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Family Offices

Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies (Part Two of Two)

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Variable insurance policies are an often utilized structure through which family offices and other high net worth investors invest in hedge funds and other private investment funds. One of the primary advantages of investing in hedge funds and other private investment funds through variable insurance policies is the deferral of income taxes. However, policy holders must first satisfy two important tests – the "diversification rules" and the "investor control" rules – in order for the policies to qualify for favorable income tax treatment.

This article is the second in a two-part series. The first article in this series described the mechanics of investing in an insurance dedicated fund ("IDF") through variable insurance policies and offered a roadmap for satisfying the two tests to ensure the variable insurance policies maintain their tax-advantaged status. See "Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies (Part One of Two)," Hedge Fund Law Report, Vol. 4, No. 11 (Apr. 1, 2011). This article describes in detail a recent restructuring transaction in which the authors participated (the "Transaction") and provides the key terms in the Transaction documents applicable to the diversification and investor control rules.

IDF Restructuring and Investment Transaction

Shipman & Goodwin LLP was engaged by a newly-formed limited partnership series (the "Series") of a multi-series IDF (the "Issuer Fund") to structure, and then negotiate the terms of, the Transaction. The Issuer Fund was created to offer limited partnership interests (the "Interests") to (i) separate accounts of life insurance companies that fund variable life insurance policies, variable annuity policies and other variable insurance policies, such as the Account (defined below); and (ii) private investment funds that are eligible to purchase and hold the Interests under Section 817(h) of the Internal Revenue Code of 1986, as amended (the "Code"), and corresponding Treasury Regulations Section 1.817-5, and in compliance with Revenue Ruling 2005-7.[1] For purposes of this Article, references herein to the Issuer Fund will be deemed to include the Series. The figure immediately below depicts the structure of the Issuer Fund.

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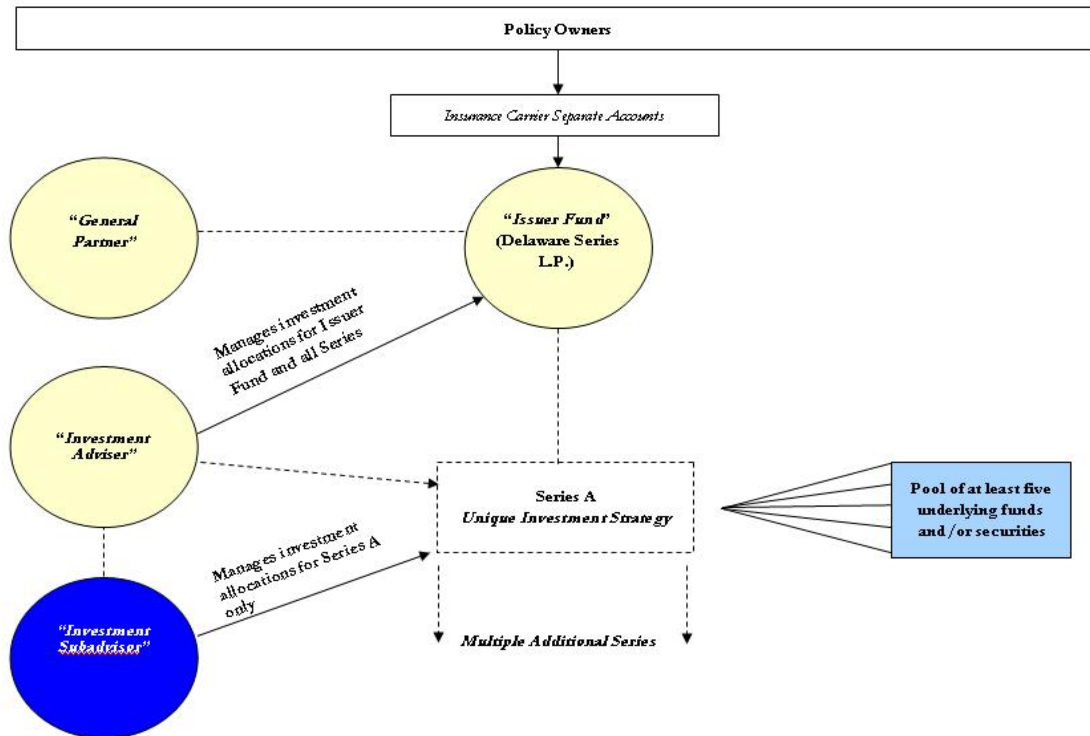

Offshore trusts formed for the benefit of members of a large family office (the "Family Office") were the owners of various policies issued by an offshore affiliate of an international insurance company ("Insurance Company Investor"). The Insurance Company Investor in turn made an investment in an existing insurance dedicated fund (the "Existing Fund"). As a result of a decline in the net asset value of the Insurance Company Investor's capital account with the Existing Fund and the increasing loan to value ratio of the Existing Fund's debt facility, the Insurance Company Investor, in consultation with the Family Office, requested that the Existing Fund redeem a substantial portion of the capital account and transfer the assets to a corresponding capital account with the Issuer Fund.

The requested restructuring involved three separate, but simultaneous transactions: (i) an investment in the Issuer Fund by the separate account (the "Account") of the Insurance Company Investor of (A) cash and (B) an in-kind contribution of hedge fund and hedge fund of fund ("FOF") interests; (ii) the transfer from the Existing Fund to the Issuer Fund of a portfolio of hedge fund and FOF interests held for the benefit of the Account; and (iii) the establishment of a new debt facility provided by an international financial institution (the "Lender") to the Issuer Fund containing similar terms and conditions to the Lender's existing debt facility with the Existing Fund. The Issuer Fund was managed by an investment adviser (the "Adviser") and the Series was managed by both the Adviser and an unaffiliated sub-adviser (the "Sub-Adviser"). The Existing Fund was managed by an investment manager (the "Liquidating Manager"). The Sub-Adviser engaged the Liquidating Manager to assist it with complying with certain reporting requirements of the Lender as well as providing advice to the Sub-Adviser on liquidating the underlying funds of the Issuer Fund. An illustration of the Transaction is set forth in the figure immediately below.

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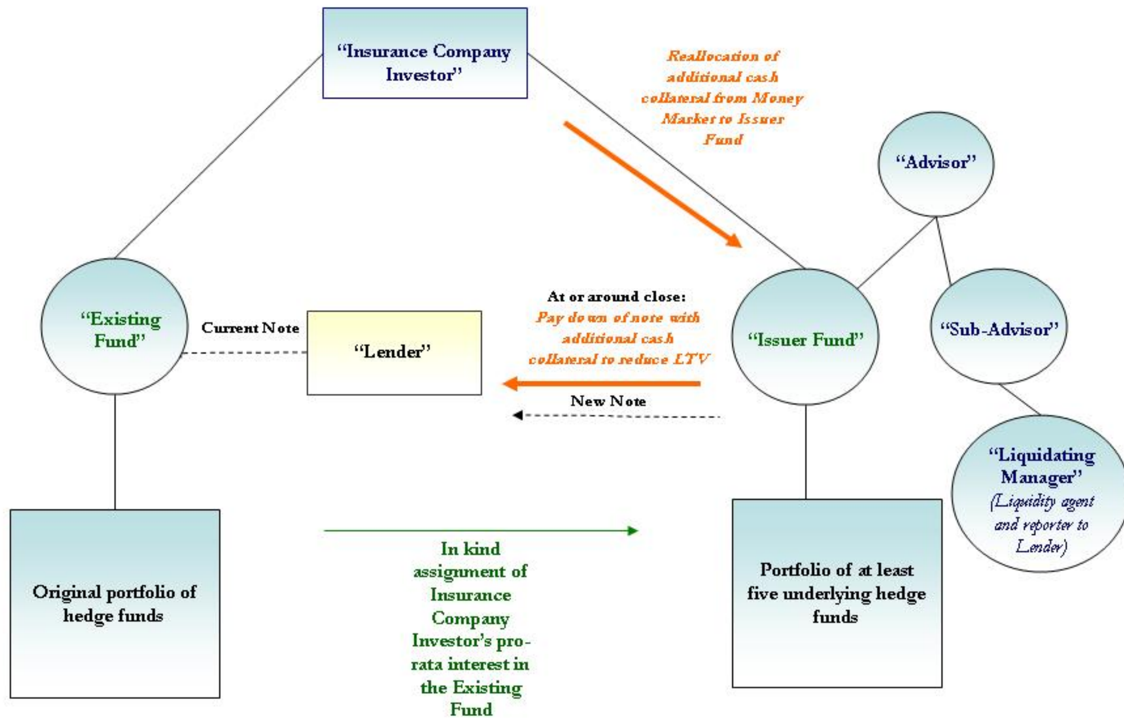
IDF Restructuring and Investment Transaction



The Transaction in a series of steps accomplished three goals: (A) establish a new secured variable funding note financing between the Lender and the Issuer Fund; (B) avoid a default under the Existing Fund debt facility with the Lender; and (C) terminate the Account of the Insurance Company Investor with the Existing Fund. In furtherance of such goals, a substantial portion of the assets of the Existing Fund had to be transferred to the Issuer Fund to form part of the collateral for the new note financing. The Transaction was completed in the following order:

1. The Existing Fund redeemed the Insurance Company Investor's interest in the Existing Fund, part in cash and part in kind (such interest representing a substantial portion of the assets of the Existing Fund and related liabilities).
2. The Insurance Company Investor contributed the assets and related liabilities to the Issuer Fund.
3. The Insurance Company Investor directed that the above two steps be accomplished by a direct transfer of the assets and liabilities from the Existing Fund to the Issuer Fund.
4. The Lender required that the Insurance Company Investor raise and contribute to the Issuer Fund a substantial amount of cash collateral to partially secure, along with the assets, the new variable funding note financing.

The Lender imposed several requirements on the parties prior to consummating the Transaction described above. The new secured variable note issued by the Issuer Fund was required to be on substantially similar terms as the Existing Fund's existing secured note, *mutatis mutandis*. In addition, the Lender required that the Liquidating Manager remain in place as a sub-adviser to the Issuer Fund with respect to the liquidation of the collateral held at the Existing Fund after the consummation of the Transaction.

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In addition to the foregoing, the Transaction was structured to comply with the requirements of the diversification rules and investor control doctrine in order to preserve the integrity of the tax deferred status of the insurance policies held by the Family Office trusts.

Since the Existing Fund and the Issuer Fund were both IDFs with investments in at least five separate hedge funds, for purposes of complying with Section 817(h), the Insurance Company Investor was entitled to "look through" the Issuer Fund and the Existing Fund to each fund's underlying investments to ensure diversification of investments. Therefore, the diversification rules set forth in Section 817(h) of the Code were satisfied with respect to both funds.

IDF Agreement

In addition to the issues raised by the investor control doctrine in the Transaction, several additional issues were raised during the negotiation of the principal documents implementing the Transaction. A discussion of these issues follows.

Participation Agreement

The participation agreement by and among the Insurance Company Investor, the Issuer Fund, its general partner (the "General Partner") and the Adviser (the "Participation Agreement") was the main operative document governing the purchase and sale of the Interests by the Insurance Company Investor on behalf of its separate accounts and subaccounts that own variable life insurance policies, variable annuity policies and other variable insurance policies (the "Variable Contracts").

In order to ensure the "look through" treatment accorded to IDFs under Section 817(h)(4) of the Code would be available (i.e., "looking-through" a private investment fund to its underlying securities portfolio to satisfy the diversification requirements of Section 817(h) of the Code), the Insurance Company Investor required that the Issuer Fund limit all offers and sales of Interests to the following types of investors: (1) participating insurance companies (i.e., only those insurance companies that fund Variable Contracts) ("Participating Insurance Companies") and (2) participating insurance funds (i.e., registered investment companies, real estate investment trusts, partnerships or trusts that (i) were eligible to purchase and hold Interests under Section 817(h) of the Code and corresponding Treasury Regulations Section 1.817-5 (including, without limitation, satisfying the "look-through" requirements of Treasury Regulations Section 1.817-5(f)) and complied with Revenue Ruling 2005-7; (ii) invested a portion of their respective assets in the Issuer Fund and (iii) entered into an agreement concerning the purchase and redemption of Interests ("Participating Insurance Funds")). The Issuer Fund was also required to represent that the Issuer Fund's other Participating Insurance Funds and Participating Insurance Company investors had represented and warranted to the Issuer Fund that such investors had met certain suitability requirements and would purchase and hold Interests only for the benefit of policy owners that they believed met such suitability requirements. Further, the Issuer Fund was prohibited from issuing or selling Interests to any Participating Insurance Funds or Participating Insurance Companies unless their respective participation agreements with the Issuer Fund contained provisions substantially similar to the provisions described above as well as certain other provisions contained in the Participation Agreement, which include, but are not limited to, the following:

- Suitability requirements relating to the underlying insurance company account investors;

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- Suitability requirements relating to the Participating Insurance Funds and Participating Insurance Companies;
- Certain typical redemption provisions (e.g., gates, redemption suspension, and mandatory redemption);
- Certain special redemption provisions to override gates and redemption suspensions (e.g., redemptions for the payment of any insurance charges and or charges for Variable Contracts, redemptions required for the payment of a death benefit and redemptions for the occurrence of certain events (e.g., the Issuer Fund is no longer exempt from registration under the Investment Company Act of 1940, as amended, the Issuer Fund is no longer holding assets in compliance with the requirements of Section 817(h) and Treasury Regulations Section 1.817-5 and there is a violation of the "investor control" doctrine, each, a "Redemption Event"). With respect to certain Redemption Events, the Participation Agreement provided a cure period for certain violations;
- All contracts held by account investors were required to be Variable Contracts;
- The Issuer Fund must invest, dispose of and hold assets in compliance with Section 817(h) and Treasury Regulations Section 1.817-5 and notify the Participating Insurance Fund or Participating Insurance Company investor of any non-compliance and cure such noncompliance within the cure period afforded under Treasury Regulations Section 1.817-5;
- The Issuer Fund and its affiliates must conduct their business at all times so that no account owner will have incidents of control which cause the Issuer Fund's income and gains to be currently taxable to the account owner as a result of the application of the investor control doctrine; and
- The Issuer Fund and its affiliates agree (i) to not accept any investment recommendation or any investment decisions regarding the direct or indirect investment of its assets based, in whole or in part, on information received from an account owner or its representative; (ii) no policy owner will have any right, or be permitted, to select or identify any particular investment to be made with any assets of the Issuer Fund; and (iii) except for the general description of the investment objectives and policies of the Issuer Fund, there is no pre-arranged plan or agreement between any account owner or its representative, known to the Issuer Fund or its affiliates, with respect to investments to be made by the Issuer Fund.

The Insurance Company Investor required the Issuer Fund and its affiliates to provide a special indemnity with respect to (i) compliance with Section 817(h) and Treasury Regulations 1.817-5 and any amendments or modifications or successor provisions to such section or regulation, subject to the cure provision in (a)(2) of Treasury Regulations Section 1.817-5; and (ii) any failure to comply with the terms of the Participation Agreement resulting in the policy owner or its representative having incidents of control.

The indemnity section of the Participation Agreement was heavily negotiated by the parties; counsel should pay particular attention to conflict provisions in the agreement which would override the indemnification and exculpation provisions under the constitutive documents of a private investment fund or any other contract or document to which the private investment fund, its general partner or investment manager are party. Further, of particular importance, practitioners should be wary of prohibitions by insurance company investors against indemnification of certain unaffiliated service providers of the private investment fund (e.g., administrators, sub-investment advisers, prime brokers and other lenders) which could frustrate the private investment fund's ability to conduct its business.

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Subadviser Agreement between Sub-Adviser and Liquidating Manager

As part of the Transaction, the Liquidating Manager was engaged by the Sub-Adviser pursuant to the terms of a subadviser agreement (the "Subadviser Agreement"). Pursuant to the Subadviser Agreement, the Liquidating Manager was responsible for the orderly liquidation of certain existing hedge fund and FOF interests held (but not redeemed) by the Issuer Fund in consideration for the payment of certain asset-based fees (the "Liquidation Fees").

In order to ensure the Issuer Fund's compliance with the representations, warranties and covenants made to the Insurance Company Investor in the Participation Agreement, the Liquidating Manager was required to make similar representations, warranties and covenants regarding compliance with Section 817(h) and Treasury Regulations Section 1.817-5 as well as the investor control doctrine. The Liquidating Manager in turn required a provision declaring it had no responsibility for the Sub-Adviser's and Issuer Fund's own compliance with Section 817(h) and Treasury Regulations Section 1.817-5.

In addition to the specific requirements mandated by the Insurance Company Investor in the Participation Agreement, the Insurance Company Investor further required in the Subadviser Agreement that all Liquidation Fees as well as any account trading fees and/or extraordinary litigation expenses incurred on behalf of the Issuer Fund by the Liquidating Manager be paid out of the operating account of the Issuer Fund and not from any other assets of the Issuer Fund. The foregoing provision was consistent with the thinking behind the restrictive indemnification provisions contained in the Participation Agreement; ultimately, the Insurance Company Investor's main objective during the Transaction was to: (1) limit all parties' (and their respective affiliates) and any service providers' rights to indemnification by the Issuer Fund; and (2) limit the fees which could be charged against assets held by the Issuer Fund and contributed by the Insurance Company Investor on behalf of the Account. For the reasons previously stated, practitioners should resist this draconian restriction on indemnification which will likely jeopardize the IDF's ability to enter into agreements with its key service providers.

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investments in private investment funds and other investment vehicles. Mr. Bilfield also works with fund principals to implement contractual arrangements that govern their relationships within the fund management company structure.

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[1] Rev. Rul. 2005-7 clarifies the look-through rules for purposes of the diversification requirement under Section 817(h). Specifically, the ruling provides that look-through treatment is permitted at multiple levels of regulated investment companies, provided that all beneficial interests in each regulated investment company are held directly by one or more segregated insurance company accounts (except as otherwise permitted by Treasury Regulations Section 1.817-5(f)(3)) or by other regulated investment companies, all the beneficial interests of which are ultimately owned by one or more segregated insurance company accounts.

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