

Locke Lord QuickStudy: Protecting the Parties' Rights Under Qualified Financial Contracts and Netting Agreements When an Insurer Goes Into Receivership

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As the derivative exposure of U.S. insurers continues to increase and the industry increasingly engages in derivative transactions, including Qualified Financial Contracts ("QFCs") and Netting Agreements (defined below), it is helpful to fully understand how these transactions may be impacted by State Insurance Receivership Laws. Typically, the derivative transactions are designed to hedge interest rate and other investment risk. In those instances where the insurer is financially troubled and ends up in state insurance receivership^[1], special statutory rules apply that protect the counterparties to such derivative transactions (e.g., large banks or institutional investors, "Financial Institutions")(the "Counterparty") and provide a level of certainty in the event of the insurer's receivership. Unlike under the Federal Bankruptcy Code^[2], State Insurance Receivership Laws prioritize policyholders over other creditors.

In accordance with applicable State Insurance Receivership Laws, state insurance receivers have a statutory obligation to marshal all of the insolvent insurer's assets for the benefit of policyholders and other creditors and to distribute those assets in accordance with a statutory priority scheme. Typically, assets pledged by insurers as collateral for the derivative transaction are considered "admitted assets" subject to applicable insurance law and statutory accounting rules. The pledged collateral is disclosed in the insurer's statutory financial statements. As such, state insurance receivers may attempt to recover the posted collateral from the Counterparty as part of their asset marshalling efforts for the benefit of policyholders and creditors. The special statutory rules protect the Counterparty's rights under the QFCs and Netting Agreements by providing some statutory exceptions to State Insurance Receivership Laws whereby the state insurance receiver has broad statutory powers to collect and marshal the insurer's assets.

By way of background, the [NAIC](#) describes current insurance industry's derivative exposure as follows:

The amount of U.S. insurers' derivative exposure, as measured by the notional value, was \$3 trillion as of year-end 2021, an increase of 6.2% compared to year-end 2020. Life companies accounted for 98.3% of the industry's notional value of derivatives exposure at year-end 2021, followed by P/C companies which accounted for 1.7% of the notional value.

Swaps were the largest derivative type reported by insurers in 2021, accounting for approximately 50.6% of total derivative exposure or \$1.5 trillion, a 3% notional value increase over the previous year. Options (the second largest derivative type) increased to 40.1% (\$1.2 trillion) of the total notional value of derivative exposure as of

year-end 2021, a notional value increase of 12%. Futures and Forwards represented 5.8% and 3.5%, respectively, of the total notional value of derivative exposure.

The current NAIC Insurance Receivership Model Act has a provision (*i.e.*, Section 711) that was added to specifically address derivative transactions. Consistent with the Model Act, almost half of the States have enacted State Insurance Receivership Laws governing the QFCs and Netting Agreements in the event of the insurer's insolvency.^[3] Typically, state insurance receivers deal with International Swaps and Derivatives Association Master Agreements and related Credit Agreements that require the insurer to post collateral in support of the QFCs and Netting Agreements.^[4] These special rules enacted in the State Insurance Receivership Laws are intended to "level the playing field" so that Counterparties are able to enforce their contractual rights under QFCs and Netting Agreements if the insurer goes into state insurance receivership. Absent the special rules, Counterparties are prevented from enforcing their rights except in the receivership proceedings before the receivership court consistent with the State Insurance Receivership Laws. The ability to enforce rights in the receivership promotes assurances that that QFCs and Netting Agreements are priced at reasonable market values notwithstanding the insurer's potential insolvency or financial condition.

Section 711 of the Insurer Receivership Model Act^[5] provides important protections or a "safe harbor" for those Counterparties entering into QFCs and Netting Agreements with insurers. Many States also have enacted the same or similar provisions in their State Insurance Receivership Laws. These Laws are similar to the same provisions in the Federal Bankruptcy Code and the Federal Deposit Insurance Act.

Section 711 of the Insurer Receivership Model Act (and related enacted state insurance receivership laws) provides, among others, the following protections:

- The State Insurance Receivership Law "safe harbor" provisions allow Counterparties to net the various agreements and realize the collateral notwithstanding the normal anti-suit injunctions imposed in the insurer's receivership order. The typical anti-suit injunction prevents creditors and other persons from asserting any claims or causes of action against the receiver ("standing in the insurer's shoes" by operation of law), except within the receivership court proceedings.
- Prevent Counterparties from being stayed or prohibited from exercising a contractual right in any QFC or Netting Agreement to resolve the obligations due to the insurer's insolvency, financial condition or default, any right under a security agreement or other credit enhancement relating to one or more QFCs or Netting Agreements, or any right to set off or net out any transfer obligation arising under one or more QFCs or Netting Agreements.
- In a transfer of amounts owed by an insolvent insurer to QFC and Netting Agreement counterparties, the state insurance receiver is required to transfer all of the Netting Agreements or QFCs and all of the property and credit enhancements securing claims under the Netting Agreements or QFCs. This prevents "cherry picking" by the receiver and requires that everything be transferred.

In reviewing the documentation in connection with derivative transactions, the parties to the agreements should understand the applicable definitions and related scope of the applicable State Insurance Receivership Laws. For example, Section 104 of the Insurer Receivership Model Act defines certain derivative transaction terms, including:

(Q)(1) "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, liquidation, setoff, termination, acceleration or close out under or in connection with one or more qualified financial contracts or present or future payment or delivery obligations or payment or delivery entitlements thereunder (including liquidation or close-out values relating to such obligations or entitlements) among the parties to the netting agreement; (2) any master agreement or bridge agreement for one or more master agreements described in Paragraph (1) of this subsection; or (3) any security agreement or arrangement or other credit enhancement or guarantee or reimbursement obligation related to any contract or agreement described in Paragraph (1) or (2) of this subsection; provided that any contract or agreement described in Paragraph (1) or (2) of this subsection relating to agreements or transactions that are not qualified financial contracts shall be deemed to be a netting agreement only with respect to those agreements or transactions that are qualified financial contracts.

(W) Qualified Financial Contract as:

any 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.

These State Insurance Receivership Laws also govern when a state insurance receiver may avoid a transfer in connection with a QFC or a Netting Agreement under applicable voidable preference and fraudulent transfer laws. Counterparties should be aware of the state insurance receiver's broad statutory powers as well as the statutory limitations, including the "safe harbor" in the special rules.

We frequently see these issues arise in negotiations and documentation of new QFCs and Netting Agreements and related credit and security agreements. It is important to ensure that the representations and warranties in such agreements address these issues consistent with applicable State Insurance Receivership Laws. Additionally, for those derivative transactions entered into prior to the enactment of the special rules, both parties to the agreements should be aware of the protections under those rules in the event of the insurer's receivership.

Please contact [Paige D. Waters](#) or [Stephanie O'Neill Macro](#) if you have any questions or if we can be of any assistance.

[1] Insurers are exempt from the Federal Bankruptcy Code. 11 U.S. Code § 109. Insurers are subject to state insurance receivership laws in their states of domicile.

[2] 11 U.S. Code § 101.

[3] ? See e.g., Ariz. Rev. Stat. § 20-637; Colo. Rev. Stat. § 10-3-540.5; Conn. Gen. Stat. § 38-423 and ??§ 38a-944; Del. Code Ann. tit. § 5901 and § 5933; 215 ILCS 5/187 and 206.1; Ind. Code § 27-9-??3.1-6 and § 27-9-3.1-11 et seq.; Iowa Code § 507C.2 and § 507C.28A; Kan. Stat. Ann. § 40-??3607 and § 40-3659; Me. Rev. Stat. Ann. tit. 24-A § 4353 and § 4387; Md. Code Ann., Ins. § 9-??229.1; Mass. Gen. Laws Ann. ch. 175, § 180A and § 180L 1/2; Mich. Comp. Laws § 500.8115a; ?Minn. Stat. § 60B.03; Mo. Rev. Stat. § 375.1152, § 375.1155,

and § 375.1191; Neb. Rev. Stat. § 44-4803 and § 44-4830.01; N.J. Stat. Ann. § 17B:32-92; N.Y. Ins. Law § 7437; Ohio Code Ann. §§ 3903.01 and § 3903.301; Tenn. Code Ann. §56-9-103 and § 56-9-338; Tex. Ins. Code § 443.004 and § 443.261; Utah Code Ann. § 31A-27a-102, § 31A-27A-108, and § 31A-27a-611; Va. § 38.2-1501 and § 38.2-1522; and Wisc. Stat. § 645.675.

[4] Capitalized terms not defined here in are typically defined in the relevant State Insurance Receivership Laws.

[5] NAIC Insurance Receivership Act, Model # 55.

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