

Legislative Analysis



NAIC REGULATION ON NETTING AGREEMENTS AND QUALIFIED FINANCIAL CONTRACTS

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House Bill 5930 as introduced
Sponsor: Rep. David Robertson
Committee: Insurance

Complete to 6-9-04

A SUMMARY OF HOUSE BILL 5930 AS REPORTED FROM COMMITTEE 6-2-04

The bill would amend Chapter 81 of the Insurance Code (MCL 500.8115a) to adopt Section 46 of the Insurers Rehabilitation and Liquidation Model Act developed by the National Association of Insurance Commissioners. It also would import related definitions from other sections of the NAIC model act. Chapter 81 of the code addresses the supervision, rehabilitation, and liquidation of insurance companies.

The provisions deal with “netting agreements” and “qualified financial contracts” (defined later). The bill would specify that, notwithstanding any other provision in the Insurance Code, no person could be stayed or prohibited from exercising a contractual right to terminate, liquidate, or close out any netting agreement or qualified financial contract with an insurance company because of 1) the insolvency, financial condition, or default of the insurer (provided the right was enforceable under applicable law other than the Insurance Code); or 2) the commencement of a formal delinquency proceeding under the code.

Further, a person could not be stayed or prohibited from exercising 1) any right under a pledge, security, collateral or guarantee agreement or any other similar security arrangement or credit support document relating to a netting agreement or qualified financial contract; or 2) subject to Section 8130 (2), any right to set off or net out any termination value, payment amount, or other transfer obligation arising under or in connection with a netting agreement or qualified financial contract where the counterparty or its guarantor is organized under the laws of the United States or a state or foreign jurisdiction approved by the Securities Valuation Office (SVO) of the NAIC as eligible for netting.

(See Background Information for current Insurance Code provisions in Chapter 81 regarding stays of proceedings and actions.)

Upon termination of a netting agreement, the net or settlement amount, if any, owed by a non-defaulting party to an insurer against which an application or petition has been filed under Chapter 81 would be transferred to (or on the order of) the receiver for the insurer, even if the insurer is the defaulting party, notwithstanding any provision in the netting

agreement that may provide that the non-defaulting party is not required to pay any net or settlement amount due to the defaulting party upon termination. Any limited two-way payment provision in a netting agreement with an insurer that has defaulted would be deemed to be a full two-way payment provision as against the defaulting insurer. Any such property or amount would be a general asset of the insurer (except to the extent it is subject to one or more secondary liens or encumbrances).

[The NAIC “drafting note” regarding the previous paragraph says: *This provision requires that, upon termination of a netting agreement, the non-defaulting party will be required to pay to the defaulting party (the insurer) any net or settlement amounts owed to the insurer, notwithstanding any provision in the netting agreement that provides that the non-defaulting party is not required to make such payments to the defaulting party. In short, this provision renders “limited two-way payment” provisions in master swap agreements unenforceable as against a defaulting insurer.* Underlining added]

In making any transfer of a netting agreement or qualified financial contract of an insurer subject to a proceeding under the chapter, the receiver would have to either:

- 1) Transfer to one party (other than an insurer subject to a proceeding under the chapter) all netting agreements and qualified financial contracts between a counterparty or any affiliate of the counterparty and the insurer that is the subject of the proceeding, including all rights and obligations of each party under each such netting agreement and qualified financial contract; and all property, including any guarantees or credit support documents, securing any claims of each party under each such netting agreement and qualified financial contract; or
- 2) Transfer none of the netting agreements, qualified financial contracts, rights, obligations or property referred to in the paragraph above (with respect to the counterparty and any affiliate of the counterparty).

If a receiver for an insurer makes a transfer of one or more netting agreements or qualified financial contracts, then the receiver would have to use its best efforts to notify any party to the netting agreements or qualified financial contracts of the transfer by Noon (the receiver’s local time) on the business day following the transfer. For purposes of this subsection, “business day” means a day other than a Saturday, Sunday or any day on which either the New York Stock Exchange or the Federal Reserve Bank of New York is closed.

Notwithstanding any other provision of the Insurance Code, a receiver could not avoid a transfer of money or other property arising under or in connection with a netting agreement or qualified financial contract (or any pledge, security, collateral or guarantee agreement or any other similar security arrangement or credit support document relating to a netting agreement or qualified financial contract) made before the commencement of a formal delinquency proceeding under the chapter. However, a transfer could be avoided under Section 8126 of the code if the transfer was made with actual intent to hinder,

delay or defraud the insurer, a receiver appointed for the insurer, or existing or future creditors.

In exercising any of its powers under the chapter to disaffirm or repudiate a netting agreement or qualified financial contract, the receiver would have to take action with respect to each netting agreement or qualified financial contract and all transactions entered into in connection therewith, in its entirety. Notwithstanding any other provision of the chapter, any claim of a counterparty against the estate arising from the receiver's disaffirmance or repudiation of a netting agreement or qualified financial contract that has not been previously affirmed in the liquidation or immediately preceding rehabilitation case would have to be determined and allowed or disallowed as if the claim had arisen before the date of the filing of the petition for liquidation or, if a rehabilitation proceeding is converted to a liquidation proceeding, as if the claim had arisen before the date of the filing of the petition for rehabilitation. The amount of the claim would be the actual direct compensatory damages determined as of the date of the disaffirmance or repudiation of the netting agreement or qualified financial contract. The term "actual direct compensatory damages" would not include punitive or exemplary damages, damages for lost profit or lost opportunity or damages for pain and suffering, but would include normal and reasonable costs of cover or other reasonable measures of damages used in the derivatives market for the contract and agreement claims.

[The NAIC model contains the following drafting note about the previous paragraph: *The intended effect of this provision is that, except where the receiver has expressly affirmed a netting agreement or qualified financial contract, the claim of a counterparty against the estate of an insolvent insurer (after completion of the netting and setoff processes) will have no greater priority than the claim of a general creditor.*]

The bill specifies that its provisions would not apply to affiliates of the insurance company that is the subject of the proceeding.

All rights of counterparties under this act would apply to netting agreements and qualified financial contracts entered into on behalf of the general account or separate accounts if the assets of each separate account are available only to counterparties to netting agreements and qualified financial contracts entered into on behalf of that separate account.

Definitions. A "qualified financial contract" is defined in the bill as a commodity contract, forward, contract, repurchase agreement, securities contract, swap agreement, and similar agreement determined by the commissioner of OFIS (by regulation, resolution, or order) to be a qualified financial contract for the purposes of Chapter 81. A "netting agreement" is defined, generally, as a contract or agreement that documents one or more transactions between the parties to the agreement 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).

BACKGROUND INFORMATION:

Stays Under Section 8115 of the Insurance Code. Currently, Section 8115 of the Insurance Code requires a court to stay a legal action or proceeding for 90 days when a rehabilitation order has been entered against an insurance company that is a party (or is obligated to defend a party) to the action or proceeding. The stay can be for a longer time if needed for the rehabilitator to obtain property representation and prepare for further proceedings. The code allows the rehabilitator to take actions regarding the pending litigation that he or she considers necessary in the interests of justice and for the protection of creditors, policyholders, and the public. Section 8115 also grants a guaranty association covering life or health insurance or annuities standing to appear in a court proceeding about the rehabilitation of a life or health insurer if the association is, or may become, liable to act as a result of the rehabilitation.

Purposes of the Chapter 81. The Insurance Code says that the purpose of Chapter 81 is the protection of the interests of insureds, claimants, creditors and the public with minimum interference with the normal prerogatives of the owners and managers of insurers, through the following:

- 1) Early detection of potentially dangerous conditions in an insurer and prompt application of appropriate corrective measures;
- 2) Improved methods for rehabilitating insurers, involving the cooperation and management expertise of the insurance industry;
- 3) Enhanced efficiency and economy of liquidation to minimize legal uncertainty and litigation;
- 4) Equitable apportionment of unavoidable loss;
- 5) Lessening the problems of interstate rehabilitation and liquidation by facilitating cooperation between states in the liquidation process and by extending the scope of personal jurisdiction over debtors of the insurer outside this state; and
- 6) Regulation of the insurance business relating to delinquency procedures and rules on the entire insurance business.

POSITIONS:

Representatives of the following indicated support for the bill to the House Insurance Committee: Jackson National Life Insurance; the American Council of Life Insurers; the Life Insurance Association of Michigan; and Prudential Insurance. (6-2-04)

The Office of Financial and Insurance Services (OFIS) does not yet have a position on the bill, although it is under examination by staff; and suggested to the House Insurance Committee that there should be no pressing need to pass what is a highly complicated bill until it is better understood. (6-2-04)

Legislative Analyst: Chris Couch

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.