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Advocate's View: Life insurance trustee absolved of policy lapse — this time

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An Irrevocable Life Insurance Trust — ILIT for short — is a common estate planning tool, well known to attorneys and financial planners. Its sole purpose is to own and maintain a life insurance policy, keeping it out of the insured's name until death, when the benefit is then paid to the named beneficiaries per the terms of the trust agreement. By making the trust irrevocable, the life insurance policy and its proceeds stay out of the trust grantor's estate and beyond the reach of creditors.

The need for ILITs has declined in recent years due to changes in the estate tax laws, but plenty of those trusts continue in place today. ILITs can be a source of personal liability for their trustees.

Typically, the trustee of an ILIT accepts responsibility, pursuant to a written trust agreement, to hold an insurance policy on the life of the trust grantor and to pay the policy premiums using annual gifts from the grantor to the trust. (If gift taxes are a concern, the trustee must first notify beneficiaries of a right to receive the cash instead.) Light duty for a trustee, as long as the creator of the

The Baron case involved an irrevocable trust that Harry Baron created in 1992 to hold two whole-life insurance policies for the benefit of his children. Baron named a business associate, Roy Leibowitz, as trustee. Until 1998, Baron made annual gifts to the trust that Leibowitz used to pay the policy premiums. But the trust agreement didn't require Baron to make those annual gifts, and after 1997 he stopped doing so.

When that happened, Leibowitz, as trustee, funded annual premiums by taking loans against the cash values of the policies. By 2010, those cash values became exhausted and the policies lapsed for non-payment of premiums.

No longer having any trust assets to administer, Leibowitz petitioned the Supreme Court to settle his account as trustee. Baron's children objected, charging that Leibowitz had breached his fiduciary duties as trustee by allowing the policies to lapse. They also faulted him for failing to notify their father or them that the policies were in danger of lapsing, and for generally failing to prudently manage or protect the trust assets.

On summary judgment, the Court exonerated Leibowitz, finding that the trust agreement "did not require either Baron or [the trustee] to forward funds to insure that the policies did not lapse or to provide notices to the beneficiaries that they were in danger of lapsing, or give the beneficiaries an option to pay premiums." Also finding it "perfectly obvious … that life insurance policies would eventually lapse in the absence of continued premium payments," the Court concluded that Leibowitz had satisfied his fiduciary obligation to preserve trust assets by using policy cash values to pay premiums as long as he could.

Thus a happy ending for Leibowitz, except for the attorney's fees he incurred in defending himself. But under a

For starters, it's not unusual for an ILIT trust agreement to obligate, or at least empower, the trustee to notify beneficiaries when a grantor has failed to fund a premium payment, giving the beneficiaries an opportunity to do so. In such a case, the trustee's failure to timely give such notice, or to identify and implement other alternatives, can make a trustee liable for a resultant policy lapse, or even for a significant reduction in death benefit caused by extended reliance on high-interest policy loans taken with insufficient notice to beneficiaries.

But even without trust language specifically mandating such communications, every trustee has a general duty to inform beneficiaries of significant developments concerning the trust, "particularly material information needed by beneficiaries for protection of their interests." Restatement (Third) of Trusts § 82. That would seem to require notifying beneficiaries before significantly encumbering the policy in a life insurance trust to pay ongoing premiums that the beneficiaries might prefer to fund themselves to preserve the trust's death benefit.

Matter of Baron reminds us that the lapse of a policy in an ILIT trust doesn't necessarily mean that the trustee failed in its fiduciary obligations. A trustee's performance is to be determined in light of the facts and circumstances facing the fiduciary at the time of decision making, and never by hindsight. But a trustee owes trust beneficiaries a duty of undivided loyalty, as well as a duty of due diligence that encompasses an obligation to periodically review the policies within the trust to determine whether they continue to be suitable for achieving trust objectives. More particularly, policies need to be monitored for performance based on changing internal costs, as well as the sufficiency of funds for current and future premium payments, and how any withdrawals or loans outstanding may impact the policy over time. Certainly the trustee should conduct such a review, and implement a plan, whenever the anticipated source for an annual premium payment fails, either because the grantor fails to fund it or a beneficiary (or a creditor) has diverted it.

Simply taking a loan against the policy to pay the premium is an apparently easy solution, but it can lead to trouble, especially if it becomes a habit. Generally, such loans need not be repaid until an insured's death, when the outstanding principal and interest are deducted from the death benefit. But typically, loan interest is compounded annually, and as new loans continue to be taken to pay premiums each year, the death benefit can be significantly compromised. Moreover, most policies will lapse if the accumulated loan balance approaches the policy's cash value too closely, not only forfeiting the policy's death benefit but also transforming the accumulated loan balance to a taxable capital gain. At that point, unless the trust holds other assets to pay the tax, the ILIT would become insolvent, leaving nothing for the beneficiaries.

If a policy premium can't be paid due to the failure of an anticipated gift from the trust donor, the trustee should immediately investigate whether that failure is likely to be temporary or long term. A temporary policy loan for a single annual premium, if soon repaid, is unlikely to pose a material threat to the trust or its beneficiaries. On the other hand, if the grantor's failure to fund a premium is likely to recur, whether due to the grantor's financial stress or otherwise, the trustee will have to consider other alternatives, including notifying the beneficiaries and giving them an opportunity to fund the missing premiums.

Should the funding failure appear to be more than temporary, and if the beneficiaries decline to cover it, the trustee may have to make a frank evaluation of the insured person's life expectancy, taking age and health into account. Although perhaps a morbid task, such an assessment may be necessary to determine whether the insurance policy can continue to meet the purposes of the trust and the needs of the beneficiaries if funded by premium loans for the remainder of the insured person's life.

The trustee should also consider whether the accumulated cash value in the trust policy or policies can be reinvested in a new insurance policy that may have a reduced death benefit but can be purchased with a single up-front premium. If so, the trustee must compare that alternative with the risk that the existing policies in the ILIT will lapse or become substantially impaired if they continue to be funded with the policy loans. It was just this kind of analysis that shielded an ILIT trustee from substantial personal liability in the Indiana case of In re Stuart Cochran Irrevocable Trust in 2009.

The take-away is that a trustee of an irrevocable life insurance trust, like any trustee, assumes fiduciary obligations that go beyond the mere instructions in the operative trust agreement. Before accepting such a charge, the potential trustee needs to appreciate the obligations they are taking on. And upon accepting those obligations, the trustee must carry them out diligently, with prudence and loyalty to the interests of the trust beneficiaries, and not merely to the creator of the trust.

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