

Termination and Setoff Rights in Derivatives Transactions Under State Insurance Insolvency Laws

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I. INTRODUCTION

The Federal Deposit Insurance Act (the “FDIA”)¹, the New York Banking Law², and the United States Bankruptcy Code (the “Bankruptcy Code”)³, address the termination and setoff rights of derivatives counterparties of federally chartered banks, New York chartered banks, or entities that are not financial institutions, if the bank or non-financial institution becomes insolvent. This article looks at the termination and setoff rights of derivatives transaction participants when their counterparties are either (i) insurance companies organized and licensed in the United States under state law (“U.S. Insurers”) that have been placed into receivership; or (ii) credit enhanced by U.S. Insurers that have been placed into receivership.

II. BANKRUPTCY CODE AND FEDERAL AND STATE BANKING LAWS DO NOT APPLY TO U.S. INSURERS

The attorney for a multinational bank is negotiating an International Swaps and Derivatives Association, Inc. (“ISDA”) Master Agreement (the

“Master Agreement”⁴) to cover derivatives transactions with a U.S. Insurer. The bank’s attorney has represented the bank in many derivatives transactions with federally chartered banks, New York chartered banks, and United States counterparties that are not financial institutions. In those transactions, if the bank’s counterparty became insolvent, the Bankruptcy Code, the FDIA, and the New York Banking Law, as applicable, provide the bank with certain termination and setoff rights, notwithstanding automatic stay provisions of, or injunctions under, applicable law. The attorney assumes that if the U.S. Insurer is placed into receivership, these statutes will provide the bank with the same termination and setoff rights for its derivatives transactions with the U.S. Insurer.

The attorney is wrong. Although under certain circumstances, the Bankruptcy Code and the banking laws permit a counterparty to terminate and setoff certain prepetition/prereceivership derivatives transactions entered into with a

Bankruptcy Code “debtor” or a failed bank, the same is not true for a counterparty that has entered into derivatives transactions with a U.S. Insurer.

Neither the Bankruptcy Code, the FDIA, nor the New York Banking Law applies to derivatives transactions with a U.S. Insurer that has been placed into receivership.⁵ State insurance insolvency laws and regulations, and relevant case law, which vary from state to state, determine the termination rights of a counterparty to derivatives transactions with a U.S. Insurer that is placed into receivership.⁶ With the exception of transactions with Connecticut domiciled insurers (as discussed below), such transactions generally are subject to either or both the automatic stay provisions of, and injunctions under, applicable state insurance insolvency laws.

III. TERMINATION AND SETOFF PROVISIONS UNDER THE ISDA MASTER AGREEMENT

A. Unilateral Postpetition Termination

Under Section 6(a) of the Master Agreement, unless a party elects Automatic Early Termination (“AET”), discussed below, a nondefaulting party may terminate all outstanding transactions unilaterally upon the occurrence of an event of default with respect to the defaulting party or its credit support provider (“CSP”). The commencement of insolvency proceedings with respect to a party or its CSP is an event of default under Section 5(a)(vii) of the Master Agreement. However, an attempt to terminate following such an event of default would, under most state insurance insolvency laws, be subject to either or both an automatic stay and an injunction. Thus, the above-referenced contractual provisions would not be enforceable against a U.S. Insurer subject to those laws.

B. Automatic Postpetition Termination

As an alternative, the parties may specify in the Master Agreement Schedule (the “Schedule”) that all outstanding transactions automatically terminate if

insolvency proceedings are commenced against a party or its CSP. However, the automatic stay provisions of many state insurance insolvency laws probably would render such a provision unenforceable against a U.S. Insurer counterparty.

C. Automatic Prepetition Termination

It is standard practice for the parties to specify in the Schedule, with respect to each party, whether AET will apply. Section 6(a) of the Master Agreement provides that if AET does apply with respect to a party that becomes insolvent, then all transactions governed by the Agreement will be deemed terminated “as of the time *immediately preceding* the institution of the relevant proceeding or the presentation of the relevant petition” (emphasis added). It is unclear whether this provision would be given effect if challenged in state court, as it could be construed as an attempt to circumvent either or both the automatic stay provisions of, and injunctions under, state insurance insolvency laws.

D. Preinsolvency Termination Events

The parties also may specify in the Schedule “pre-receivership” termination events with respect to U.S. Insurer derivatives counterparties and U.S. Insurer CSPs. The inclusion of such termination events in Master Agreement Schedules (see “Recommendations and Guidelines,” below), enables the nondefaulting party to terminate outstanding trades when the creditworthiness of the U.S. Insurer counterparty or the U.S. Insurer CSP has severely declined. This alternative should be considered in states in which the insurance insolvency laws might render the first three alternatives unenforceable.

IV. STATE INSOLVENCY LAWS

A. The Model Act

1. Automatic Stays Under Section 5

At least some provisions of the National Association of Insurance Commissioners’ Insurers’ Rehabilitation and Liquidation Model Act (the

“Model Act”) have been incorporated into most state insurance insolvency laws.⁷ Section 5 of the Model Act provides that an application or petition for: (1) a court’s seizure order,⁸ (2) commencement of a formal delinquency proceeding,⁹ (3) a rehabilitation order,¹⁰ or (4) a liquidation order,¹¹ operates as a matter of law as an automatic stay. This stay survives the entry of an order of conservation, rehabilitation or liquidation, is applicable to all persons and entities, other than the receiver, and prohibits, among other things (a) the transaction of further business by the insurer; (b) waste of the insurer’s assets; and (c) any other “threatened or contemplated action that might lessen the value of the insurer’s assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of any proceeding” under the Model Act.

Even if the first two provisions were not interpreted to prohibit termination of outstanding derivatives trades with a U.S. Insurer, such termination probably would be stayed automatically under the catchall language of the third. The state law automatic stay provision based upon the Model Act would prohibit the nondefaulting party from collecting on a financial guaranty or surety bond issued by a U.S. Insurer CSP that has been placed into receivership, except as a claimant against the CSP’s estate or any applicable guaranty fund.

2. The Safe Harbor of Section 46

The drafters of section 46 of the Model Act understood that there are circumstances in which derivatives counterparties must be permitted to terminate and setoff certain derivatives contracts. Without such a right, some counterparties would be reluctant to deal with U.S. Insurers, or, when dealing with U.S. Insurers, would increase prices or demand additional collateral. Any of these outcomes would place U.S. Insurers at a competitive disadvantage in the derivatives markets.

To address this concern, section 46 of the Model Act provides a safe harbor that permits the exercise of a contractual right to terminate, liquidate or close out any netting agreement¹² or qualified financial contract¹³ of an insurer due to:

- the insolvency, financial condition or default of the insurer at any time, provided that the right is enforceable under applicable law other than the Model Act; or
- the commencement of a formal delinquency proceeding under the Model Act.

Under section 46, the nondefaulting party may exercise its contractual right to terminate, liquidate or close out its derivatives transactions with its U.S. Insurer counterparty even after the commencement of formal delinquency proceedings and without regard to the automatic stay. Because the Model Act permits termination by “exercising a contractual right,” a contractual provision permitting unilateral termination by the nondefaulting counterparty will not be stayed, but will be enforceable against an insolvent U.S. Insurer in receivership in a jurisdiction that has adopted section 46 of the Model Act.

B. Connecticut

Connecticut has adopted the section 46 carveout for netting agreements and qualified financial contracts.¹⁴ Consequently, when a Connecticut insurer is placed into receivership, its derivatives counterparty may lawfully terminate outstanding transactions covered by their Master Agreement. At present, Connecticut is the only United States jurisdiction that has adopted this provision.¹⁵

C. Florida

Florida is at the other end of the spectrum. Florida adopted the Model Act’s automatic stay provision, but not section 46’s carveout for netting agreements and qualified financial contracts. Moreover, in 1998, it rejected section 612 of the “Interstate Compact

Uniform Receivership Law,” a carveout for netting agreements and qualified financial contracts that was virtually identical to section 46 of the Model Act. The Florida Department of Insurance opposed section 612 on the following grounds:

[T]here must be no self-executing rights against the property of an insurer, and no extrajudicial resolution of any disputes involving its assets. The possibilities for abuse of this provision far outweigh any prospective benefits. Persons having contracts of this type with an insolvent insurer should not be treated any differently from other claimants.¹⁶

Consequently, there is no carveout under Florida law for netting agreements or qualified financial contracts. When a Florida insurer that is a party to a derivatives transaction is placed into receivership, Florida law imposes an automatic stay that prohibits its derivatives counterparty from terminating outstanding transactions covered by a Master Agreement, notwithstanding any contractual provision permitting unilateral termination by the counterparty. Nor does it seem likely, given the position of the Florida Department of Insurance (as of January 1, 2003, the Florida Department of Financial Services), that an AET election would enable a nondefaulting party to circumvent Florida’s statutory automatic stay.

D. California, New York and New Jersey

Some states, such as California, New York and New Jersey, which have not enacted the automatic stay provision of the Model Act, have adopted modified versions of the injunction provision of the Uniform Act (see footnote 9). Under the Uniform Act, courts overseeing insurer receiverships may, at any time, issue an injunction to prevent interference with the commissioner, superintendent or the proceeding, to prevent waste of the assets of the insurer, commencement or prosecution of any actions, obtaining of preferences, judgments,

attachments or other liens, or making of any levy against the insurer, its assets or any part thereof.

Though technically not an automatic stay, the commencement of a receivership proceeding in these jurisdictions is almost always accompanied by a separate injunction entered by the receivership court prohibiting the waste of the insurer’s assets. Such an injunction would prevent a derivatives counterparty from terminating outstanding derivatives trades with a California, New York or New Jersey insurer in receivership. Unlike the Model Act, under the Uniform Act, once such an injunction has been issued, and so long as it remains in force, there is no mechanism for a U.S. Insurer’s derivatives counterparty to terminate the outstanding transactions covered by a Master Agreement. Consequently, in jurisdictions such as California, New York and New Jersey, the nondefaulting party cannot lawfully terminate under Section 6(a) of the Master Agreement, and a specially drafted provision providing for the automatic termination of such transactions upon the commencement of insolvency proceedings against a U.S. Insurer counterparty will not be given effect (assuming entry of an injunction by the receivership court). Furthermore, it is unlikely that the AET provisions of the Master Agreement will be enforced in such jurisdictions.

Of course, if the insolvent U.S. Insurer were not the derivatives counterparty, but instead were the CSP for one of its affiliates, none of the foregoing restrictions would apply. In that case, the insolvency of the U.S. Insurer CSP would constitute an event of default with respect to its affiliate under Section 5(a)(vii) of the Master Agreement,¹⁷ permitting the nondefaulting party to terminate and liquidate all existing trades.

In that case, the critical issue for the nondefaulting party is the ability of the U.S. Insurer CSP to pay whatever amount is owed by its defaulting party affiliate under the terms of their

Master Agreement. Counterparties relying on insurance policies issued by U.S. Insurers to support obligations under derivatives transactions are legitimately concerned about the ongoing financial health of these CSPs, especially when the existing trades may extend several years into the future. As bilateral pledge arrangements between derivatives market participants have become the rule rather than the exception,¹⁸ it is understandable that counterparties relying upon the creditworthiness of U.S. Insurer CSPs would want the cushion of protection that collateralization provides. Unfortunately, it is in these very situations, where this protection may be needed the most, that it may be most difficult to achieve.

V. THE COLLATERALIZATION ALTERNATIVE

Many state insurance laws restrict the ability of a U.S. Insurer to pledge its assets as collateral. These laws may restrict the amount that may be pledged, the type of obligation being secured by the pledge, and the form of pledge and may also result in adverse statutory accounting treatment of any pledged assets. Additionally, the posting of collateral by a U.S. Insurer within a statutorily prescribed time period prior to the filing of a successful petition for receivership may constitute a voidable preference. *See, e.g.*, N.Y. Ins. Law §7425. Although the bottom line is that U.S. Insurers generally are permitted to pledge assets in connection with derivatives transactions, the road to that conclusion is filled with curves and bumps.

A. Admitted Asset Treatment

If a U.S. Insurer acting as a CSP is asked to pledge assets as collateral in a derivatives transaction, it may resist the request because pledged assets may not qualify as “admitted assets”¹⁹ when calculating the U.S. Insurer CSP’s financial condition. As noted in Statement of Statutory Accounting Principles No. 4 (“SSAP No. 4”), which has been adopted in most states:

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet.²⁰

SSAP No. 4 concludes that such assets “are therefore, considered nonadmitted.”

Based upon SSAP No. 4, assets pledged by a U.S. Insurer acting as a CSP to secure its obligations under a financial guaranty insurance policy generally would qualify as admitted assets only to the extent that the insurer has posted a liability on its statutory financial statements corresponding to its obligations under the insurance policy. Because the obligation to pledge assets probably would be triggered by a deterioration of the U.S. Insurer’s creditworthiness (an event wholly unrelated to the likelihood of loss under the related derivatives transaction), and assuming the guaranteed transaction was continuing to perform, the U.S. Insurer probably would not have posted a corresponding liability on its statutory financial statements. In such a case, the assets posted as collateral would not qualify as “admitted assets.”

Because an insurer’s policyholders’ surplus (*i.e.*, its net worth determined in accordance with statutory accounting principles) is determined by subtracting its liabilities from its admitted assets, to the extent that assets pledged as collateral in respect of a derivatives transaction do not qualify as admitted assets, there would be a corresponding reduction in the policyholders’ surplus of the U.S. Insurer. This can result in any or all of the following: (1) one or more of the CSP’s financial guaranty insurance policies exceeding any statutory

single risk limits; (2) a CSP's policyholders' surplus that is less than any statutory aggregate risk limits; and (3) a CSP's policyholders' surplus that is less than the minimum amount required by statute.

The negative effect that a pledge of collateral has on a U.S. Insurer CSP's admitted assets is the primary reason U.S. Insurer CSPs are so reluctant to secure their obligations under policies. A U.S. Insurer CSP will likely seek to avoid all of these outcomes.

In contrast, Statement of Statutory Accounting Principles No. 18 ("SSAP No. 18") in most cases would permit a U.S. Insurer that posts collateral in connection with a derivatives transaction into which it has entered directly with a counterparty to recognize the collateral as an admitted asset. SSAP No. 18, which has been adopted in most United States jurisdictions, sets out the accounting rules to be used in connection with an obligor (e.g., a U.S. Insurer) granting a security interest in certain of its assets to a secured party and cites interest rate swaps as an example. SSAP No. 18 provides that the accounting treatment for collateral by the obligor and the secured party depends on (a) whether the secured party has taken control over the collateral, and (b) the rights and obligations that result from the collateral arrangement, and describes, in paragraph 10 thereof, the following three scenarios into which such transactions may be placed:

Scenario 1

The secured party is permitted to sell or repledge the collateral, and the obligor does not have the right and ability to redeem the collateral on short notice (e.g., by substituting other collateral or terminating the contract). In this scenario, the obligor is required to disclose in its financial statements the amount of the collateral pledged and the secured party's right to sell or repledge such

collateral. The secured party is required to recognize the collateral as its asset and also recognize its obligation to return it.

Scenario 2

The secured party actually sells or repledges the collateral on terms that do not give it the right to repurchase or redeem the collateral from the transferee on short notice. In such case, the secured party is required, to the extent that it has not already done so, to recognize the proceeds from the sale or the value of the assets repledged and its obligation to return the assets.

Scenario 3

The obligor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral. In such case, the obligor cannot recognize the collateral as an admitted asset.

In Scenarios 1 and 2, the obligor must recognize the collateral as an asset. This is consistent with the guidance provided in Statutory Issue Paper No. 122 of the National Association of Insurance Commissioners (the "NAIC"), which was recently adopted by the NAIC's Statutory Accounting Principles Working Group. As in SSAP No. 18, Issue Paper No. 122 describes the accounting treatment associated with secured borrowings and collateral and sets forth, almost verbatim, the three scenarios described in SSAP No. 18. However, whereas SSAP No. 18 provides in Scenario 1 that the obligor "shall disclose the amount of such assets and the secured party's right to sell or repledge such collateral," Issue Paper No. 122 provides that the obligor "shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered." The effect of this language

difference appears to be that under Issue Paper No. 122 only, what would otherwise qualify as “invested assets”²¹ would no longer qualify as invested assets in Scenarios 1 and 2 if they are pledged as collateral. Thus, although pledged assets would still qualify as admitted assets in Scenarios 1 and 2 under both SSAP No. 18 and Issue Paper No. 122, under Issue Paper No. 122, any financial ratio that includes invested assets as a component would be worsened by the reclassification of pledged assets as noninvested assets.

It should be noted that a new version of paragraph 10 of SSAP No. 18, which will appear as paragraph 12 in SSAP No. 91, and that will set forth, almost verbatim, the above quoted language from Issue Paper No. 122 (i) was exposed at the NAIC Spring 2004 National Meeting, (ii) was adopted by the Accounting Practices and Procedures Task Force and by the Financial Condition Committee on June 15, 2004, and (iii) will become effective if it is adopted by the Executive Committee in September of 2004.

Accordingly, assuming it is adopted by the Executive Committee in September of 2004, in those jurisdictions that adopt SSAP No. 91, a U.S. Insurer that posts collateral in connection with a derivatives transaction it has entered into directly with a counterparty could object to the posting of collateral based upon the fear that the collateral would not qualify as an “invested asset.”

B. Voidable Preferences

Even if a U.S. Insurer agrees to pledge collateral to secure its obligations as a party or as a CSP in a derivatives transaction, the counterparty may be unable to retain the collateral in the circumstance in which it might well be of most value – the insolvency of the U.S. Insurer. This is because the pledge of collateral might be deemed to be a voidable preference under the insolvency statutes of some states.

Section 32 of the Model Act defines a preference as:

[A] transfer of any of the property of an insurer to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the insurer within one year before the filing of a successful petition for liquidation under this Act, the effect of which transfer may be to enable the creditor to obtain a greater percentage of this debt than another creditor of the same class would receive.²²

Section 32 of the Model Act provides that a preference may be avoided by the insurer’s liquidator if: (i) the insurer was insolvent at the time of the transfer; (ii) the transfer was made within four months before the filing of the petition; (iii) the creditor receiving the transfer had reasonable cause to believe the insurer was insolvent or was about to become insolvent; or (iv) the creditor was a person who was in a position to deal with the insurer other than at arms length.

California and Connecticut have enacted statutes that are virtually identical to the provisions of section 32 of the Model Act described above. Other states such as New York and Florida, which have not enacted the voidable preference provisions of the Model Act, have adopted modified versions of the voidable preference provisions of the Uniform Act. Under the Uniform Act, a receiver may avoid, as a preferential transfer, any pledge of assets made by an insurer within the four months prior to the commencement of the insurer’s receivership if the pledge was made with the intent of giving a preference and the creditor had reasonable cause to believe that such a preference would occur. Although Florida has retained the four month look-back period, New York has extended it to twelve months. New Jersey has adopted the voidable preference provisions of the Model Act for life insurers and the voidable preference provisions of the Uniform Act for property/casualty insurers.

Although little has been written on whether collateral posted in a derivatives transaction may be treated as a voidable preference, regulators in New York have addressed the issue. In a May 11, 2000 Opinion, the New York Insurance Department's Office of General Counsel reviewed the issue and concluded that in connection with a derivatives transaction:

Although the particular facts of any given collateral or security arrangement may vary . . . the pledging of assets as collateral by an insurer should not be viewed as insulating those assets from attachment by the Superintendent in the event of a liquidation or rehabilitation of the insurer.

Accordingly, where an insurer has posted collateral in a derivatives transaction, the proximity of such a posting to the liquidation or receivership of the insurer (as well as knowledge and intent) may determine whether such a posting may be voided by the liquidator/receiver as a preference.

VI. RECOMMENDATIONS: CONNECTICUT INSURERS

Because Connecticut has adopted the Model Act's special protections for netting agreements and qualified financial contracts, it is inadvisable to provide in a Master Agreement that AET applies to transactions entered into with a Connecticut insurer. If a Master Agreement provides that AET does not apply, termination will not be automatic. This enables the counterparty to determine whether and when to terminate outstanding transactions with its U.S. Insurer counterparty based on the adequacy of credit support, the counterparty's strategy for unwinding hedges and entering into replacement trades, and other relevant factors.

VII. RECOMMENDATIONS: ALL OTHER U.S. INSURERS

A. Using Financial Indicators as Trigger Events

When a non-Connecticut U.S. Insurer is placed

into receivership, its derivatives counterparty generally is prohibited, by an automatic stay, an injunction issued by the receivership court prohibiting the waste of the insurer's assets, or both, from lawfully terminating outstanding transactions covered by an ISDA Master Agreement with the U.S. Insurer. To preserve termination rights in this situation, the parties can negotiate provisions to be included in the Schedule that enable the nondefaulting party to terminate transactions, or obtain other relief, when the other party is at risk of being placed into receivership, but before the receivership proceedings commence.

Some financial indicators signal imminent and severe financial distress and often are documented as Additional Termination Events permitting the counterparty to terminate all outstanding transactions with the U.S. Insurer. Other indicators signal a serious decline in the creditworthiness of a U.S. Insurer but do not necessarily signal that insolvency is imminent. Though certain events might not justify termination, they might more appropriately be included as triggers for the right to demand full collateralization of all existing exposure. Still other indicators may not reflect severe credit deterioration, but nonetheless may merit special relief such as the right to require adequate assurances of the U.S. Insurer's ability to perform its obligations – with the failure to provide such assurances being grounds for termination. All three categories are discussed below.

B. Rating Agency Downgrade or Suspension

Each year, A.M. Best Company ("Best") assigns a rating (a "Best's Rating") to the vast majority of U.S. Insurers. The Best's Rating is an important indicator of the solvency and financial health of a U.S. Insurer and, as discussed below, a downgrade or suspension of a U.S. Insurer's Best's Rating can serve as a trigger for the right to terminate or other remedies:

- **Significant Downgrade of Best's Rating.**

The parties can specify in the Master Agreement that a downgrade of two or more levels of the U.S. Insurer's Best's Rating (*e.g.*, B+ to B- in one or more steps) since entering into the Master Agreement entitles the counterparty to terminate all outstanding transactions under the Master Agreement.

- **Suspension of Best's Rating.** The parties can specify in the Master Agreement that the suspension of the U.S. Insurer's Best's Rating (*i.e.*, assignment of a rating of "S" because the U.S. Insurer has experienced sudden and significant events affecting its balance sheet strength or operating performance whose implications cannot be evaluated due to a lack of timely or adequate information) entitles the counterparty to require the U.S. Insurer to provide adequate assurances of its ability to perform its obligations under the Master Agreement, with the failure to do so triggering the right to terminate.

C. Risk Based Capital

A second potential financial indicator is adequacy of risk based capital ("RBC").²³ Unlike ratings based triggers (*e.g.*, a rating agency downgrade or suspension), which are dependent upon a third party's determination and action, RBC is a financial measure that can be calculated using publicly available information. Generally, a U.S. Insurer's RBC is compared to its adjusted capital and surplus to determine whether the adjusted capital and surplus falls below one of four established RBC thresholds for regulatory action:

- Company Action Level RBC;
- Regulatory Action Level RBC;
- Authorized Control Level RBC; and
- Mandatory Control Level RBC.

The RBC Report states that if a U.S. Insurer's adjusted capital and surplus falls below its Authorized Control Level RBC, the U.S. Insurer's domiciliary regulator is authorized to take "whatever actions are considered necessary to protect the best interests of the policyholders and creditors of the insurer," including "the actions necessary to cause the insurer to be placed under regulatory control (*i.e.*, rehabilitation or liquidation)."

In most cases, when a U.S. Insurer's adjusted capital and surplus falls below 200% of its Authorized Control Level RBC, its adjusted capital and surplus will not meet the minimum RBC required under the NAIC's "Risk-Based Capital for Insurer's Model Act" and the U.S. Insurer will be subject to some level of regulatory attention. According to the RBC Report, as of December 31, 1997 98.5% of U.S. property/casualty insurers had adjusted capital and surplus exceeding 200% of the Authorized Control Level RBC of such insurers.

To address deterioration of adjusted capital and surplus, the parties can specify in the Master Agreement that:

- a decline in the U.S. Insurer's adjusted capital and surplus to a level below 250% of the U.S. Insurer's Authorized Control Level RBC will trigger requirements for additional collateralization; and
- a decline in the U.S. Insurer's adjusted capital and surplus to a level below 200% of the U.S. Insurer's Authorized Control Level RBC will entitle the derivatives counterparty to terminate all outstanding transactions under the Master Agreement.

There are two potential problems with the "minimum RBC level" approach. First, not all troubled insurers will fall below minimum RBC levels. Furthermore, the failure to satisfy minimum RBC levels is not always a predictor of imminent

insolvency.²⁴ The first problem suggests the need for additional financial indicators, some of which are discussed below. The second suggests that an RBC-based collateralization or termination trigger may not always be appropriate. An alternative provision would require a U.S. Insurer with a below minimum RBC level to provide adequate assurance of its ability to perform its obligations.

D. Loss Reserves to Surplus Ratio

The ratio of a U.S. Insurer's loss and loss adjustment expense reserves ("Loss Reserves") to its policyholders' surplus is another financial indicator that can be calculated using publicly available information. This ratio (the "Loss Reserves to Surplus Ratio") is applicable only to U.S. Insurers that insure against property and casualty risks.

Loss Reserves are the liability recorded by a U.S. Insurer on its financial statements to provide for the payment of its losses and related expenses. An insurance actuary examines Loss Reserves to determine their adequacy. Policyholders' surplus, the insurance company equivalent of "net worth," is the amount by which a U.S. Insurer's assets exceed its liabilities. In the event a U.S. Insurer's Loss Reserves are determined to be inadequate to pay its losses and related expenses, an appropriate amount of policyholders' surplus is reallocated to increase Loss Reserves.

Reallocation of policyholders' surplus to Loss Reserves because of adverse development can have a dramatic effect on a U.S. Insurer's financial condition. If a U.S. Insurer with \$100 million in Loss Reserves and \$50 million in policyholders' surplus (a two to one ratio) were required to increase its Loss Reserves by ten percent (\$10 million), its policyholders' surplus would decrease by one-fifth (to \$40 million). Such an insurer, if it wrote no more business (and so incurred no more

insurance exposures) could sustain only four more years of such adversity.

Because it is not unusual for a U.S. Insurer to be required to increase its Loss Reserves by ten percent, the parties may specify in their Master Agreement that an increase in the U.S. Insurer's Loss Reserves to Surplus Ratio above 2:1 will trigger a requirement for additional collateralization, and an increase above 2.5:1 will entitle the derivatives counterparty to terminate its outstanding transactions under the Master Agreement.

E. Regulatory Action Falling Short of Receivership

If an insurance regulator perceives that a U.S. Insurer is in financial difficulty, it can take regulatory action that falls short of receivership, including:

- Requiring the U.S. Insurer to file financial statements on a monthly, rather than quarterly, basis. The parties can specify in the Master Agreement that such regulatory action entitles the derivatives counterparty to require adequate assurances by the U.S. Insurer of its ability to perform its obligations under the Master Agreement, with the failure to do so constituting a termination event.
- Requiring the U.S. Insurer to reduce its premium writings. The parties can specify in the Master Agreement that such regulatory action entitles the derivatives counterparty to receive collateral or to terminate outstanding transactions, depending on the level of reduced premium writings required by the regulator.
- Requesting that a court place the U.S. Insurer in "conservation" or under "supervision." The parties can specify in the Master Agreement that such regulatory action entitles the derivatives counterparty to terminate outstanding transactions under the Master Agreement.

VIII. CONCLUSION

As the presence of U.S. Insurers in the derivatives markets increases, both as direct parties and as providers of credit enhancement, so will the importance to market participants of understanding the differences between the rules that generally apply to noninsurer bankruptcies and those that apply to U.S. Insurer receiverships. Of course, the terms and structure of derivatives transactions depend on the parties involved and the facts and circumstances of the particular deal. Nonetheless, both U.S. Insurers and their derivatives counterparties increasingly will be called on to consider whether one or more of the provisions and remedies discussed above are appropriate for inclusion in their Master Agreement. Both U.S. Insurers and their counterparties will benefit from carefully considering the ramifications of various alternatives and including appropriate language based upon the provisions of the state insolvency law applicable to the transactions in question.

This article was produced on June 23, 2004. The authors take no responsibility for any changes in the law that may have occurred, or any additional information that may have become available, after the date of this article.

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1. 12 U.S.C. §§ 1811-1835a.
2. N.Y. BANKING LAW §§ 1-9019.
3. 11 U.S.C. §§ 101-1330.
4. As used in this article, unless otherwise specified, the term "ISDA Master Agreement" refers to both the form of master agreement published by ISDA in 1992 and the form of master agreement published in 2002.
5. This article does not address potential issues relating to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 or the Federal Deposit Insurance Corporation Improvement Act.
6. Section 109 of the Bankruptcy Code specifically provides that a "domestic insurance company" and a "foreign insurance company . . . engaged in such business in the United States" may not be a Bankruptcy Code debtor either for purposes of liquidation (11 U.S.C. § 109(b)(2) and (3)) or reorganization (11 U.S.C. § 109(d)). It appears that section 109 of the Bankruptcy Code does not exclude a foreign insurance company not "engaged in such business in the United States" from being a debtor under the Bankruptcy Code.
7. In addition, many state insolvency laws applicable to U.S. Insurers have been based, in whole or in part, on the Uniform Insurers Liquidation Act of 1939 (the "Uniform Act"). Nearly every United States jurisdiction has enacted a version of the Uniform Act that has been modified, in some respect, by the Model Act.
8. Section 10 of the Model Act.
9. Section 11 of the Model Act.
10. Section 17 of the Model Act.
11. Section 20 of the Model Act.
12. Under section 3 of the Model Act, 'Netting agreement' means a contract or agreement (including terms and conditions incorporated by reference therein), including a master agreement (which master agreement, together with all schedules, confirmations, definitions and addenda thereto and transactions under any thereof, shall be treated as one netting agreement), that documents one or more transactions between the parties to the agreement for or involving one or more qualified financial contracts and that provides for the netting or liquidation of qualified financial contracts or present or future payment obligations or payment entitlements thereunder (including liquidation or close out values relating to such obligations or entitlements) among the parties to the netting agreement.

13. Under section 3 of the Model Act, “‘Qualified financial contract’ means a commodity contract, forward contract, repurchase agreement, securities contract, swap agreement and any similar agreement that the commissioner determines by regulation, resolution or order to be a qualified financial contract for the purposes of this Act.”
14. Connecticut Insurance Code sections 38a-907 and 38a-944a.
15. Michigan is considering enacting section 46 of the Model Act.
16. Recommendation on Proposed Legislation Entitled *Uniform Receivership Law*, (Sept. 14, 1998), (unpublished, Florida Department of Financial Services).
17. The “Bankruptcy” Event of Default under Section 5(a)(vii) of the Master Agreement is triggered by an insolvency event occurring with respect to “The party, any *Credit Support Provider* of such party or any applicable Specified Entity of such party . . .” (emphasis added).
18. The ISDA Margin Survey (previously called the ISDA Collateral Survey) for 2003 reports the following increase in the number of collateral agreements in recent years: “For the 2003 Survey, respondents report over 38,500 collateral agreements in place . . ., compared with 28,140 in the 2002 Survey, 16,000 in the 2001 Survey, and 11,000 in the 2000 Survey.”
19. An “admitted asset” is an asset an insurance company owner is permitted to recognize at a value prescribed or permitted under applicable state law.
20. Citing the Statutory Accounting Principles Statement of Concepts.
21. An insurer’s “invested assets” are those admitted assets that are most readily available to pay claims and meet other obligations of the insurer. Liquidity ratios and other financial ratios that measure an insurer’s ability to meet its claims obligations generally include “invested assets” as a component.
22. Section 32 provides that if a liquidation is ordered while the insurer is already subject to a rehabilitation order, the transfers are deemed to be preferences if made within one year before the filing of a successful petition for rehabilitation or within two years before the filing of a successful petition for liquidation, whichever time is shorter.
23. RBC analysis is a method of establishing the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile.
24. Vincent Laurenzano, *Balancing Capital with Risks: Risk-Based Capital Requirements for Insurers*, Best’s Rev. – Property-Casualty Ins. Ed. (June 1992).

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