Insurance Dedicated Funds and Related Strategies

Schulte Roth&Zabel

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Partner
New York Office
+1 212.756.2201
daniel.hunter@srz.com

Practices

Investment Management

Hedge Funds

Private Equity

Daniel F. Hunter

Dan has more than 15 years of experience guiding investment management firms from formation through fund launch. He counsels managers on the formation and operation of a range of private investment funds across the liquidity spectrum, with a focus on complex credit funds. The credit funds Dan helps design target distressed, stressed or performing credit assets and may offer no liquidity rights, hybrid liquidity rights or general liquidity rights. These types of credit funds are often referred to in the industry as private debt funds, credit funds, loan funds, opportunity funds or special situation funds. Dan also advises more traditional hedge funds (long-short equity, macro, quant and multi-strategy), fund of hedge funds, fund of private equity funds, growth equity private equity funds and traditional private equity funds. Dan has represented many investment managers in complex negotiations of seed-capital arrangements and capital raising, and he is also an expert on succession planning and change of control of investment managers.

Dan is ranked by *Chambers USA* and *Chambers Global* in the Investment Funds: Hedge Funds category. He is also listed in *The Legal 500 US*. A recognized thought leader, Dan was interviewed on conflicts of interest for the *HFMWeek* article “Don’t Play Favourites with Your Investors.” In addition, he spoke on “Succession Planning” at the Goldman Sachs Twentieth Annual Hedge Fund conference. He also presented at AIMA’s Navigating the Landscape of Side Letter Terms Seminar. Dan received his A.B., *cum laude* and with high honors in history, from the University of Michigan and his J.D. from the University of Michigan Law School, where he was articles editor of the *University of Michigan Journal of Law Reform*.

Partner
New York Office
+1 212.756.2760
jason.kaplan@srz.com

Practices

Investment Management

Hedge Funds

Private Equity

Regulatory & Compliance

Jason S. Kaplan

Jason concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships and joint ventures; and advising investment managers with respect to regulatory and compliance issues.

Jason has been recognized as a leading lawyer by *Chambers USA*, *The Legal 500 US*, *IFLR1000* and *New York Super Lawyers*. He publishes and speaks often on topics of concern to private investment funds. A co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), Jason was quoted in the *Financial Times FundFire* article "Hedge Co-Investing Gains Ground" and *The Hedge Fund Journal* articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments with SRZ's Leading Fund Formation Group." Jason has presented at the Goldman Sachs Annual Hedge Fund Conference, Financial Executives Alliance's Regulatory Hot Topics for Private Equity Firms conference and at ALM's Hedge Fund General Counsel & Compliance Officer Summit. Jason earned his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

Special Counsel
New York Office
+1 212.756.2156
karen.loga@srz.com

Practices

Tax

Private Equity

Hedge Funds

Real Estate Capital Markets & REITs

Karen J. Loga

Karen focuses on tax aspects of investment funds, including structuring of domestic and non-U.S. hedge funds, private equity funds and real estate funds. She advises clients with respect to offering documents, partnership agreements and related materials for funds and investment management businesses. Her practice also includes advice to clients on tax aspects of mergers and acquisitions, as well as a variety of other multinational corporate transactions. She counsels clients on tax considerations in real estate transactions, including structures involving joint ventures and real estate investment trusts.

Karen earned her LL.M. in taxation, with honors, from the Georgetown University Law Center, her J.D. from The George Washington University Law School and her B.S./B.A., *cum laude*, from Miami University.

Partner
New York Office
+1 212.756.2140
boris.ziser@srz.com

Practices

Structured Finance & Derivatives

Litigation Finance

Boris Ziser

Boris is co-head of the firm's Structured Finance & Derivatives Group. With almost 25 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation funding and cell towers, in addition to other esoteric asset classes such as intellectual property, various insurance-related cash flows and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in acquisitions and dispositions of portfolios of assets and financings secured by those portfolios.

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA*, *Chambers Global* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association, and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization, litigation funding and life settlement seminars in the United States and abroad. Most recently, Boris was interviewed for the articles "Attorneys Must Tread Carefully in Litigation Funding's Next Stage" published in *Law360* and the articles "SRZ's Leading Litigation Finance Practice: Holistic Expertise for a Booming Asset Class" and "Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds," both published in *The Hedge Fund Journal*. His speaking engagements have included "Flash Briefings on Alternative & Emerging Asset Classes — Structured Settlements" at SFIG and IMN Vegas 2018 and "Investing in Litigation Finance" at SRZ's 27th Annual Private Investment Funds Seminar. Boris earned his J.D. from New York University School of Law and his B.A., with honors, from Oberlin College.

Insurance Dedicated Funds and Related Strategies

I. Insurance Dedicated Funds

A. Background

1. What Is an Insurance Dedicated Fund ("IDF")?

   (a) An IDF is a fund established by a manager, the investors of which are generally segregated asset accounts ("separate accounts") of insurance companies that maintain variable life insurance and/or annuity contracts. The insurance company issues the contracts, or policies, to policy owners.

2. What Is a Separate Account?

   (a) A separate account is an account of an insurance company that is segregated from the general asset accounts of the insurance company pursuant to U.S. federal and/or state law. It is a separate pool subject to separate accounting.

3. Growth

   (a) IDFs have grown significantly over the last 13 years. One market intermediary noted that it handled just four IDFs in 2004, a number which grew to 108 IDFs in 2017.

4. From a U.S. federal tax perspective, gains are generally not taxed until the end of the contract and are possibly excluded from gross income if paid out as death benefits.

B. Structure

1. For managers experienced with advising private funds, the IDF will be a new fund that may have overlapping strategies with your existing funds. It must be a separate legal entity from the life insurance company's segregated asset account.

2. *Structural Overview*. In an ordinary private fund structure, the basic setup includes asset managers who advise legal entities (i.e., the funds) that sell interests to persons or entities (i.e., the investors) who invest their capital in the funds that are advised by the managers. When setting up an IDF, there are a few more parts to the structure.

   (a) The IDF structure begins with the life insurance or annuity contract policy owners, however, these are not the investors in the IDF. They are not limited partners in the IDF and do not have any rights as such. The policy owners interact with the insurance brokers and take out a policy that will have its returns linked to the IDF. As discussed below, the policy owners are prohibited from directing the investment program of the IDF.

   (b) Licensed insurance brokers interact with the policy owners and assist with obtaining the appropriate insurance policy from one or more life insurance companies.

   (c) The life insurance companies become investors by purchasing interests in the IDF through their separate accounts. The life insurance companies negotiate the terms and conditions of the IDF (as opposed to the policy owners). There are service providers in the market who, for a fee, sit as intermediaries between the life insurance companies and the IDFs ("IDF Intermediaries"). IDF

Intermediaries may also form their own Delaware limited partnership structure and different managers may each advise a separate series of the Delaware entity.

(d) The premiums from the insurance policies are contributed to life insurance company separate accounts and are invested by the insurance companies in the IDF (sometimes through the multi-series legal entities sponsored by the IDF Intermediaries).

(e) An IDF may be a fund designed by the manager to follow one or more of the manager's investment strategies (without being a "clone" fund of any of the manager's other funds) and invest the premiums contributed to the IDF from the life insurance company separate accounts.

C. IDF Setup and Operation

1. Below are some of the implementation considerations for a manager wishing to build an IDF.

(a) The manager should learn the key tax rules surrounding IDFs, which are outlined below.

(b) Like any other fund formation process, the manager will need to create legal entities.

(c) The manager will need to prepare offering documents with counsel (e.g., PPM, limited partnership agreement/operating agreement, subscription agreement and side letters, which most insurance companies will insist on).

(d) The negotiations with the life insurance companies resemble the negotiations a manager might have with any significant investors in the manager's other funds; however, the life insurance companies pay particular attention to the details of the tax risks with these products and expect indemnities and other protections in their side letters.

2. Many of the ongoing responsibilities of an investment manager mirror the manager's existing obligations for its other funds.

(a) Monitoring underlying funds;

(b) Managing the portfolio; and

(c) Providing periodic performance reports and tax information to investors. In addition, the manager of an IDF must monitor for compliance with the diversification rules of Section 817(h) of the U.S. Internal Revenue Code of 1986, as amended ("Code"), and the investor control doctrine.

D. Diversification Rules

1. There are general diversification requirements that apply to separate accounts that are funded by private placement life insurance policies and annuity contracts are set forth in Treasury Regulations Section 1.817-5 ("Diversification Rules").

2. Tax consequences if not adequately diversified:

(a) Under the Treasury Regulations, a variable contract which is based on one or more separate accounts shall <u>not</u> be treated as a life insurance or annuity contract for any calendar quarter period for which the investments of any such account are not adequately diversified in accordance with the Diversification Rules. If the variable contract is not respected as a life insurance or annuity contract, then the tax benefits associated with such a contract are lost.

3. The Diversification Rules place certain limitations on the proportion of the assets of a separate account that may be represented by any single investment, generally:

   (a) No more than 55 percent of the value of the total assets of the account is represented by any one investment;

   (b) No more than 70 percent of the value of the total assets of the account is represented by any two investments;

   (c) No more than 80 percent of the value of the total assets of the account is represented by any three investments; and

   (d) No more than 90 percent of the value of the total assets of the account is represented by any four investments (“Diversification Test”).

4. Compliance with the Diversification Test is tested at the end of each calendar quarter (or within 30 days thereafter). Insurance company investors generally require an investment manager to make quarterly certifications with respect to an IDF.

5. There are exceptions for the start-up period and the liquidation period, as follows: a separate account will be considered adequately diversified (i) for its first year and (ii) for the one-year period beginning on the date it adopts a plan of liquidation (subject to special rules for “real property accounts”).

6. Look-Through Rule

   (a) The Treasury Regulations provide a “look-through rule” for partnerships that allows a separate account to look through an IDF to its underlying investments for purposes of satisfying the Diversification Rules. In general, to be eligible for look through treatment, all the interests in the IDF must be held by separate accounts (subject to limited exceptions for insurance company general accounts, the manager of the IDF in certain circumstances and others).

7. Market Fluctuations

   (a) A separate account that satisfies the Diversification Test at the end of any calendar quarter (or within 30 days thereafter) shall not be considered non-diversified in a subsequent quarter because of a discrepancy between the value of its assets and the Diversification Test if the discrepancy results solely from changes in market prices (and not from the acquisition or sale of an asset or assets).

E. The Investor Control Doctrine

1. The investor control doctrine limits the control that a policy owner may have over the underlying investment assets of an IDF.

   (a) Determinations of impermissible investor control are based on facts and circumstances rather than a bright line test and are guided by Internal Revenue Service revenue rulings and other official interpretations.

2. Tax Consequences of Impermissible Investor Control

   (a) If a policy owner has investment control over the assets underlying its policy or contract, then the policy owner, and not the insurance company, is deemed to be the owner of the assets. If the policy owner is deemed to be the owner of the assets, then the policy owner loses the tax benefits of the insurance or annuity contract and is currently taxable on the income attributable to the assets.

3. There shall be no arrangement, plan, contract or agreement between the policy owner and the investment manager or the insurance company regarding the availability of a particular fund, the investment strategy of any fund or the assets to be held by a particular fund. The policy owner may not communicate (directly or indirectly) with the investment manager regarding the selection, quality or rate of return of any specific investment or group of investments.

   (a) All investment decisions for the IDF must be made by the investment manager. The policy owner may not select or recommend particular investments or investment strategies. The policy owner shall not be able to insist on the use of a specific investment manager or remove the investment manager.

   (b) The ability to choose among broad, general investment strategies does not constitute sufficient control over investment decisions so as to cause ownership of the underlying assets to be attributable to the policy owner.

4. The IDF cannot be a "clone" of a fund that is otherwise available to non-insurance investors. Generally speaking, interests in an IDF shall be available solely through the purchase of a variable life insurance policy or annuity contract (subject to narrow exceptions for certain other permitted holders) and the investment portfolio of the IDF must be differentiated from the investment portfolio of the investment manager's other funds.

F. Corporate Terms and General Considerations

1. In many ways, the PPM for a manager's IDF will follow the same format as the PPM for its other funds. However, there are a few key terms that are unique to IDFs and to which a manager must pay special attention.

   (a) First, the IDF's withdrawal rights generally need to include two special withdrawal rights.

      (i) Periodically, the life insurance company must be able to make withdrawals to pay fees, including fees to its insurance brokers.

      (ii) If the policy holder dies, the IDF must be able to distribute cash to the life insurance company to meet the death benefit obligation of the life insurance company. The timing of these payments varies depending on the jurisdiction of the life insurance company.

   (b) Second, the manager's compensation may be structured differently.

      (i) The "look-through rule" in the Treasury Regulations described above provides that a manager may hold an interest in an IDF, but only if the return on such interest is computed in the same manner as the return on an interest held by a separate account. A performance allocation or carried interest at the IDF level would cause a different return on the manager's interest. Asset-based and/or performance-based fees to a manager do not run afoul of this rule.

      (ii) If the IDF invests in the manager's other funds, then those other funds may charge their regular compensation, including performance allocations or carried interest, which is relevant if the manager wishes to invest a percentage of the IDF into the manager's other funds.

(c) Third, allocation of investment opportunities must be handled carefully to conform to obligations under the Investment Advisers Act, the manager's allocation policies and the differentiation requirement described above.

(d) Fourth, onboarding with either the IDF Intermediaries or directly with the life insurance companies will require some level of negotiation. In particular, the indemnification obligations of the manager must be defined and resolved. The key to this negotiation is understanding who bears the risk of a breach of the diversification rules and the investor control doctrine and what the tax and other costs of doing so could entail.

(e) Finally, the manager of an IDF should review how the manager's marketing team approaches the sale of interests in the IDF. The marketing agents should make certain not to violate the investor control doctrine discussed above, provide insurance-related advice in breach of local insurance laws or over-sell the tax benefits of the IDF in violation of the advertising provisions of the Investment Advisers Act.

G. Group Variable Annuity Products

1. Some non-U.S. insurance company investors are seeking the tax advantages associated with IDFs through the use of a group variable annuity ("GVA") product. Under this structure, a non-U.S. investor purchases a GVA from a non-U.S. insurance company. The non-U.S. insurance company places the premium contributions in a separate account, which makes investments at the direction of an investment manager. The separate account is subject to the Diversification Rules and the investor control doctrine discussed above. Underlying funds in which the separate account invests may withhold U.S. federal income tax on income that is "effectively connected" with a U.S. trade or business in accordance with applicable law, and the non-U.S. insurance company files to recapture such tax in the form of a refund.

II. Various Product Types[1]

A. Life Settlements

1. Current Trends in Life Settlements

(a) Background

(i) The industry began in the 1980s with the onset of the AIDS epidemic in the United States. Many AIDS patients owned life insurance policies that they no longer needed, and viatical settlements were created.

(1) A viatical settlement is the sale of a life insurance policy by a terminally ill person (generally, someone with a life expectancy of less than two years).

(ii) With the development of protease inhibitors, AIDS patients were better able to control their illness and their life expectancies increased substantially.

(iii) In the 1990s, the viatical settlements industry was reborn as the life settlements industry and focused on purchasing life insurance policies from seniors who were not suffering from terminal illnesses.

[1] This is not an exhaustive list of insurance-related investments.

(iv) The demand for life settlements was driven initially by German investment funds who believed that life settlement investments provided attractive benefits under the German tax code.

(v) With the growth of the life settlement industry, states adopted new laws and regulations, with most of the legislative and regulatory activity taking place between 2005 and 2009.

(b) Risks of investing in life settlements include longevity, insufficient reserves for premiums, inconsistent cash flows during ramp-up, insurable interest (validity of policy), fraud in the application and cost of insurance.

(c) Benefits of investing in life settlements include the ability to build a performing portfolio, the challenge risk has significantly declined, noise has subsided and the asset class is generally uncorrelated.

(d) Regulation of Life Settlements

(i) State Regulation Today

(1) 45 states, Washington, DC and Puerto Rico regulate life settlements.

(2) Three states of the 45 regulate viatical transactions only.

(3) Five states do not have any life settlement-related regulation.

(ii) The Contestability Period

(1) With a number of limited exceptions, carriers may not challenge a policy based on fraud in the application after the end of the two-year contestability period.

(2) Generally, carriers may challenge a policy after the end of the contestability period based on a lack of insurable interest at the time of issuance.

(3) The following states, however, have ruled that a policy may not be challenged after the end of the contestability period for any reason: Florida, New York, Michigan, Wisconsin and Utah.

(4) Most recently, the Florida Supreme Court ruled that, based on a plain reading of the incontestability statute, a carrier may not challenge a policy for any reason after the end of the two year contestability period. Policies issued after the effective date of Florida's 2010 anti-STOLI statute were not addressed.

(5) This followed a Wisconsin decision holding that Wisconsin's anti-wagering laws do not apply to life insurance and that an insurable interest challenge may not be brought after the end of the contestability period.

a. The decision was upheld on appeal to the 7th Circuit, and the carrier is seeking additional time to file an appeal to the U.S. Supreme Court.

(6) In *PHL Variable Ins. Co. v. Price Dawe*, the Delaware Supreme Court ruled that a carrier may challenge a policy based on an alleged lack of insurable interest after the end of the contestability period.

a. The court noted that the intent of the insured at the time the policy was issued is not relevant.

b. The court did look to who paid the premiums in order to determine the true party in interest. At the same time, the court noted that premium finance is legal.

(7) Delaware courts have held that if a carrier seeks to rescind a policy, it must return the premiums paid, but it may have a claim for damages.

(e) Secondary Market Transactions

(i) The policy owner retains a life settlement broker to sell his/her policy.

(ii) The life settlement broker prepares the documentation and submits it to life settlement providers.

(iii) The life settlement broker negotiates with the life settlement providers and, after receiving approval from the policy owner, accepts the winning bid.

(iv) The life settlement provider arranges for funding through an institutional funder.

(v) The transaction is consummated through an escrow agent.

(vi) The price paid in a secondary market transaction exceeds the cash surrender value of the policy.

(f) Tertiary Market Transactions

(i) In a tertiary market transaction, life insurance policies that were previously purchased by an investor through a life settlement provider are sold by such investor to another investor and in subsequent transactions.

(ii) As discussed below, tertiary market transactions are not subject to the regulatory scheme applicable to the secondary market transactions. Accordingly, neither a life settlement broker nor a life settlement provider is involved in a tertiary market transaction and the form of purchase agreement is not filed with, nor approved by, the applicable state insurance regulator.

(g) Key Players in Life Settlement Transactions

(i) Policy Owner/Viator

(1) The person or entity to whom the life insurance company originally issued the life insurance policy.

(ii) Insured

(1) The person or persons named as an insured in the life insurance policy.

(iii) Consumer Representative (Agent and Life Settlement Broker)

(1) The person retained by the policy owner to solicit offers for the life insurance policy. A life settlement broker owes a fiduciary duty to the policy owner. A life settlement broker must be licensed, where applicable.

(iv) Life Settlement Provider

(1) The person that initially purchases a policy from the original policy owner is called a life settlement provider. The life settlement provider often acts on behalf of an investor and owes a fiduciary duty to the investor.

(v) Institutional Funder

(vi) Insurer

(vii) Life Expectancy Provider

(1) An independent third party that evaluates the insured's medical records and produces a report, called a life expectancy report, setting forth an estimate of the insured's life expectancy.

(viii) Escrow Agent

(1) Secondary market transactions are closed through escrow with a third-party escrow agent.

(ix) Policy Servicer

(h) Life Settlement Transaction Cycle

(i) The policy owner retains a life settlement broker to sell his policy.

(ii) The life settlement broker prepares the documentation and submits it to life settlement providers.

(iii) The life settlement broker negotiates with the life settlement providers and, after receiving approval from the policy owner, accepts the winning bid.

(iv) The life settlement provider arranges for funding through an institutional funder.

(v) The transaction is consummated through an escrow agent.

B. Structured Settlements

1. Guaranteed Structured Settlements

(a) These arise primarily out of personal injury settlements and represent pure insurance company credit risk. Historically, guaranteed structured settlements have very low delinquency rates and are generally uncorrelated.

2. Life Contingent Structured Settlements

(a) These represent insurance company credit risk and mortality risk, and are generally uncorrelated.

3. Legal Framework

(a) IRC § 5891: Structured settlement factoring transactions.

(i) The tax code imposes an excise tax on the purchase of structured settlements unless the transaction satisfies the requirements of § 5891, which requires a court to approve the sale.

(b) State transfer statutes: State laws governing transferability.

C. Personal Annuities

1. Guaranteed Annuities

(a) These represent pure insurance company credit risk. Historically, guaranteed annuities have very low delinquency rates and are generally uncorrelated.

2. Life Contingent Annuities

(a) These represent insurance company credit risk and mortality risk and are generally uncorrelated.

3. Legal Framework

(a) Personal annuities are issued by licensed carriers and the subsequent sale of such annuities is largely unregulated. Some states have raised the question of insurable interest.

D. Commissions

1. Originating commissions are paid in connection with the origination of a policy.

(a) Renewal commissions provide recurring cash flows which are paid periodically, typically annually, but are subject to persistency risk.

2. Legal Framework

(a) Both the agent and the assignee must be licensed.

III. Certain Structuring Considerations for Insurance-Related Investments

A. Life settlement funds investing in life insurance policies with U.S. risks may be structured to address tax considerations relevant to foreign investors, taxable U.S. investors and tax-exempt U.S. investors.

B. Absent an applicable tax treaty, the involvement of a U.S. insurance carrier and U.S. insured may result in U.S.-source income that would be subject to withholding taxes for foreign investors.

C. Under an applicable U.S. income tax treaty, the insurance payouts may constitute business profits or other income not attributable to a U.S. permanent establishment. Such income would be exempt from withholding taxes. One jurisdiction with a favorable treaty in which such fund entities may be formed is Ireland. The fund entity is treated as a corporation for U.S. federal income tax purposes and, depending on satisfaction of certain treaty provisions and considerations of the Passive Foreign Investment Company ("PFIC") and Controlled Foreign Corporation ("CFC") rules under U.S. tax law, may be used as the investment vehicle for foreign investors and tax-exempt U.S. investors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com