

Best Practices for Relationships With Insurance Company Limited Partners

Guidance and Considerations for General Partners

December 2019



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Introduction

Insurance companies are an important and unique type of limited partner investor. Their beneficiaries rely on the companies' ability to manage large pools of capital so that claims may be paid out seamlessly at critical times in their lifecycles. Private equity investment is a crucial allocation within the insurer's portfolio allocation, and these investors rely on PE to produce the necessary returns and diversification to serve their stakeholders. Given the nature of their business, insurance companies also face regulation and reporting requirements that impact their operations.

The ILPA Insurance Network, a subset of the ILPA membership that comprises limited partners investing on behalf of insurance companies, represents more than 75 insurance organizations investing in private equity and comprises 11% of total ILPA Membership. It includes ~500 active insurance investing professionals and has combined assets under management of \$7 Trillion USD. The Network came together in 2019 to discuss best practices associated with their unique investing requirements in the United States.

In addition to benefiting from the ILPA Principles 3.0 guidance released this year, the Insurance Network concluded that the nature of their business offered additional opportunities to improve processes and the alignment of interests between limited and general partners operating in the space. A working group was formed to explore these opportunities and determine an effective manner in which to share information with the general partner community.

The working group effort produced guidance which sought to provide considerations for General Partners who wish to improve their engagement with US-based Insurance LPs. The guidance focused on disclosures and reporting requirements, ownership and control provisions, partnership structures and tax issues. The document was further vetted by the wider ILPA Insurance Network, including legal counsel, and is presented here for use by all stakeholders doing business with Insurance Company LPs.

Each element of the guidance included in this document has met the following criteria:

- It is universally and uniquely beneficial to the insurance community;
- It enjoys strong support from a majority of insurance community members;
- It is specific, well-defined and actionable for the General Partner

The document also includes sample legal language that can be applied to the Limited Partnership Agreement (LPA) to effectively codify the best practices presented herein. It should be noted that such sample legal language is illustrative, and each organization should work with counsel to determine their respective approach to codifying terms and conditions.

We encourage appropriate stakeholders to use this guidance as a road map to set mutual expectations when entering into a private equity partnership. It is to be used as a companion and in conjunction with ILPA Principles 3.0, which was published in June 2019 for use by the broader private equity industry, including Insurance LPs and the private equity funds who accept their commitments.

Questions or comments regarding the guidance can be directed to principles@ilpa.org.

Annual Audit of Investment Vehicle to Which Commitment is Made

LIMITED PARTNER REQUIREMENT:

General Partners should provide an annual audit of the specific vehicle in which insurance LPs invest, even when the underlying holdings are themselves audited - including but not limited to co-investment vehicles and feeder funds. Additionally, the audit opinion should be provided to insurance LPs.

EXPLANATION:

When insurance companies report financial statements to regulators, only "Admitted Assets" are permitted to be included on the insurer's balance sheet for determining solvency and capital adequacy. Although each state has discretion over its insurance laws, there are general Statutory Accounting Principles that govern which assets are considered Admitted Assets. A guideline applicable to private equity investments is the requirement to have an annual audit of the specific vehicle in which the insurance LP invests, including co-investments, feeder funds, etc.

If an insurance LP's private equity investments is not audited, it cannot be included on the insurer's regulatory balance sheet as an Admitted Asset. As a result, this "non-admitted" investment is effectively treated as if it was a total capital loss which negatively impacts the insurer's regulatory capital.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBERS:

Sample #1

To the extent that the General Partner does not provide the Investor with (i) the audited financial statements of the Partnership for a fiscal year on or before March 15 of the following fiscal year or (ii) the unaudited financial statements of the Partnership for any of the first three fiscal quarters of a fiscal year within sixty (60) days following the end of the prior fiscal quarter, the General Partner shall provide the Investor on or before the expiration of the period set forth in clause (i) or clause (ii) an estimate of the information to be set forth in the applicable financial statements.

Timely Receipt of Quarterly Capital Account Statements

LIMITED PARTNER REQUIREMENT:

General Partners should deliver capital account statements to their Limited Partners on a timely basis each quarter.

EXPLANATION:

Insurance companies are required to report their income to regulators every quarter to ensure minimum capital requirements to support business operations are met. Insurance LPs are also required to file GAAP and SAP financial statements every quarter. In order to accurately report this information to regulators, insurance LPs need timely financial statements from their Private Equity Investments.

Due to the timing of receipt of financial statements from private equity investments, insurance LPs report related GAAP and SAP information on their financial statements on a quarterly lag even when financial statements are received within 90 days of quarter end. When financial statements (or drafts) are not received within 90 days of quarter end, reporting becomes lagged by two quarters. Reported asset values, income, statutory capital, etc. all become potentially inaccurate and impact an insurer's ability to comply with their specific accounting regulations. It also introduces non-economic volatility to reported financial information.

Specifically, GPs should:

- Provide insurance LPs with quarterly capital account statements within 90 days of each quarter end;
- In-lieu of final statements, GPs should provide insurance LPs with an estimate or draft of the capital account balance within 90 days of each quarter end;
- Mark-to-market changes in fair value of holdings should flow through the partnership's income statement;
- These statements should be issued by the same vehicle or entity to which the insurance LP has committed capital.

PRINCIPLES 3.0 REFERENCE:

Principles recommends the following financial disclosures, quarterly

- Unaudited quarterly profit and loss statements also showing year-to-date results
- Information on material changes in investments and expenses
- Summary of all capital calls and distribution notices including on uncalled capital commitments
- Management comments about changes during the quarter
- An explanation of any quarter-to-quarter valuation changes, including any changes in the valuation's methodology applied

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBERS:

Sample #1

a) *The Partnership shall deliver to the Investor each fiscal quarter a summary of the Investor's capital account activity, including (a) beginning capital balance, (b) contributions, (c) distributions, (d) income/loss, and (e) ending capital balance, no later than ninety (90) days following the end of the prior fiscal quarter.*

b) *To the extent that the General Partner does not provide the Investor with (i) the audited financial statements of the Partnership for a fiscal year on or before March 15 of the following fiscal year or (ii) the unaudited financial statements of the Partnership for any of the first three fiscal quarters of a fiscal year within ninety (90) days following the end of the prior fiscal quarter, the General Partner shall provide the Investor on or before the expiration of the period set forth in clause (i) or clause (ii) an estimate of the information to be set forth in the applicable financial statements.*

Timely Receipt of Annual K-1 Tax Forms

LIMITED PARTNER REQUIREMENT:

General Partners from all geographies should provide annual K-1 tax forms to their Limited Partners on a timely basis.

EXPLANATION:

US taxable investors investing in partnerships are required to report a Schedule K-1 tax form to the Internal Revenue Service (IRS) annually. The K-1 tax form reports each partners' share of the partnership's earnings, losses, deductions, and credits. Many US-based LPs have difficulty in receiving timely K-1 forms, particularly from European GPs. Fund documents will often require each LP to individually request K-1 forms annually creating additional burden. Also, LPs often receive the forms late in the filing period. In order to accurately file their tax documents, US-based insurance LPs need timely receipt of K-1 tax forms from GPs of all geographies.

In order to support US-based taxable LPs, GPs should proactively provide K-1 forms to all US-based taxable LPs by July 15th and no later than July 30th based on the specific requirements of the insurance LP, annually. At a minimum, GPs should provide K-1 forms upon request. If the GP cannot provide a timely receipt of K-1 tax forms, GPs should provide an estimated tax liability for each US-based taxable investor. The cost of providing the forms should be a fund expense.

Filing tax returns for insurance LPs is a complex process. Late K-1 forms may lead to true-ups in subsequent years or, depending on the materiality, amended tax filings to avoid assessment of interest for underpayment of tax liability. Both of those consequences are administratively burdensome and have additional financial planning and reporting implications.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBERS:

Sample #1

To the extent that the General Partner does not provide the Investor with U.S. Internal Revenue Service Schedule K-1, "Partner's Share of Income, Credits, Deductions, Etc.," or any successor schedule or form, for any fiscal on or before March 15 of the following fiscal year, the General Partner shall provide the Investor on or before March 15 of the following fiscal year an estimate of the information to be set forth in the Schedule K-1 concerning the prior fiscal year.

Sample #2

In light of the Investor's status as a taxable investor, the Partnership shall (i) provide the Investor with a confirmation accompanying Schedule K-1 (based on information available as of such date) as to whether the Partnership has directly or indirectly participated in any "reportable transactions," together with any information (available on or prior to such date) the Investor will need to complete and file an IRS Form 8886 and (ii) promptly provide any information regarding reportable transactions which subsequently becomes available. The General Partner shall cause the Partnership to comply with any filing requirements imposed on both the Partnership and the Partners by Sections 6038, 6038B and 6046A of the Code and the Treasury Regulations promulgated thereunder, where the filing by either the Partnership or a Partner would satisfy such filing requirement.

Permissions on Statutory and Regulatory Disclosures

LIMITED PARTNER REQUIREMENT:

General Partners should permit the disclosure of investment entity level information including investment name, unfunded commitment, percent ownership, accounting information such as market value, cost basis, and income for regulatory purposes without prior notice or regulatory approval

EXPLANATION:

Insurance LPs must make regulatory disclosures to the NAIC and state regulators. The investment name, unfunded commitment, amount invested, percent ownership, and accounting info such as market value, cost basis, and income are required disclosures that become public (for fund investments, this is often called fund level information). In addition, insurance LPs often include the regulatory filings which includes such information on other public facing materials (like their website). This information need not contain sensitive portfolio company information. LPs should not require notices or approvals to disclose investment names, commitment, and invested amounts to meet regulatory requirements.

If LPs are not allowed to disclose the investment name and commitment amount, they may not be permitted to participate in the investment. If insurance LPs are required to periodically give notice/get approval for disclosure it creates an unnecessary burden.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBERS

Sample #1

The General Partner further acknowledges and agrees to the disclosure, without further notice to the General Partner, in the annual and quarterly statutory financial statements that the Investor is required to file with certain insurance regulators (which financial statements are made available to the public) of such Partnership Information as is required to be contained in such financial statements, and that the Investor may continue to post such financial statements on its website.

Sample #2

The General Partner agrees that the Investor will be deemed to not be in violation of Section [●] of the Partnership Agreement if the Investor discloses [Partnership Information] (a) to any regulatory, government, administrative or quasi-regulatory or self-regulatory agency or agencies having jurisdiction or supervisory authority over the Investor, including without limitation the National Association of Insurance Commissioners, the Securities Valuation Office, various state insurance commissioners and any rating agency (each an "Agency," and collectively, the "Agencies") at the request of such Agency, including but not limited to a request in connection with an examination or review by such Agency, or (b) to any of the officers, directors, employees or Affiliates of the Investor or their respective auditors or attorneys who need to know such information (collectively, the "Representatives") but only to the extent such Representatives are informed of and agree to maintain the confidentiality of the [Partnership Information] in a manner no less restrictive than required under Section [●] of the Partnership Agreement. The General Partner further acknowledges and agrees to the disclosure, without further notice to the General Partner, in the annual and quarterly statutory financial statements that the Investor is required to file with certain insurance regulators (which financial statements are made available to the public) of such Partnership Information as is required to be contained in such financial statements, and that the Investor may continue to post such financial statements on its website

Ability to Reassign Among Affiliates

LIMITED PARTNER REQUIREMENT:

General Partners should allow Limited Partners to transfer their interests among affiliates, without requiring approval.

EXPLANATION:

From time-to-time insurance LPs may seek to transfer investments to an affiliate as part of standard portfolio management practices. In order to support insurance LPs, GPs should waive the need for approval by the LP to transfer their limited partner interests of the GP. At the minimum, GPs should agree to not unreasonably withhold consent for transfers amongst affiliates.

When insurance LPs must get approval to reassign limited partner interests among affiliates, it creates regulatory and business burdens. It creates an impediment to portfolio rebalancing.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBERS:

Sample #1:

The General Partner and the Fund each agree that the Investor shall be permitted to transfer its interest in the Fund to an affiliate of the Investor at any time without any further approval or consent required, provided that (i) the transferee provides such information reasonably necessary for the General Partner and the Fund to conclude that the transferee is eligible to hold such interest without causing the Fund, the General Partner or the Manager to be in violation of a specified law or applicable regulation and (ii) the transferee agrees to a duly executed instrument to be admitted as a substitute limited partner with respect to the interest so transferred. The General Partner and the Fund agree that any transferee of all or any fraction of Investor's interest in the Fund, shall, to the extent applicable to such transferee, be entitled upon such transfer to all benefits of this letter agreement as if this letter agreement were originally addressed to it.

Sample #2

Notwithstanding anything to the contrary in the Partnership Agreement, the General Partner hereby consents in advance (a) to a transfer of all or any portion of the Investor's interest in the Partnership to one or more Affiliates of such Investor, and (b) subject to the provisions of clauses (i) and (ii) of Section [●] of the Partnership Agreement, to the admission of any such transferee as a substitute Limited Partner. The General Partner hereby agrees that the terms of this letter agreement shall, as of the effective date of any such transfer, apply to the transferee as if the General Partner had issued this letter agreement to the transferee.

Change of Control of the Limited Partner

LIMITED PARTNER REQUIREMENT:

The anti-assignment provisions of partnership agreements should not apply to transfers that result from a change of control of an insurance LP.

EXPLANATION:

In the event that an insurance company determines the most prudent course of action is to sell to an affiliate, private equity limited partnership agreements should not prohibit a change in the ultimate owner due to transfer restrictions. This issue can cause burdensome legal processes and expense or the sale of applicable investments (and related loss and expense) in order to implement strategic decisions.

A potential concern of GPs may be that a new ultimate owner will be less credit worthy or cause the LP to become so. However, all insurance companies are regulated financial institutions with capital requirements. Any purchaser of an insurance affiliate would be a credit worthy entity and would be prohibited from stripping out capital of the entity.

To support an insurance LPs main business activities, insurance LPs should be able to change their ultimate owner without GP approval.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBER:

Sample #1

Notwithstanding anything contained in Section [●] of the Partnership Agreement to the contrary, the Investor may enter into an indirect transfer without the consent of the General Partner; provided (a) such indirect transfer (combined with any other indirect Transfers entered into by such Investor after the date hereof) does not result in a change in control of the Investor or (b) such indirect transfer (combined with any other indirect transfers entered into by the Investor after the date hereof) results in a change of control of the Investor, if such transfer was not utilized to avoid the limitations set forth in Section [●] of the Partnership Agreement.

Office of Foreign Asset Control (OFAC) Checks

LIMITED PARTNER REQUIREMENT:

General Partners should provide all the necessary information to enable the insurance LP to successfully complete its required OFAC check, including the middle initials of employees, where relevant.

EXPLANATION:

The US Treasury Department's Office of Foreign Assets Control (OFAC) oversees US economic and trade sanctions against governments, as well as financial restrictions on groups and individuals involved in terrorism, drug trafficking, money laundering, etc. Financial institutions are required to follow applicable laws and therefore periodically review financial relationships including performing "OFAC Checks" to ensure individuals who they do business with are not on the Specially Designated Nationals and Blocked Persons list.

To successfully check against the Specially Designated Nationals and Blocked Persons list, Insurance LPs need information on the GP's principals. To support insurance LPs, GPs should provide when requested the required information on individual principals to successfully complete an OFAC check. Sometimes this requires minute details such as a middle initial to complete.

Failure to spot an individual on the list, or failure to complete the check, can lead to potential civil and criminal penalties for insurance LPs.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBER:

Sample #1

None of the Partnership, the General Partner or any Affiliate thereof (i) is named on the List of Specially Designated Nationals and Blocked Persons maintained by the U.S. Office of Foreign Asset Control ("OFAC"), U.S. Department of the Treasury or on any other similar list maintained by OFAC pursuant to any authorizing statute, executive order or regulation, (ii) has been convicted of or charged with a felony relating to money laundering, or (iii) is under investigation by any governmental authority for money laundering. The General Partner will use its reasonable best efforts to ensure that the Partnership does not invest in any entity which would be described in clauses (i), (ii) and (iii) above.

Insurer Status as a Premium Taxpayer

LIMITED PARTNER REQUIREMENT:

The General Partner should make every effort to notify the limited partner prior to withholding and paying a tax liability, offering exemption forms where appropriate and supporting the redemption process as soon as possible.

EXPLANATION:

An insurance premium tax is a form of gross receipts or excise tax. It is not based on profits or earnings. Insurance LPs in most states pay taxes based on the amount of premiums written or contracted in a respective state. Therefore, most insurance companies are exempt from paying income taxes in many states and are unlikely to be subject to state and local withholding obligations with respect to any allocation, payment or distribution by the Investment to the Insurer. Additionally, insurance LPs do not need withholding for tax liabilities.

To help insurance LPs receive optimal tax treatment, GPs should provide insurance LPs with prior notice of state and local income tax withholding and/or payment by the Partnership and offer exemption forms that may be available to reduce the withholding or obtain a refund. Ideally, the GP will provide reasonable effort to assist in the filing. At a minimum, GPs should notify insurance LPs of a withholding/payment so the insurance LPs can attempt to file a withholding redemption.

If insurance LPs are not notified of a withholding, they may end up paying more taxes to state and local entities than required, lowering their overall return on the investment.

SAMPLE LEGAL LANGUAGE PROVIDED BY ILPA MEMBER:

Sample #1

The Investor is a life insurance company and is operating as such, and consequently, the Investor is, to the best of Investor's knowledge, exempt from paying income taxes in many states (including the states listed on Schedule I hereto as of the date hereof, as it may be amended from time to time by supplemental letter to the Partnership), as it pays premium taxes and is unlikely to be subject to state and/or local income tax withholding obligations in such states with respect to any allocation, payment or distribution by the Partnership to the Investor. Based on the foregoing, the General Partner agrees that, with respect to withholding by the Partnership and paying over to any taxing authority from a state listed in Schedule I any amount purportedly representing a state income tax liability of the Investor pursuant to the provisions of the Agreement, the General Partner will use its commercially reasonable efforts, to the extent practicable, to provide the Investor with prior notice of such withholding and payment by the Partnership; provided that the provision of such notice does not subject the Partnership, the General Partner, or any Partner (other than the Investor), or its beneficial owners, officers, employees and representatives, to any potential liability to such taxing authority or other person, including for the amount of any such claimed withholding and payment and, without limitation, any penalties, interest, sanctions or injunctions arising therefrom.

Sample #2

The Investor represents that it is an insurance company organized under the laws of the state of its incorporation and, accordingly, the Investor pays state tax in most jurisdictions based on the amount of premiums written or contracted to in a respective state (as opposed to paying tax under a state's corporate income, franchise, gross receipts, or other tax generally imposed on business entities) ("Insurance Status"). In the event the General Partner concludes that the Fund is required to withhold

and pay to any U.S. state taxing authority any amount purportedly representing a tax liability of the Investor, to the extent practicable, the General Partner agrees to notify the Investor reasonably promptly after so determining, and to solicit from the Investor any exemption forms that may be available in respect of such state tax or other information entitling such Investor to reduced withholding.

Limited Partnership Structure for Co-Investments

LIMITED PARTNER REQUIREMENT:

Accounting treatment of investments held directly as securities is sub-optimal for insurers GAAP operating income compared to investments held in limited partnership vehicles.

EXPLANATION:

Investments held as securities makes reporting to regulators more difficult for insurance LPs. Unlike most LPs, insurance LPs don't operate under the terms of the Investment Company Act of 1940 and therefore don't benefit from the Act's rules on investment accounting. Insurance LPs are governed by GAAP rules for insurers. According to those rules, when co-investments are held under limited partnership vehicles insurance LPs can report the valuation that the GP assigns to each of the underlying businesses. Therefore, *GPs should consider utilizing a limited partnership vehicle to pool co-investment capital when offering co-investment to insurance LPs.*

However, according to the GAAP rules for insurers, when investments are held as securities insurance companies must report the income line item on the income statement for each underlying business. If a co-investment was reporting negative net income an insurance LP would have to report negative income no matter the valuation that the GP assigns.

Glossary

Admitted Assets - assets of an insurance company that are permitted by state law to be included in the company's financial statement. Each state has discretion over its own insurance laws, but there is a general consensus over which assets are suitable to use when determining the insurance company's solvency. Admitted assets often include mortgages, accounts receivable, stocks and bonds. The assets must be liquid and available to pay claims when necessary.

<https://www.investopedia.com/terms/a/admitted-assets.asp>

<https://www.usacoverage.com/admitted-assets.html>

Generally Accepted Accounting Principles (GAAP) - accounting method that most business use. Unlike SAP, GAAP assumes that a company will continue to do business rather than liquidate; all potential revenue is calculated as part of the annual statement, including accounts receivable not yet invoiced.

<https://smallbusiness.chron.com/statutory-accounting-vs-gaap-insurance-companies-38680.html>

National Association of Insurance Commissioners (NAIC) - a nationwide organization designed to protect the interests of insurance consumers. The NAIC provides support to insurance regulators across the country by promoting competitive markets, the improvement of insurance regulations and equitable treatment of insurance consumers.

<https://www.investopedia.com/terms/n/nainsuranceec.asp>

https://www.naic.org/documents/about_faq.pdf

New Money Rates - a method of crediting interest. In managing the new money interest rate, the insurer places the annuity premium deposits during any given interest rate cycle into a pocket or bucket. Once these buckets have been established, the insurer evaluates each of them at renewal time to establish the renewal rate. The insurer looks at the cash flows from the underlying investments, reinvestment of the undistributed cash flows, the market value of the investment portfolio and other factors before arriving at a renewal rate. The declared renewal rate only applies to contracts issued during the time the bucket was open. In essence, each contract holder buys into a limited portfolio of investments available at that particular time. Most experts agree that this is the fairest way to treat contract holders and the safest way for an insurer to handle its annuity business.

Other Than Temporary Impairments (OTTI) - an impairment charge taken on a security whose fair value has fallen below the carrying value on the balance sheet and its value is not expected to recover through the holding period of the security

<https://www.nasdaq.com/investing/glossary/o/other-than-temporary-impairment>

Risk Based Capital (RBC) - a method of measuring the minimum amount of capital appropriate for a reporting insurance company to support its overall business operations in consideration of its size and risk profile. RBC requires a company with a higher amount of risk to hold a higher amount of capital. RBC is intended to be a minimum regulatory capital standard and not necessarily the full amount of capital that an insurer would want to hold meet its safety and competitive objectives.

https://www.naic.org/cipr_topics/topic_risk_based_capital.htm

Statutory Accounting Principles (SAP) - designed to assist state insurance departments in the regulation of the solvency of insurance companies. The ultimate objective of solvency regulation is to ensure that insurance companies maintain capital and surplus at all times and in such forms as required by statute to provide a margin of safety. SAP focuses on the balance sheet, rather than the income statement, and emphasizes insurers' liquidity. The annual statement indicates its value as if it were in liquidation rather than continuing in business. The NAIC mandates that all insurance companies follow SAP.

https://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm

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