. Whether disclosed or not, these factors are the same for all policies: (a) cost of insurance charges, (b) policy expenses and (c) policy earnings. Therefore, the pricing and performance of any policy can be measured using the following formula:

**Pricing/Performance** = **Cost-of-Insurance Charges** + **Policy Expenses** - **Policy Interest/Earnings**

Each of these factors is discussed in turn.

### 1. Cost of Insurance Charges (COIs)

Cost of insurance charges (COIs) are deductions from permanent life insurance policies to cover the insurer's anticipated payments for death claims. They are the largest single cost of any policy, typically accounting for about 75% of total premiums. (Indeed, if claims are not the largest single cost factor, then the product probably isn't really insurance against the risk of death.) These deductions are much like term life insurance premiums in that they are predominantly for claims paid during a given period (typically 1 year). For this reason, COIs are frequently referred to as the pure "risk" portion of the premium, reimbursing the insurance company for the risk associated with paying the death benefit. Because the risk of death increases with age, so does the COI.

COI is calculated each year using two factors: the net "at-risk" amount of the policy death benefit and a COI rate provided by the insurance company for each age corresponding to each policy year for each product. The net at risk amount is multiplied by the rate to determine the COI; the higher the death benefit or the rate, the greater the COI and therefore the higher the premium.

For example, assume an insurance company provides permanent life insurance for a group of 1,000 policyholders whom all are insured for $100,000 and three (3) insureds out of the group of 1,000 die in a given year. The insurance company pays $300,000 to the beneficiaries of those three insureds. The insurance company must therefore collect $300 from each policy owner over the course of the period in order to pay this $300,000. The COI Rate would equal $3.00 per $1,000 of death benefit (i.e. each insured paid $3.00 multiplied times 100 for each $1,000 of death benefit). Of course, as the average age of the population increases, the risk of more deaths increases and so does the COI and therefore the premium.

[17] *Id.*

Insurance companies add several other charges to COI. First, the company builds in a profit margin. Second, some insurers "load" the COI to cover other policy expenses that are not disclosed elsewhere. For instance, some policies are marketed as "no-load" or "low-load" policies, and do not disclose certain policy expenses or loads such as sales loads and other premium based loads. However, because certain premium based loads must be paid (e.g. state premium taxes, federal deferred acquisition costs taxes, and the cost to distribute the policies), some insurers "hide" these costs inside "loaded" COIs.

The other factor, the "net at risk" death benefit, is that portion of the total death benefit in excess of any policy cash value (e.g., the higher the policy cash value of the policy, the lower the net at risk amount of death benefit to the insurer). If policy cash values increase over time, this net-at-risk death benefit will decline each year in a level-death-benefit policy design, or will remain level in an increasing-death-benefit policy design.

While different policies calculate the "net at risk" death benefit differently, this Net Amount at Risk (NAR) in any given year can be generally calculated as follows:

**Net Amount at Risk = Policy Death Benefit - Policy Cash Value**

Because COI is calculated on the NAR, and because COI increases geometrically with age, the NAR is a significant factor in insurance pricing. COI is reduced when cash values are nearly equal to the policy death benefit. However, once the insured dies, the insurance company pays the death benefit in large measure by “giving back” the policy cash value. Because policy cash values are “confiscated” by the insurer upon death, any COI cost savings associated with high cash values and a corresponding low NAR must be measured against the “cost” of forfeiting policy cash values.

The reasonableness of COI for any given product can be measured against a generally accepted mortality table like the 1990-95 Gender Distinct Select and Ultimate Mortality Table published by the Society of Actuaries (www.SOA.org), COI benchmarking systems like the Policy Pricing Calculator (available without charge at www.PolicyPricingCalculator.com) or the Confidential Policy Evaluator (CPE) system from www.TheInsuranceAdvisor.com (TIA).

### 2. Policy Expenses

In addition to COI, most policy issues are priced for expected expenses related to actuarial design, sales and marketing, underwriting and new business processing, state and federal taxes and service and administration. While different insurers use different names for these expenses, they all fall into one of three categories: fixed administration expenses, cash-wrap fees and premium loads.

### a. Fixed Administration Expense (FAE)

FAEs are charged as a fixed amount either as a flat monthly charge (e.g. $10.00 a month), or in relation to the originally issued policy face amount (e.g. $1.00 per $1,000 of policy face amount). While this charge is fixed in amount at the time of policy issued, it can vary from year to year by a predetermined schedule. FAEs can include contingent or back-end policy surrender charges that are deducted from the policy cash account value upon surrender or cancellation/termination of the policy. These surrender charges are calculated in relation to the initially issued policy face amount and can be as much as 100% or more of the planned annual premium for policy issues available to the general public or can be reduced or waived for policies purchased in larger volumes. This surrender charge typically remains level for an initial period, then reduces to zero over an additional period.

### b. Cash-Value-Based "Wrap Fees"

Cash-value-based "wrap fees" are charged as a percent of policy account values in the same way that investment managers charge a management fee based on a percent of assets under management. These fees can be divided into two categories: *insurance fees,* which are specific to the policy and collected at the policy level; and *investment fees,* which also charged as a percent of policy account values, but which are specific to the investment fund and collected at the fund level.

Fund-level or fund-specific charges relate specifically to the investment portfolio or separate accounts funds upon which the cash value is based and typically range from 0.25% to 2.00%, depending upon the type of investment funds used. Examples of fund-level or fund-specific charges include, but are not limited to, charges at the investment fund or portfolio level for investment management fees, investment advisory fees, and fund operating expenses. Whole life and universal life policies do not customarily disclose these charges, while variable products do. Because these charges are a function of the underlying investment portfolio, they should only be taken into account when comparing investment or separate account fund selections, and not when comparing policy level costs.

On the other hand, policy-level or policy-specific charges relate to the policy itself, without regard to underlying investments, and typically range from 0-1%, and can vary from year to year and based on the policy account value. The most common policy-level or policy-specific cash-value-based charge is the M&E charge intended to cover the risks assumed by the insurance company that actual cost of insurance charges will be greater than expected (i.e. insureds live less time than anticipated resulting in increased claims) and that actual expense charges will be greater than expected. Some products also include policy-level or policy-specific cash-value-based charge in addition to the M&E charge, both of which can vary depending on the year of the policy (e.g. 1.00% of cash values during the first 10 policy years, and 0.5% of cash values thereafter). These charges are true policy costs, to be considered when comparing one policy to another.

### c. Premium-Loads

Premium loads are charged to policyholders as a percent of premiums paid in a given year. They typically range between 0% to 35%, and typically cover state premium taxes, DAC taxes sales loads and expenses. In addition, while insurance companies must pay state premium and DAC taxes, they are not required to assess the charge as a percent of premium, so many pass these charges through as COI rather than premium charges. Premium-based charges can vary, depending on either the policy year in which a premium is paid or the level of the premium paid. For instance, a higher premium load may be assessed in the early policy years to recover up-front expenses related to underwriting, issue and distribution of a given policy. After these up-front expenses have been amortized (frequently over a period of ten policy years), premium loads are then often reduced to cover the relatively lower policy owner service and policy administration expenses. In addition, a higher premium load may be charged on actual premiums paid up to a "Base Policy Premium" or "Target Premium" level (generally the premium which, if paid every policy year, would endow or mature the policy for its originally issued face amount based on guaranteed policy pricing assumptions as to COIs, expenses and earnings), while a lower premium load may be charged on actual premiums paid in excess of this amount.

### d. Application of Policy Expenses

The manner in which these fixed administration expenses, cash-value-based "wrap fees", and premium-loads are constructed and calculated in a given policy determines the suitability of a given product to a given situation. For instance, products with low COI and FAEs perform best in defined-death benefit, minimum premium situations, even if premium loads and cash-value-based fees are relatively high, because these expenses are calculated as a percent of a minimum premium and minimum cash values, and thus have less influence on performance. On the other hand, products with low premium loads and low cash-value-based fees perform best in defined-contribution, maximum-accumulation situations, even if COI and FAEs are relatively high, because maximizing premiums and cash values has the effect of reducing the Net Amount at Risk, which in turn minimizes COI. Of course, the best of all worlds would be to hold a policy that has low COI, FAEs, cash-value-based fees and premium-loads. The reasonableness of such expenses for any given product can be again measured either against an industry aggregate expense studies published by the Society of Actuaries (www.SOA.org), policy expense benchmarking systems like the Policy Pricing Calculator (available at www.PolicyPricingCalculator.com) or the Confidential Policy Evaluator (CPE) system from www.TheInsuranceAdvisor.com (TIA).

## 3. Policy Interest and Earnings

Premiums paid in excess of the premium expenses, discussed above, are credited with some form of policy interest or earnings based on product type and the allocation of invested assets underlying policy cash values. For instance, "fixed products" (i.e., universal life and whole life) are required by regulation to invest policy assets mainly in

high-grade corporate bonds and government-backed mortgages. As a result, the policy interest crediting rate for universal life products and the dividend interest crediting rate for whole life products is generally the same as the 6.0% historical rate of return on these investments. Similarly, "variable products" (i.e., variable universal life and variable whole life), which can invest policy cash values in a wide variety of mutual-fund-like "separate accounts," have a policy earnings rate that is very similar to the rate of return for the assets classes into which cash values are allocated (domestic index funds, international funds or balanced funds, for example).

Obviously, while life insurance policy pricing and performance projection systems allow for a wide range of interest and investment earnings assumptions in calculating hypothetical policy values, actual policy performance depends upon the actual performance of invested policy assets. In other words, while an illustration of hypothetical future policy values may reflect a current interest rate declared by the insurer, actual policy earnings will vary from those hypothetical values. Several factors can affect the actual performance of policy investments. For example, some insurers declare higher interest crediting rates for new policies than for renewing policies (e.g., 5.5% interest for new policies, 5% for renewals), while others declare a market interest rate at issue with a "bonus interest crediting rate" after some period of time (e.g., 0.5% bonus beginning in the 11$^{th}$ policy year). Either way, such declared rates are generally guaranteed for a year or less and are routinely changed. Variable products allow for an even wider range of interest and investment earnings assumptions in calculating policy pricing and projected performance: earnings expectations are generally set by agent or broker rather than the insurer, and generally do not reflect actual rates of return for the actual policy investments. An agent or broker can project a policy earnings assumption between 0.0% and 12.0% without regard to the actual type of investment accounts the policy will hold.

As a result, trustees must look beneath the assumed policy earnings rate when setting expectations as to future policy performance (discussed in greater detail below in Part III) and instead consider the historical performance of the policy investments and the expected rate of return for the appropriate allocation of cash values among the separate accounts. The reasonableness of an illustrated policy earnings rate can be measured using either LifeLink VitalSigns for performance of insurance company general accounts underlying whole or universal life policy cash values, while Morningstar PrincipiaPro can be used to measure the performance of variable life policy investments. Other services include policy performance benchmarking systems like the Policy Pricing Calculator (available at www.PolicyPricingCalculator.com) or the Confidential Policy Evaluator (CPE) system from www.TheInsuranceAdvisor.com (TIA).

### 4. Determining the Rate of Policy Earnings

Because the reporting of life insurance policy earnings is not yet standardized, measuring policy performance also requires an understanding of the three ways in which life insurance policy earnings can be expressed and reported: the gross rate, the net rate and the net-net rate. First, the gross rate is that rate of return credited to policy cash

values reported *before* deduction of *investment*-related fund management expenses (FMEs) and *before* deduction of cash-value-based *insurance* expenses. The gross rate is directly related to the rate of return on invested policy assets, and thus is more a measure of general "asset-class rate of return" than of policy-specific returns. Therefore, while the gross rate may be an interesting piece of information at is relates to benchmark performance of the respective asset classes underlying policy cash values, because it does not reflect the earnings actually credited to TOLI policy holdings, it is limited in its use by trustees in setting reasonable expectations as to the investment performance of TOLI holdings.

Second, the net rate (or "single net rate") is that rate of return credited to policy cash values reported *after* deduction of investment-related FMEs, but before deduction of cash-value-based insurance expenses. In other words, the net rate equals the gross rate minus FMEs, and so is analogous to the "investment rate of return" on policy cash values. Because the net rate is derived directly from the gross rate for a given asset allocation, and because FMEs are a function of that asset allocation (i.e., they are lower for conservative fixed-income cash value allocations than for aggressive equity allocations), the net rate is useful for in setting reasonable return expectations for policy investments.

Finally, the net-net rate is that rate of return credited to policy cash values reported after deduction of <u>both</u> investment FMEs and cash-value-based insurance "wrap fees" (e.g., M&Es). In other words, this "net-net rate" is equal to the net rate minus M&Es, and because this net-net rate reflects the rate of return reported on policy cash values after deduction of all cash-value-based fees, it can also be referred to as the "policy rate of return" or the "double net rate" (i.e., the rate of return on policy cash values after deduction of both investment *and* insurance "wrap fees", but not considering COIs, FAEs nor premium loads). Because this net-net rate is a function of the individual TOLI holding, it is less useful in setting reasonable expectations as to the interest or earnings actually credited to trust assets, and is instead most useful in measuring the appropriateness of policy expenses.

Because some TOLI policies may not disclose the gross rate, the net rate or the net-net rate, or clearly distinguish which rate is which even if it is disclosed, ILIT trustees need to exercise considerable care both when setting reasonable expectations for return on investment from TOLI policies, and when determining the suitability of one policy versus another. For instance, two TOLI policies may have the same underlying cash value asset allocation, the same 1% investment wrap-fees, the same .75% insurance wrap-fees and the same 8.0% rate of return. However, if the policies do not make clear that the Product A rate of return is net of only investment expenses (i.e., the single net rate), while the Product B rate of return is net of all cash-value-based expenses (i.e., the double net rate), the performance can vary significantly without the potential purchaser being aware of the difference:

| | Product A | Product B |
|---|---|---|
| Gross Rate | 9.00% | 9.75% |
| Less Investment Wrap-Fees | 1.00% | 1.00% |
| **Net Rate** | **8.00%** | 8.75% |
| Less Insurance Wrap-Fees | 0.75% | 0.75% |
| **Net-Net Rate** | 7.25% | **8.00%** |

Comparing rates of return without determining which types of rate are being compared can lead to an improper choice of product (an ultimately a potential breach of fiduciary duty claim if the purchaser is a trustee).

The same problem can occur when comparing two policies that report the same the same 9.0% ***gross*** rate of return, but where investment wrap fees are reported differently:

| | Product A | Product B |
|---|---|---|
| **Gross Rate** | **9.00%** | **9.00%** |
| Less Investment Wrap-Fees | 1.00% | 0.25% |
| Net Rate | 8.00% | 8.75% |
| Less Insurance Wrap-Fees | 0.75% | 0.75% |
| Net-Net Rate | 7.25% | 8.00% |

Here, the problem lies in comparing assumed rate of return, but not determining whether which expenses are deducted from this return

## C. Understanding Pricing & Performance Factors in each Product Type

While all life insurance products are priced using COI, policy expenses and policy earnings, different products use these pricing factors differently, some products disclose these factors while others do not, and some products guarantee certain factors while others do not, as shown in the table on Exhibit A. What follows is a discussion of the ways these pricing factors are constructed in each product, which products generally disclose these pricing factors, and which product types guarantee which pricing factors (by product type in alphabetical order).

### 1. Fixed-Duration Term Insurance

Term insurance products like Annually Renewable Term ("ART") and Level-Premium Term (e.g., LT10 for a ten-year term and LT20 for a twenty year term of fixed premiums) provide a specified death benefit for a fixed term of years and charge a premium corresponding to that duration of coverage, and are thus often referred to as Fixed-Duration Term Life. For instance, ART products charge a premium for one year of insurance coverage at a time, and generally allow the policy to be renewed at an increasing premium for some number of years. As a result, ART initially provides the greatest death benefit per initial premium dollar, but becomes the most costly for extended durations of coverage due to the effects actuarial principles such as "select and

ultimate rate scales"[18] and "adverse selection"[19]. On the other hand, Level-Premium Term products charge a fixed, level premium for the specified duration of coverage (typically 10, 20 or 30 years). If coverage is renewable after the initial level premium period, premiums generally increase substantially, cease to be guaranteed and continue to increase annually each year thereafter like ART products. Further, because Level-Premium Term products rarely provide coverage under the initial level-premium period that extends to life expectancy (in other words, no one older than 50 typically can obtain a LT30 product), Level-Premium Term products generally provide the greatest death benefit per premium dollar for the specified coverage period, because they are generally priced to pay claims on less than 50% of the insured population.

Pricing of Term products is not disclosed but is generally guaranteed. Because ART product premiums by definition equal COI and expenses, policy earnings are not a factor. Further, because of the guarantee for Term products, the reasonableness of pricing factors is the concern of the insurer who bears the risk of unrealistic pricing assumptions, not the policy holder. Therefore, there are only three relevant considerations in determining the suitability of a Fixed-Duration Term product as a TOLI policy: (a) the actual premium for the appropriate duration of coverage; (b) the terms of the premium guarantee (i.e., some insurers offer guarantees for the entire initial level premium period, while others publish an initial level premium, but only guarantee that premium for a portion of the specified coverage duration); and (c) the financial strength and claims-paying ability of the insurer.

### 2. Flexible-Duration Term Insurance (e.g., Universal Life Insurance with Secondary Death Benefit Guarantees)

Flexible-Duration Term Life is a marketplace term for the genre of products that are filed with State Departments of Insurance on the either a Universal Life form or a Whole Life form to include certain premium and death benefit guarantees known as either Secondary Death Benefit Guarantees or No-Lapse Guarantees. However, because these Universal Life and Whole Life products offer a guaranteed death benefit in exchange for a guaranteed premium and include little or not cash value, they typically

[18] Most insurers file two (2) different sets of rates with the State Departments of Insurance for each and every risk class. Select Rates are filed for use in newly-issued policies where health examinations and medical records provide underwriters with the information needed to "select" the rates most appropriate for a given applicant (e.g., super-preferred, preferred, standard, sub-standard rates). Ultimate Rates are filed for use in the renewal of existing policies where this underwriting information is aged or not available. Ultimate Rates are, therefore, higher than Select Rates to compensate the insurer for the risk that a health condition (e.g., heart attack, cancer, etc.) can develop after policy issuance. Select Rates apply in the initial policy year(s) with Ultimate Rates phased in as underwriting information ages (typically over the first 10 - 15 policy years). Policies that have reached the Ultimate Rate period (e.g., policies 10 years old and older) may be "re-rated" by supplying a new health examination and updated medical records thereby "refreshing" the underwriting information needed to "select" the appropriate rate class.

[19] Insurers experience and price for adverse selection when healthy, low-risk insureds requalify for different coverage at lower "select rates" in response to otherwise annually increasing premiums, whereas unhealthy, high-risk insureds cannot requalify for new coverage, and thus create a disproportionate increase in the likelihood the insurer will pay a claim to a member of a given pool of insureds, for which the insurer charges a disproportionately higher premium.

look, smell and taste more like term life insurance than permanent life insurance, hence the marketplace term Flexible-Duration Term. . These products combine the flexible-premium feature of Universal Life and certain Whole Life products (discussed in greater detail below) with the pricing features of Fixed-Duration Term products to provide Level Premium Term-like coverage for a period of the policy owner's choosing ranging from an unusual term of years (e.g., like the number of years to precisely coincide with a planning tool with a specific duration like term of a GRAT or a Personal Residence GRIT) or for the life of the insured (which has also given rise the use of "Permanent Term" as another marketplace term for this genre of product). Coverage duration can vary from contract to contract, and can generally be lengthened or shortened after policy issuance at any time during the initial coverage duration simply by increasing or reducing planned annual premium payments. Because Flexible-Duration Term Life products can be structured to provide coverage to and beyond the life expectancy of the insured, they are priced for the greater probability that the insured will pay a claim, and so are more expensive than Fixed-Duration Term products. On the other hand, Flexible-Duration Term Life products can be most cost-effective for either specific coverage durations not available with Fixed-Duration Term products, or coverage durations beyond life expectancy where Fixed-Duration Term products are not available and other forms of permanent life insurance are too expensive.

The underlying pricing of Flexible-Duration Term Life products is generally not disclosed, at least not to the extent of guaranteed premiums and guaranteed death benefits. Like Level Premium Term products, Flexible-Duration Term Life premiums in excess of underlying cost of insurance charges and policy expenses in the early years of the guaranteed period are credited with interest and earnings to create a surplus (commonly referred to as the "Shadow Account") to cover cost of insurance charges and policy expenses that exceed planned premiums in the later years of the guaranteed period. And like traditional Universal Life products, Flexible-Duration Term Life death benefits are generally only guaranteed to the extent this "Shadow Account" is sufficient to cover the cost of insurance charges and policy expenses.

Because Flexible-Duration Term Life offers guaranteed premiums and guaranteed death benefits, the reasonableness of underlying pricing factors are again less the concern of the policy holder and more the concern of the insurer. Therefore, as with Fixed-Duration Term Products, the relevant considerations in determining suitability of a Flexible-Duration Term Life products as a TOLI policy are: (a) the actual premium for the appropriate duration of coverage, (b) the terms of the premium and death benefit guarantees, and (c) the financial strength and claims-paying ability of the insurer. However, unlike Fixed-Duration Term products, Flexible-Duration Term Life products require greater scrutiny when determining the policy terms (i.e., some contacts include catch-up provisions that allow for guarantees to be reinstated after a missed premium payment, while other contracts lapse without value and without paying a death claim in the event of a missed premium payment unless policy cash values are otherwise sufficient to cover cost of insurance charges and policy expenses).

### 3. Universal Life

Universal Life (hereafter also referred to as UL) products are distinguished by the fact that the owner's premium payments are flexible rather than fixed. Premiums paid in excess of COI and policy expenses create policy cash value, which then is credited with policy interest based on the insurer's general account portfolio of predominantly high-grade corporate bonds and government-backed mortgages. While death benefits under Term and Flexible-Duration Term Life products are typically based on the timely payment of premiums (i.e., death benefits lapse when a premium is not paid), death benefits under traditional UL policies generally remain in full effect without regard to the payment of a planned premium so long as planned premiums, accumulated cash values and policy interest together are sufficient to cover COI charges and policy expenses.

Traditional Universal Life premium pricing is generally *not* guaranteed (at least not as typically illustrated), but generally do disclose current pricing assumptions (i.e., *current* COI charges, policy expenses, and declared interest crediting rate), and guaranteed pricing assumptions (i.e., *guaranteed* COI charges, policy expenses, and declared interest crediting rate). Because insurers can change current COI charges and policy expenses to some extent, and because insurers routinely change current policy interest crediting rates, ILIT trustees bear the risk for unreasonable pricing assumptions and expectations regarding policy earnings. In addition, because guaranteed pricing factors are the basis for the insurer's reserve requirements (i.e., the higher the guaranteed charges the lower the reserve requirements, and therefore the greater the insurer's opportunity for profit), Universal Life guaranteed charges are typically set at the maximum allowable statutory amount. As a result, guaranteed prices are often similar from one Universal Life product to the next, are typically many times more expensive than non-guaranteed *current* pricing assumptions, and thus do not generally offer ILIT trustees much in the way of pricing protection. In fact, because guaranteed prices for traditional Universal Life products have more to do with insurer statutory reserve requirements, and less with pricing protection, Flexible-Duration Term Life guaranteed rates and terms are often far more attractive than seeking such guarantees though traditional Universal Life products.

However, ILIT trustees can mitigate this pricing risk by determining whether: (a) *current* COI charges are consistent with historical mortality experience; (b) *current* policy expenses are consistent with historical operating experience; and (c) the *current* policy interest crediting rate is consistent with both the historical rates of return for the asset classes of investment holdings underlying policy cash values (i.e., predominantly high-grade corporate bond and government-backed mortgages), and the historical policy interest crediting rates for the current universal life product series and for predecessor universal life product series. In other words, in determining the suitability of a given Universal Life policy as a TOLI holding, ILIT trustees should consider the competitiveness and stability of published pricing, the historical performance of assets underlying policy cash values, the liquidity and accessibility of policy cash values, and the financial strength and claims-paying ability ratings of the insurer.

### 4. Variable Life

Variable Life products (hereafter also referred to as VL) allow the policy owner to invest policy cash values into a family of mutual-fund-like "Separate Accounts" (which can include domestic and foreign stock funds, domestic and foreign bond funds, a money market account, and usually a fixed account). Variable Life products tend to be universal, in that they can generally accept flexible premium payments. Variable Life premiums, as with Universal Life premiums, paid in excess of published COI charges and policy expenses create policy cash value, which then is credited with a return based on the performance of the "Separate Accounts." Death benefits under Variable Life policies also generally remain in force without regard to investment performance so long as planned premiums, accumulated cash values and policy earnings are together sufficient to cover COI charges and policy expenses.

As with Traditional Universal Life, Variable Life premium pricing is generally *not* guaranteed (at least not as typically illustrated), but generally do disclose current pricing assumptions (i.e., *current* COI charges, policy expenses, and declared interest crediting rate), and guaranteed pricing assumptions (i.e., *guaranteed* COI charges, policy expenses, and declared interest crediting rate). Because insurers can change current COI charges and policy expenses to some extent, and because policy earnings are based on the performance of the selected Separate Accounts which can be positive or negative (i.e., Variable Life policy cash values can actually experience a loss due to investment performance in addition to deductions for policy charges), ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expectations regarding policy earnings. Indeed, this risk is even greater for Variable Life products than it is for traditional Universal Life products. In addition, because guaranteed pricing of Variable Life products is essentially the same as that of Universal Life products, discussed above, Flexible-Duration Term Life guaranteed rates and terms are often far more attractive than seeking such guarantees though Variable Life products.

Again, however, ILIT trustees can mitigate this pricing risk for Variable Life in the same manner as can be done for traditional Unversal Life, just discussed (in other words, an ILIT trustee should consider the competitiveness and stability of published pricing, the historical performance of funds similar to the Separate Accounts, the accessibility of policy cash values, and the financial strength and claims-paying ability ratings of the insurer).

### 5. Whole Life

Whole Life products (hereafter also referred to as WL) are characterized by fixed, guaranteed, and typically level premiums set by actuaries. Whole Life premiums are based on undisclosed actuarial expectations as to mortality (i.e., COI charges), operating expenses and policy earnings (again based on the performance of the General Account required by regulation to invest predominantly in high-grade corporate bonds and government-backed mortgages). As a result, level Whole Life premiums are greater than expected COIs and expenses in the early policy years, and thus create cash value, eventually growing to an amount equal to the policy face amount by maturity. And like

Term Life products, Whole Life premiums must be paid each year, either in cash by the policy owner or from the cash value, or the policy can lapse. On the other hand, if the premium is paid (either in cash or from policy cash values), Whole Life death benefits are generally guaranteed.

While actuaries set policy premiums, cash values and death benefits based on their most conservative expectations as to COI, expense and interest factors, Whole Life policies generally pay a dividend if actual mortality experience is lower than the actuary's most conservative COI expectations, actual operations experience is lower than the actuary's most conservative expense expectations, or actual investment experience is higher than the actuary's most conservative interest expectations. In other words, Whole Life policy pricing (as typically illustrated) is effectively comprised of: (a) *guaranteed* cost of insurance charges less a "refund" of "excess" cost of insurance charges to result in *current* cost of insurance charges; (b) *guaranteed* policy expenses less a "refund" of "excess" policy expenses to result in *current* policy expenses; and (c) the *guaranteed* interest crediting rate plus excess interest to result in the *current* declared dividend interest crediting rate. In addition, unlike Universal Life products, Whole Life product pricing may or may not require State Departments of Insurance approval of dividends.

Because WL policy pricing is generally neither guaranteed (at least not as generally illustrated) nor disclosed, ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expectations as to the policy earnings rate. However, ILIT trustees can mitigate this pricing risk by determining whether or not a) *current* cost of insurance charges is consistent with actual/historical mortality experience, b) *current* policy expenses is consistent with actual/historical operating experience, and c) the *current* policy interest crediting rate is consistent with both the historical rates of return for the asset classes of investment holdings underlying policy cash values (i.e., predominantly high-grade corporate bond and government-backed mortgages), and the historical dividend interest crediting rates for either the current whole life product series or for predecessor whole life product series. In other words, in determining the suitability of a given WL policy as a TOLI holding, ILIT trustees should consider 1) the competitiveness of published pricing, 2) the stability of such published pricing, as well as 3) the historical performance of assets underlying policy cash values, 4) the liquidity and accessibility of policy cash values, and 5) the financial strength and claims-paying ability ratings of the insurer.

### 6. Private Placement

Private Placement products are not registered with the State Departments of Insurance, and thus are only available to "Accredited Investors" through a Private Placement. While Private Placement products could conceivably take on the form of any of above policy types, they are typically constructed as Variable Universal Life products (hereafter also referred to as PPVUL). These products can generally accept flexible premium payments, set by the agent or the trustee, which can vary between the contractual minimum premium set by each respective insurer and the TEFRA Guideline Maximum Premium allowable under the definition of Life Insurance. Premiums paid in excess of published cost of insurance charges and policy expenses create policy cash

value which can be directed to an even wider range of investments than in registered VUL products. Like registered VUL products, death benefits under these policies also generally remain in effect without regard to this investment performance, so long as planned premiums, accumulated cash values and policy earnings are together sufficient to cover cost of insurance charges and policy expenses.

The pricing of Private Placement products is not guaranteed, but is generally disclosed both as to current pricing assumptions (i.e., current cost of insurance charges, current policy expenses, and the current declared interest crediting rate), and guaranteed pricing assumptions (i.e., guaranteed cost of insurance charges, guaranteed policy expenses, and the guaranteed declared interest crediting rate). This pricing can also be more flexible to accommodate specific client circumstances (e.g., more flexibility in structuring policy expenses to consider volume break-points) or specific investment objectives (e.g., investing policy cash values in hedge funds otherwise unavailable in registered products). In addition, unlike registered products, insurers can generally change current cost of insurance charges and policy expenses without approval of State Departments of Insurance, without having to justify the change, and without having to make uniform changes to all policies. As a result of the ability to make such changes, and of the increased volatility in these products, ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expectations as to the policy earnings rate.

Once again, even though Private Placement products generally include pricing guarantees, because *guaranteed* pricing factors are the basis for the insurer's reserve requirements, because higher guaranteed charges reduce reserve requirements, and because reduced reserve requirements increase the insurer's opportunity for profit, PPVUL guaranteed charges are typically set at the maximum allowable statutory amount. As such, *guaranteed* pricing factors are often similar to other VL products, are typically many times more expensive than non-guaranteed *current* PPVUL pricing assumptions, and thus do not generally offer ILIT trustees much in the way of pricing protection. In fact, because *guaranteed* pricing factors under PPVUL products have more to do with insurer statutory reserve requirements, and less to do with policy owner pricing protection, guaranteed rates and terms under Flexible-Duration Term products are often far more attractive than seeking such guarantees through a PPVUL product.

However, ILIT trustees can mitigate this pricing risk by again determining whether or not a) *current* cost of insurance charges is consistent with actual/historical mortality experience, b) *current* policy expenses are consistent with actual/historical operating experience, and c) the *current* policy earnings rate is consistent with the historical rates of return for the asset classes corresponding to invested assets underlying policy cash values. In other words, in determining the suitability of a given PPVUL policy as a TOLI holding, ILIT trustees should consider 1) the competitiveness of published pricing, 2) the stability of such published pricing, as well as 3) the historical performance of assets underlying policy cash values, 4) the liquidity/accessibility of policy cash values, and 5) the financial strength and claims-paying ability ratings of the insurer.

## 7. Historical Issues.

The question of which type of insurance product to choose has not always been answered in a very satisfactory fashion, but rather has often been the product of economic whim. Until the late 70's and early 80's, most TOLI was whole life. However, when interest rates soared, many such whole life policies were exchanged for universal life products, often with the promise from agents of higher policy interest crediting rates. Of course, the premium illustrations at these higher rates were projected for 30 years or more, but typically guaranteed for only 30 days, and eventually those illustrations did not hold up. As a result of these unreasonable expectations and the considerable expense involved in making changing policies, many universal life policies purchased in the 1980s are in jeopardy of lapsing without value and without paying the expected death claim.

This same troubling cycle repeated itself in the 90's, when falling interest rates and rising stock prices led the insurance industry to promote exchanges of universal life policies to variable life policies. Once again, premiums were computed (but not guaranteed) using unsustainable market conditions, with the result that these products, too, are in danger of lapsing without value and without paying the expected death claim.

## 8. Summary.

No product type is inherently more suitable than another for all situations. While Term products are most suitable for fixed coverage durations, Universal Life products are most suitable where guarantees are less important and premium flexibility is needed, and Variable Life products are most suitable where the asset allocation appropriate for trust assets includes some balance to assets underlying policy cash values beyond fixed-income. Whole Life products can make sense where a fixed maximum annual premium is more important and pricing disclosure is less important, whereas Private Placement products are most suitable in situations requiring maximum flexibility in the structuring of policy expenses and the investment of policy cash values. Ultimately, the suitability of any TOLI holding ultimately depends not only on product type, but also on 1) the competitiveness of published pricing over the intended holding period, 2) the stability of such published pricing over the intended holding period, 3) the historical performance of assets underlying policy cash values (to the extent trust objectives are served by accumulating policy cash values), 4) the liquidity/accessibility of policy cash values (if applicable), and 5) the financial strength and claims-paying ability ratings of the insurer. This analysis is supported in the April 1999 issue of Trusts & Estates magazine where a survey of TOLI holdings reported that TOLI death benefits can be increased by 40% or more, or TOLI premiums can be reduced by 40% or more, in 65% to 85% of single-life and survivorship trust-owned policies respectively.

## PART THREE: ESTABLISHING A BASIS FOR ILIT COMPLIANCE WITH THE ACT

Irrevocable life insurance trusts raise a number of administration issues. To begin with, most ILITs are funded by the grantor making annual contributions to the trust equal to the insurance premium due for that year. In order to ensure that such contributions are not taxable gifts, the trust agreement typically grants "Crummey" withdrawal rights to one or more of the beneficiaries, so that the contribution qualifies for "annual exclusion" treatment under Internal Revenue Code §2503. Although this article will not address the problems inherent in administering a trust with such withdrawal rights in any detail, some of the following points should be considered:

- The IRS has in several rulings required that, for a Crummey power to be valid, the beneficiary must have received notice of the right to make the withdrawal in sufficient time to exercise that right. While these rulings are contrary to the holding in the actual Crummey decision, prudent practice dictates that these notices be sent. This notice must be received by the beneficiary with sufficient time before the withdrawal right expires. The trustee should consider mailing these notice with return receipt requested, to establish the date of mailing.

- If notices are sent, however, several other issues arise. First, if the beneficiary is a minor, can the notice be given to the minor's parents, and does the answer change if the parent is also the grantor, who may not want the beneficiary to exercise the withdrawal right? Second, if the contribution is transferred by the trustee to the insurance company before the withdrawal right ends, so that there are no assets to withdraw, does that render the withdrawal right void? There are no answers to these questions.

- Care must be taken in drafting notice provisions: for example, if the notice has a space for signature by the beneficiary acknowledging receipt, the trustee must ensure that it gets the signed document back. This is a detail that can slip through the cracks, but can make for a bad fact if the gifts are ever audited.

Turning to the specific issues raised by the Act, the way to address those issues depends upon the relationship established between the grantor and the trustee. There are two different approaches to Act issues: the ideal approach and the necessary approach. Whichever approach is used, compliance hinges on *process*, not performance, but the types of process used with each approach is very different.

### A. The Ideal Approach.

In an ideal world, a trustee would have the flexibility to make all the appropriate decisions after taking enough time to work up the necessary analysis. Such fortunate trustees should, at a minimum, undertake the following steps:

- Determine the trust purpose;

- Draft an investment plan;
- Determine if the type of insurance chosen is appropriate to that plan;
- Ensure that the particular product chosen is priced appropriately; and
- Conduct annual check-ups.

Each of these steps will be analyzed in turn.

**1. Determine the Trust Purpose.**

At first glance, this may seem to be a silly step: the purpose is to hold life insurance! However, not all ILITs or policies are created equal. Perhaps the most important factor in determining the trust purpose is the time horizon. For example, an ILIT that is intended to pay estate taxes might hold a different type of policy, depending upon the insured's age. And it may be that the purpose has changed; with rising estate tax exemptions, ILITs that once were created for estate tax savings may no longer necessary for that purpose. In that case, the trustee may want to exchange one type of policy (say a current whole life policy) to another (perhaps a variable product with a higher investment return potential), or simply terminate the policy altogether.

**2. Draft an Investment Plan.**

This plan should be drafted in a manner similar to that for any other irrevocable trust, except that this plan will identify the type of time horizon needed, the necessity of a set return versus the ability to assume a certain level of risk in the death benefit in order to increase the cash value of the policy, and so forth.

The requirement of setting forth a plan is set forth in Section 8 of the Act as described above. By drafting an appropriate investment plan and maintaining it, a trustee greatly reduces the risk that its performance will be viewed in hindsight.

**3. Determine the Type Proposed Insurance Appropriate to that Plan.**

Only after the trust purpose is determined and the investment plan is set can the type of insurance (term, whole, universal, variable) be selected. This step obviously involves working with the client's insurance agent as early in the process as possible so that he or she is aware of the process needed by the trustee.

If the purpose of the ILIT is to cover estate tax costs, a younger insured might choose to buy a 20-year level term policy and "invest the difference," so that when the 20-year period has expired, the trust holds adequate liquid assets that the insurance is no longer needed. Alternatively, a variable product might be chosen so that the cash value builds inside the policy. On the other hand, an older insured might need the certainty of a

whole life policy because her only asset is an interest in her closely-held business, and term is too expensive.

**4. Ensure that the Insurance Product Chosen is Priced Appropriately.**

This step is certainly the most complex, and may very well require the services of an expert, rather than simply relying on the representations of the agent selling the product. ILIT trustees should consider seeking advice with respect to a given policy's financial strength and claims-paying ability (i.e., default risk), cost-competitiveness, pricing stability, cash value liquidity, and historical performance of invested assets. This assistance is being provided by individual agents, consultants, and independent life insurance product research providers like LifeLink Corp., Morningstar, and TheInsuranceAdvisor.com.

Regardless of how the investigation is conducted, however, ILIT trustees must dig deeper than reviewing illustrations when determining the reasonableness of investment performance and the appropriateness policy expenses. For instance, because illustrations show projected results based on combined investment and expense assumptions, they fail to provide trustees with specific information about expected returns, COIs, FAEs, cash-value-based "wrap fees," and premium loads that is necessary to justify policy expenses. In addition, because illustrations are generally only provided to agents licensed with a limited number of insurers, comparing illustrations provides the ILIT Trustee with only a fraction of the comparative data for the 100 insurers who underwrite 90% of policies each year, not to mention the thousands of products sold by the more than 500 insurers doing business in most states. This determination must be made by looking at both investment performance and policy expenses.

a. Investment Performance

Traditionally, insurance investment performance is determined by the rate of return calculated on the life insurance proceeds received by the ILIT trustee upon death of the insured less the premium investment in the policy contract as measured over the holding period. For instance, the rate of return for a TOLI contract with a $1,000,000 face amount and a $100,000 lump-sum premium investment would be 23.25% if held for 10 years (i.e., the insured dies in the $10^{th}$ policy year), 11.57% if held for 20 years (i.e., the insured dies in the $20^{th}$ policy year), or 7.70% if held for 30 years (i.e., the insured dies in the $30^{th}$ policy year). Such differences, however, or due to the timing of the death of the insured, and not the investment performance of the policy itself, and thus do not meet the criteria for prudence under the Act. A better measure of investment performance, therefore, is the investment performance of invested assets underlying policy cash values.

Fortunately, there are a variety of investment research services available to ILIT trustees to help measure performance of invested assets underlying TOLI cash values like Morningstar PrincipiaPro for the performance of separate accounts within Variable life policies, and LifeLink VitalSigns for performance of insurance company general

accounts underlying Universal Life and Whole Life policy cash values. Using such research to "paper the file" of an ILIT demonstrates the trustee is forming realistic judgments about expected returns as required by the Act, mitigates lapse risk and the corresponding liability.

b. Policy Expenses

As discussed above, the Act requires a trustee to avoid incurring costs that are not (a) justifiable and appropriate to the trust investment program and (b) reasonable in amount. Of course, the investment program for ILITs is generally comprised of TOLI policies that have both an investment element (i.e., invested assets underlying policy cash values) and an insurance element. This means the ILIT trustee must justify *both* investment-related expenses just like all other trustees as discussed above, *and* insurance-related expenses specific to TOLI. For instance, while it is taken for granted that trustees measure fund management fees (FMEs) and other investment-related expenses to justify as appropriate and reasonable in amount, ILIT trustees must also measure TOLI expenses as to COIs, FAEs, cash-value-based "wrap fees" (e.g., M&Es), and premium loads so as to also justify as appropriate and reasonable in amount.

For many years, the premium for TOLI policies was seen by the ILIT trustee as the "cost" due largely to underlying policy expenses not being disclosed and, in the absence of more complete information, the premium was seen as the "cost" of the policy by default. However, for most TOLI policies, the premium does not represent the cost of the policy, any more than a $2,000 contribution to an Individual Retirement Account represents the cost of the IRA. The costs in either case are the expenses deducted from the premium paid or the contribution made.

**5. Conduct Annual Check-Ups.**

Once the trustee has obtained the needed data and knows the strengths and weaknesses of a given policy, the trustee is able to manage trust assets in a manner that maximizes benefits and minimizes costs. Such management occurs when the ILIT trustee defines portfolio objectives, continually measures the policy's pricing and performance, identifies the policy's strengths and weaknesses, investigates available alternative products and makes necessary changes to the portfolio stemming from this information.

Further, if the objective of the ILIT is to provide a defined death benefit (for instance, to finance an obligation like buy-sell agreement funding or estate tax liabilities), the trustee also must ensure that planned premiums and corresponding cash values are adequate to pay future and generally increasing policy expenses until the policy matures at the insured's death. The trustee can do so by periodically measuring actual policy cash values against cash value targets from the original illustration of hypothetical policy values. What follows are five activities for ILIT trustees faced with a policy that is over-funded (i.e., the cash values in the policy are *more* than the amount needed to properly fund the policy) or under-funded (i.e., the cash values in the policy are *less* than the amount needed to properly fund the policy):

a. Increase or Decrease Premiums.

When a TOLI policy is over-funded, trustees should consider reducing or refunding premiums to the extent projected cash values remain sufficient to cover existing future policy expenses (to the extent such expenses are justified). Conversely, when a policy is under-funded, the trustee should consider increasing planned premiums to thereby increase cash values to cover future policy expenses (which may require the grantor to make additional gifts to the trust).

b. Increase or Decrease Expected Death Benefits.

Because benefits from over-funded policies can often be increased without additional gifts from the grantor, trustees should consider increasing over-funded policy death benefits (which may require grantor cooperation to do so). On the other hand, trustees should also consider reducing policy benefits in under-funded policies in order to reduce policy expenses to amounts supportable by existing cash values (to the extent such costs are justified).

c. Change Cash Value Investment Allocations.

If the ILIT holds a policy that allows investment allocations to be changed, the trustee should, at least annually, re-evaluate the asset allocation appropriate to the trust objective, and change TOLI cash value allocations accordingly.[20] For instance, in under-funded policies, trustees should consider a more aggressive asset allocation among asset classes with greater historical rates of return albeit with greater statistical volatility to the extent those more aggressive allocations are consistent with the stated trust objective. On the other hand, trustees with over-funded policies should consider more conservative asset allocations to reduce portfolio risk albeit also with lower historical rates of return again to the extent those more conservative allocations are consistent with trust objectives.

d. Sell, Buy or Exchange Policies.

In the same way portfolio managers sell investments that are no longer suitable, ILIT trustees should consider either a) exchanging less suitable TOLI policies in favor of more suitable products that offer rates and terms more consistent with trust objectives, b) borrowing from policy cash values and reinvesting proceeds in a manner that maximizes benefits to trust beneficiaries, or c) selling existing holdings on the secondary market for a profit that is greater than the cost and repurchasing a policy with the same benefits on the open market.[21]

e. Wait and See.

If policy cash values are slightly above or below targets but investment performance is within expected ranges, and policy expenses are justified, and cash values and planned premiums are sufficient to support projected expenses for the foreseeable future, then ILIT trustees can consider a "wait and see" approach to changes in

[20] See "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustee and Advisors" in the February 2002 issue of Trusts & Estates magazine, as well as Baker Boyeer Nat. Baond v. Garver (Ash. App. 1986) 719 P. 2nd 583, 591, Noggel v Bank of America (Cal. App. 1999) 70 CA 4th 853, Matter of Estate of Janes (1977) 90 N.Y. 41 659 N.Y. S. 2nd 165.

[21] See page 2 of "The Two-Headed Beast" in the April 2003 issue of Financial Advisor magazine.

investment returns.

Remember that Section 9 of the Act allows for a "prudent delegation" of these investment and management functions to an investment or insurance advisor who is qualified to perform these functions. Whether performed by an ILIT trustee or delegated to a qualified advisor, these management activities clearly involve new roles, responsibilities, and services for the ILIT.

**B. <u>The Necessary Approach</u>.**

While a discussion of the standards an ILIT trustee should strive for is all very interesting, it doesn't address the most common scenario in the real world. Typically, a client comes to the proposed ILIT trustee (usually either a family member, an advisor or a corporate fiduciary) with the proposal already laid out and the product already selected. The plan already has been formulated by the agent selling the policy (or perhaps the lawyer who suggested the ILIT), and the trustee finds itself in a take-it-or-leave-it situation. While the trustee would like to take the steps outlined above, it doesn't have that option, but it has a strong incentive to take the engagement anyway for client relationship purposes.

Under these circumstances, the trustee's options are limited. The steps, in this case, are probably as follows:

- First, determine whether the trustee has the opportunity to make suggestions as to the type of policy chosen. If this opportunity is available, then determine the trust purpose and investment plan, described above. The trustee may not be able to apply the analysis regarding the pricing of the selected policy relative to those issued by other carriers, because the agent selling the policy may only offer products from a limited number of carriers. In this case, obtain a written instruction (hopefully with a written indemnification or hold-harmless agreement) from the grantor regarding the particular policy held.

- Second, if the trustee has no opportunity to suggest the type of policy used, the trustee should determine the trust purpose and the investment plan as described above. However, in this case, the investment plan should include a direction from the grantor to hold the policy presented (again, hopefully with an indemnification). The written instruction from the grantor should comply with the Act's exception to the duty to diversify for "special assets;" assets with a special relation to the grantor.

- Finally, once the policy and the trust are in place and the premiums are being paid, the trustee should conduct the ongoing annual maintenance described above, including obtaining regular in-force illustrations from the agent as well as Monte Carlo simulations, if possible, to determine the likelihood of policy lapse. If this likelihood reaches an unacceptably high level, the trustee has the duty to advise the grantor or the beneficiaries that a tax-free exchange into another policy may

be appropriate.

## SUMMARY

The good news is that the management process discussed above can produce a substantial increase in trust death benefits or reduced premium requirements for the same trust death benefit.[22] Either way, this represents a substantial cost savings (perhaps $4,000 for each $10,000 in premium) that the ILIT trustee can bring to his or her beneficiary.[23] Perhaps more importantly, following the process described in this article can keep an ILIT trustee out of trouble with his or her clients and beneficiaries.

[22] According to a CASCO survey reported in the April 1999 issue of Trusts & Estates magazine, TOLI death benefits can be increased by 40% or more, or TOLI premiums can be reduced by 40% or more in 65% to 85% of single-life and survivorship trust-owned policies respectively.

[23] Trustees can and should consider charging a fee for such services. For instance, if a trustee's regular compensation schedule for TOLI assumes that the trustee will serve only as custodian of TOLI policies, it should ordinarily follow that the trustee would be able to increase its fee when adding TOLI management services.

# Exhibit A

## Pricing Factors for Various Insurance Products

| Product Type (in alphabetical order) | | Premiums | = | COI Charges | + | Policy Expenses | - | Policy Interest/Earnings |
|---|---|---|---|---|---|---|---|---|
| **Fixed-Duration Term** | | | | | | | | |
| Annually Renewable Term | | Set by actuaries & guaranteed for a 1-year term that is generally renewable. | = | Not Disclosed | + | Not Disclosed | - | 0% or Not Applicable |
| Level-Premium Term (LT## where ## is the term of years) | | Set by actuaries & guaranteed for a fixed term of years (e.g., LT10 = 10 yrs). | = | Not Disclosed | + | Not Disclosed | - | Not Disclosed |
| **Flexible-Duration Term (Universal Life with Secondary Death Benefit Guarantees)** | | | | | | | | |
| Guaranteed Pricing* | | Set by actuaries & guaranteed for a fixed term of years set by agent/broker or policy owner. | = | Not Disclosed | + | Not Disclosed | - | Not Disclosed |
| Non-Guaranteed Pricing | | Set by agent/broker or policy owner. | = | Usually disclosed, but generally greater than COIs for guaranteed pricing. | + | Usually disclosed, but generally greater than Expenses for guaranteed pricing. | - | Usually disclosed, but generally less than Interest for guaranteed pricing. |
| **Universal Life (Current Assumption Universal Life)** | | | | | | | | |
| Non-Guaranteed Pricing* | | Set by agent/broker or policy owner to cover COIs & Exps for a specified duration. | = | Usually disclosed & generally based on historical mortality experience. | + | Usually disclosed & generally based on historical operating experience. | - | Usually disclosed & based on performance of General Account of bonds & mortgages. |
| Guaranteed Pricing | | Calculated by agent/broker or policy owner from guaranteed COIs, Exps & i%. | = | Usually disclosed & generally set at maximum statutory limits. | + | Usually disclosed & generally set at maximum statutory limits. | - | Usually disclosed & generally between 3.0% - 6.0%. |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Variable Life** | | | | | | | | |
| Non-Guaranteed Pricing* | | Set by agent/broker or policy owner to cover COIs & Exps for a specified duration. | = | Required to be disclosed & generally based on historical mortality experience. | + | Required to be disclosed & generally based on historical operating experience. | - | Required to be disclosed & based on performance of mutual-fund-like Separate Accounts. |
| Guaranteed Pricing | | Calculated by agent/broker or policy owner from guaranteed COIs, Exps & i%. | = | Usually disclosed & generally set at maximum statutory limits. | + | Usually disclosed & generally set at maximum statutory limits. | - | Usually disclosed & generally between 3.0% - 6.0% only for cash values allocated to General Account. |
| **Whole Life** | | | | | | | | |
| Non-Guaranteed Pricing* | | Min prem/yr set by actuaries, but payment duration set by agent/broker or policy owner. | = | Generally not disclosed & instead included in proprietary dividend formulas. | + | Generally not disclosed & instead included in proprietary dividend formulas. | - | Sometimes disclosed upon request & included in proprietary dividend formulas. |
| Guaranteed Pricing | | Set by actuaries at amount required to fully-guarantee death benefits. | = | Generally not disclosed & instead included in "tabular cash value" calcs. | + | Generally not disclosed & instead included in "tabular cash value" calcs. | - | Sometimes disclosed & generally around 4.0%. |

* Indicated the most common/prevalent form of policy pricing.

# 3879708_v1