

# ENFORCEABILITY OF OTC DERIVATIVE TRANSACTIONS AGAINST INSOLVENT INSURANCE COMPANIES

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The insolvency of an insurance company that is a party to a derivative agreement or transaction<sup>2</sup> may create legal uncertainties with respect to the enforceability of early termination and netting provisions commonly used in such agreements and transactions. This uncertainty arises from the fact that insurance companies are regulated primarily under state law,<sup>3</sup> and thus, protections provided by federal law to parties engaging in derivative transactions with general U.S. business corporations/partnerships and/or with financial institutions are not available when engaging in such transactions with insurance company counterparties that become insolvent. Model provisions that would provide certain protections to counterparties to derivative transactions with insolvent insurance companies have been proposed by the National Association of Insurance Commissioners (“NAIC”) but not yet enacted or adopted by any state.

## **Certainty in Non-Insurance Settings.**

Three federal laws provide a large degree of certainty with respect to the enforceability of early termination and netting rights under OTC derivative agreements with general U.S. business corporations/partnerships (those other than financial institutions and insurance companies) and financial institutions. The U.S. Bankruptcy Code provides such certainty with respect to swap agreements<sup>4</sup> by providing an exception to the automatic stay, which otherwise is imposed upon the filing of a petition in bankruptcy,<sup>5</sup> to allow setoffs,<sup>6</sup> the realization of any collateral position,<sup>7</sup> and termination and net out settlements.<sup>8</sup> The U.S. Bankruptcy Code, however, specifically excludes insurance companies from its scope.<sup>9</sup> Similarly, certainty for financial institutions is provided by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”)<sup>10</sup> and the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”),<sup>11</sup> which recognize the enforceability of early termination and netting provisions in derivative agreements involving financial institutions.<sup>12</sup> Again, these provisions generally are not applicable to insurance companies.<sup>13</sup> Thus, the general certainty of the enforceability of early termination and netting rights that is created by the U.S. Bankruptcy Code, FIRREA and FDICIA does not provide comfort in connection with derivative agreements involving insurance companies.

## **Uncertainty in Insurance Insolvency Proceedings.**

The 1991 insolvency of Mutual Benefit Life Insurance Company (“MBL”) has been a focal point in discussions involving the rights of counterparties to derivative agreements involving insolvent insurance companies. As discussed below, however, the MBL rehabilitation generally should not be a source of concern regarding enforceability of derivative agreements. Instead, uncertainty arises largely from the failure of the states to adopt provisions that correspond to recent amendments adopted by the NAIC to its Insurers Rehabilitation and Liquidation Model Act (the “NAIC Model Act”), which are similar to the protections provided by the U.S. Bankruptcy Code, FIRREA and FDICIA, as well as from the imprecise language of certain state insolvency statutes.

### **1. MBL as a Case Study.**

In late 1986, MBL entered into three separate interest rate swap agreements with Citibank, N.A.; Bankers Trust Company; and Morgan Guaranty Trust Company of New York (collectively, the “Swap Banks”). On July 16, 1991, MBL was placed into rehabilitation pursuant to New Jersey state law. As of July 16, 1991, MBL had obligations of approximately \$55 million to the Swap Banks under the swap agreements. On December 23, 1991, the swap agreements were officially terminated, with MBL owing a total of \$113.5 million. MBL’s liability to the Swap Banks had increased by \$58.5 million from July 16 to December 23.

The MBL rehabilitation plan was filed on August 3, 1992, days after passage of legislation based on the NAIC

Model Act (without the 1997 amendments to the NAIC Model Act discussed in subsection B.2 below) in New Jersey (the “New Jersey Act”).<sup>14</sup> On August 12, 1993, the New Jersey Superior Court approved the rehabilitation plan for MBL and declared the retroactive application of the New Jersey Act constitutional.

In an unexpected move, the New Jersey Superior Court divided the Swap Banks’ aggregate claims against MBL into two categories. The Court placed the Swap Banks’ pre-July 16, 1991 aggregate claims (\$55 million) with the claims of general creditors in Class 4 of the new New Jersey priority scheme.<sup>15</sup> However, the Court gave the Swap Banks’ post-July 16, 1991 aggregate claims (\$58.5 million) the highest priority as an “administrative claim,” a Class 1 claim that is paid out even before policyholder claims. The Court found that the MBL rehabilitator intentionally kept the swap agreements in effect after July 16, 1991 because the rehabilitator believed interest rates would rise and thus decrease the size of MBL’s liability to the Swap Banks. The rehabilitator’s action in “assuming” the swap agreements constituted an “affirmation” of an executory contract, entitling the Swap Banks’ claims to be treated as administrative expenses in the MBL estate.

The MBL rehabilitator never challenged the ability or right of the Swap Banks to terminate the swap agreements or to exercise their netting rights. Rather, the issues surrounding the swap agreements concerned only the MBL rehabilitator’s and Swap Banks’ activities to keep the swap agreements in effect following the July 16, 1991 Order of Rehabilitation, which were construed as amounting to an affirmation of the swap agreements. The opinion of the New Jersey Superior Court implicitly recognizes the Swap Banks’ netting rights, as the aggregate claims were ultimately valued on a “net” basis.

## 2. NAIC Model Act.

State statutes governing the insolvency of insurance companies have been in existence since the turn of the century. One of the goals of the NAIC has been the development of more uniform state laws concerning insurance, including statutes that govern the rehabilitation and liquidation of insolvent insurance companies. The NAIC Model Act was adopted in 1977, for the purpose of presenting a viable scheme to govern insurance company rehabilitations and liquidations for consideration and adoption by the separate states. The NAIC Model Act has been amended numerous times since its adoption, including most recently in December 1997. The 1997 amendments to the NAIC Model Act were modeled after the federal laws that provide protections for parties to derivative transactions and expressly recognize termination and close out rights of counterparties to derivative transactions with insurance companies that are insolvent or involved in rehabilitation or liquidation proceedings. The 1997 amendments to the NAIC Model Act also recognize the right of certain counterparties to derivative transactions with insurance companies to setoff or net out obligations arising under or in connection with such transactions.

A derivative transaction falls within the protections of the NAIC Model Act by being either a “qualified financial contract” or a “netting agreement.” The NAIC Model Act defines the term “qualified financial contract” to include commodity contracts, forward contracts, repurchase agreements, securities contracts, swap agreements, and any similar agreements that the insurance commissioner determines to be a qualified financial contract.<sup>16</sup> (This definition is, and as noted in the Model Act, intended to be consistent with definitions applicable under federal laws in insolvencies of financial institutions.)<sup>17</sup> A “netting agreement” is defined in the NAIC Model Act as a contract or an agreement that documents one or more transactions between the parties “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.”<sup>18</sup> (Although the NAIC Model Act does not refer specifically to FDICIA as a source for this definition, the approach in the NAIC Model Act is quite similar to that in FDICIA, i.e., in each case the definition is based on the existence of a netting provision rather than on an enumeration of specific types of derivative agreements.)

The NAIC Model Act provides for an “automatic stay,” similar to the automatic stay provided in the U.S. Bankruptcy Code, that prohibits “transaction of further business,” “transfer of property,” etc. upon the filing

of a petition for conservation, rehabilitation or liquidation of an insurance company.<sup>19</sup> The 1997 amendments to the NAIC Model Act provide that no provision of the NAIC Model Act, including the automatic stay provision, or other state law prohibits a counterparty to a qualified financial contract or netting agreement from exercising any “contractual right to terminate, liquidate or close out” such contract or agreement with an insurer because of “[t]he commencement of a formal delinquency proceeding” (a rehabilitation or liquidation but not a conservation) with respect to or the “insolvency, financial condition or default of” the insurer.<sup>20</sup> These amendments also provide that no provision of the NAIC Model Act or other state law prohibits a counterparty from exercising 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.”<sup>21</sup> Finally, the 1997 amendments to the NAIC Model Act provide that, subject to requirements otherwise applicable to setoffs,<sup>22</sup> no provision of the NAIC Model Act or other state law prohibits any right to setoff 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” if the counterparty (or its guarantor) is organized (i) under U.S. law, or (ii) under the laws of a state or foreign jurisdiction approved by the Securities Valuation Office (“SVO”) of the NAIC as a party eligible for netting with insurance companies.<sup>23</sup> As of July 1998, the SVO has determined that any counterparty domiciled within the United States or in one of eight approved foreign jurisdictions is eligible for netting of exposures with insurance companies.<sup>24</sup>

Although the 1997 amendments to the NAIC Model Act provide some protection to counterparties to derivative transactions with insurance companies, the protection is not as broad as the protection afforded under the federal laws discussed above. First, Section 46 of the NAIC Model Act does not apply to counterparties which are affiliates of an insurance company that is the subject of a delinquency proceeding.<sup>25</sup> Second, the exemption from an automatic stay for the exercise of termination or close out rights under a netting agreement or qualified financial contract does not apply to a stay imposed in connection with a conservation proceeding, but only to stays imposed in rehabilitation and liquidation proceedings. Finally, counterparties which are not organized under U.S. law or the laws of a jurisdiction approved by the SVO do not qualify, without a special determination of the SVO, for the exemption from the automatic stay for the exercise of setoff and net out rights with an insurer in delinquency proceedings.

The exemption in the NAIC Model Act to stays imposed in insurance company rehabilitation and liquidation proceedings for the exercise of termination and setoff rights under qualified financial contracts and netting agreements, if adopted by the individual states (even with the limitations to the exemption noted above), will remove much of the legal uncertainty of dealing with insurance company counterparties to derivative transactions and create some consistency with the treatment of general business corporations/partnerships under the U.S. Bankruptcy Code and financial institutions under FIRREA and FDICIA. Until such adoption, however, uncertainty will continue to exist. A number of state insurance law provisions that may be particularly troublesome in these circumstances are discussed briefly below.

### **State Insurance Insolvency Statutes.**

Selected state statutes dealing with insurance company insolvencies contain provisions with respect to stays, anticipatory breach of contract, setoffs, and the power to affirm or disavow contracts. One or more of these provisions *might* be used by a rehabilitator or liquidator of an insurance company to support a challenge to a counterparty’s right to terminate or net under an OTC derivative agreement.

1. **Stay.** Most states have not yet followed the NAIC’s lead in adopting an automatic stay in the context of insurance company insolvencies. Consequently, the rights of a counterparty to a derivative transaction to exercise early termination and netting provisions are not restricted immediately upon the filing of a petition for commencement of a delinquency proceeding. However, most states do permit the rehabilitator or liquidator of an insolvent insurer to seek a stay order after or upon the filing of a petition for such a proceeding with respect to the insurer without providing an exemption from such a stay for early termination or netting rights. Thus,

in such states, counterparties to derivative transactions with insolvent insurance companies may be prohibited from exercising termination, netting or setoff rights under such transactions very shortly after delinquency proceedings with respect to such companies are begun.

2. **Anticipatory Breach.** In the context of delinquency proceedings involving an insurance company, a state regulator will secure an *ex parte* seizure order (which will include a stay).<sup>26</sup> Under some state insurance insolvency statutes, the entry of such a seizure order or a rehabilitation order cannot be construed as an “anticipatory breach” of any contract involving the insurance company.<sup>27</sup> These provisions were designed to prevent a conservation or rehabilitation order from being construed as a cancellation of insurance *policies* or similar contracts; that is, a company against which such an order is entered is only in conservation or rehabilitation, not liquidation, and the insurance coverage of the policyholders of the insurer should not be terminated. Nonetheless, in states with insolvency statutes containing such “no anticipatory breach” provisions, the conservator or rehabilitator of an insurance company operating under a seizure or rehabilitation order might argue that the provisions are applicable to all contracts of the insurer and thus, the early termination provisions of a standard OTC derivative agreement or other non-insurance related contracts of the insurer are inoperative. If such an interpretation were upheld, the automatic early termination provisions would not be triggered merely by a petition for conservation or rehabilitation of an insurance company but only by a petition for liquidation.
3. **Setoffs.** As noted in footnote 22 above, setoffs of mutual obligations with insurers in delinquency proceedings generally are permitted under Section 34 of the NAIC Model Act. The netting anticipated by standard OTC derivative documentation should meet the mutuality of time and party standards in the NAIC Model Act. Without an exemption from a stay imposed upon the filing of a petition for conservation, rehabilitation or liquidation, whether or not such stay is automatic, such setoffs must be made within the context of delinquency proceedings and thus, are likely to be completed more slowly than they would otherwise.
4. **Power to Affirm or Disavow or to Modify.** The NAIC Model Act provides certain powers to the rehabilitator of an insolvent insurer, “including but not limited to the power to affirm or disaffirm any contract to which the insurer is a party.”<sup>28</sup> A similar power is afforded to a liquidator, who is given the power “to enter into such contracts as are necessary to carry out the order to liquidate, and to affirm or disaffirm any contract to which the insurer is a party.”<sup>29</sup> Since these provisions were intended to apply to contracts in effect at the time of affirmation or disaffirmation, they could be interpreted to allow a rehabilitator or liquidator to keep a derivative agreement in force notwithstanding the existence of an early termination provision (other than one which is automatic) in the agreement. If automatic early termination provisions are in place, however, an OTC derivative transaction is terminated immediately prior to the filing of a petition for rehabilitation or liquidation, leaving no contract in effect for the rehabilitator or liquidator to affirm or disavow.

In addition to giving rehabilitators and liquidators the power to affirm or disaffirm contracts, the NAIC Model Act provides that “the rehabilitator of an insurer may, as part of a court approved plan of rehabilitation, modify or restructure the policies or contracts of insurance” of the insurer.<sup>30</sup> The subject power does not extend to other types of contracts; e.g., OTC derivative agreements. In some state insurance insolvency statutes, a rehabilitator’s power to modify contracts of an insurer in rehabilitation is not explicitly limited to contracts of insurance. Consequently, a rehabilitator in such a state could assert that an OTC derivative agreement (or other non-insurance contract) could be modified as part of a rehabilitation plan, including by deleting termination or setoff provisions from the agreement or contract. Again, the likelihood that such an approach would be taken may be reduced by including automatic early termination provisions in an OTC derivative agreement, which would cause the agreement to not be in effect at the time a rehabilitator obtains the power of contract modification.

5. **Priorities of Distribution.** The NAIC Model Act and state insolvency statutes establish a priority for the distribution to creditors of the assets of an insolvent insurance company based on certain classifications.<sup>31</sup>

Policyholder claims are typically accorded a higher priority than claims of general unsecured creditors. A counterparty to a derivative transaction would be classified as a general creditor and unlikely to receive any material amounts from the estate of an insolvent insurance company. Thus, such a counterparty may be well advised to secure collateral from those insurance company counterparties that do not possess appropriate financial or credit ratings.<sup>32</sup>

### **1992 ISDA Master Agreement.**

Until amendments corresponding to the 1997 amendments to the NAIC Model Act are adopted by the various states, the enforceability of the termination and netting provisions in the forms of standard agreements published by the International Swap Dealers Association, Inc. (“ISDA”) will remain uncertain. This legal uncertainty is similar to that which existed with respect to the enforceability of such provisions for general U.S. business corporations/partnerships and financial institutions prior to enactment of the applicable U.S. Bankruptcy Code provisions, FIRREA and FDICIA. Following is a brief review of the relevant provisions of the 1992 ISDA Master Agreement (Multicurrency - Cross Border) (“Master Agreement”) as they concern insolvent insurance company counterparties.

Section 5(a) of the Master Agreement sets forth a number of “Events of Default.” Section 5(a)(vii) specifies a number of “bankruptcy” or “insolvency” related events that constitute Events of Default. Under Section 6(a) of the Master Agreement, the non-defaulting party has the right (but not the obligation) to terminate all (but not less than all) outstanding “Transactions” (as defined in the Master Agreement) if an Event of Default has occurred *and* is continuing. Significantly, Section 6(a) permits the parties to specify (in the Schedule to the Master Agreement) that “Automatic Early Termination” will apply upon the occurrence of any Event of Default listed in Section 5(a)(vii).

If the Automatic Early Termination election is *not* made, the Transactions may only be terminated by the non-defaulting party *following* the bankruptcy or insolvency Event of Default. Consequently, a receiver, rehabilitator or liquidator of an insurance company in delinquency proceedings might argue that the powers granted under state insurance insolvency statutes to affirm or disavow contracts apply to Transactions outstanding between the parties, and that a stay order should be granted by the supervising court following the relevant event and before the non-defaulting party has terminated the Transactions.

If the Automatic Early Termination election under a Master Agreement *is* made, however, an “Early Termination Date” will occur *automatically* for all outstanding Transactions *immediately upon* the occurrence of certain of the insolvency events specified in Section 5(a)(vii) (events 1, 3, 5, 6 and, to the extent analogous thereto, 8) or *immediately prior* to the filing of an insolvency petition, i.e., a petition for conservation, rehabilitation or liquidation with respect to the insurance company counterparty.

Thus, if outstanding Transactions under a Master Agreement are automatically terminated immediately upon or prior to, as the case may be, a relevant Event of Default, a conservator, rehabilitator or liquidator of an insurance company would not be called upon to apply a stay order against the exercise of rights under or to affirm, disaffirm, modify or otherwise challenge the Master Agreement because there would be no Master Agreement remaining in effect. Consequently, the election of Automatic Early Termination would permit a non-insurance counterparty to exercise its termination and setoff rights outside of an insolvency proceeding.

Some market participants believe that the advantages of using automatic early termination provisions for derivative transactions are outweighed by potentially adverse economic consequences arising from the possibility that termination could occur without the knowledge of the non-defaulting party, leaving the nondefaulting party “naked” on underlying hedges designed to minimize risk associated with the transactions. This disadvantage may be mitigated by requiring the defaulting party to identify the non-defaulting party for adverse market movements related to the hedge.<sup>33</sup>

### *Endnotes*

1. Mr. Wylie is a partner at Katten Muchin & Zavis and the Chairman of the firm's Corporate Insurance Department.
2. A derivative is a financial instrument, contract or agreement that derives its value from reference to an underlying asset or index and transfers between the parties the economic risk associated with the ownership of or investment in that asset or index. Derivatives are traded on exchanges or over-the-counter. Derivatives traded over-the-counter ("OTC derivatives"), in contrast to those traded on exchanges, raise the issue of the credit risk of each party to the derivative transaction.
3. The McCarran-Ferguson Act, 15 U. S. C. § 1012(a), provides that "[t]he business of insurance ... shall be subject to the laws of the several states which relate to the regulation or taxation of such business" and that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance."
4. Section 101(53B) of the U.S. Bankruptcy Code, 11 U.S.C. § 101(53B), defines "swap agreement" by enumerating specific types of agreements encompassed by the term. Although the list of such agreements is extensive and includes a catch-all provision for agreements that are similar to those specifically enumerated, not all derivative transactions are encompassed by the definition. To the extent that a derivative transaction which does not fall within the definition of "swap agreement" meets the definition of a "forward contract," "securities contract" or "repurchase agreement" under the U.S. Bankruptcy Code, a party to the transaction might qualify for protections afforded to certain parties to such contracts or agreements, which are similar but not identical to the protections given to parties to swap agreements. Certain derivatives and/or certain types of counterparties, however, may not qualify for any such protections. Consequently, the U.S. Bankruptcy Code does not put to rest all uncertainty concerning the enforceability of early termination and netting rights under derivative agreements.
5. Section 362(a) of the U.S. Bankruptcy Code, 11 U.S. C. § 362(a).
6. Section 362(b)(17) of the U.S. Bankruptcy Code, 11 U.S.C. § 362(b)(17).
7. *Id.*
8. Section 560 of the U.S. Bankruptcy Code, 11 U.S. C. §560.
9. Section 109(b)(2) of the U. S. Bankruptcy Code, 11 U. S. C. § 109(b)(2).
10. P.L. 101-73, 103 Stat. 183 (codified, as amended, throughout Title 12, United States Code).
11. P.L. 102-242, 105 Stat. 2236 (codified at 12 U.S.C. §§ 4401-4407).
12. The approach used in FIRREA to ensure enforceability of termination and netting rights under OTC derivative transactions is similar to that used by the U.S. Bankruptcy Code, i.e., protections are given to stipulated types of agreements and to specific types of counterparties to such agreements. As a result, FIRREA creates the same possibility that not all derivative transactions and not all types of counterparties necessarily are covered by such protections. *See* footnote 4. In contrast, FDICIA provides that no stay shall "limit or delay application of otherwise enforceable netting contracts," including contracts with insolvent financial institutions, and defines the term "netting contract" as any contract or agreement between financial institutions (or members of a clearing organization) that is governed by the laws of the U.S. or any state or political subdivision thereof, provides for netting present or future payment obligations or entitlements among the parties and includes the rules of a clearing organization. Because the type of agreement protected from the effect of a stay depends on the inclusion of a netting provision but not on other purposes or functional aspects of the agreement, the potential exclusion through

failure to explicitly enumerate one or more types of derivative agreements is not raised by FDICIA.

13. The FIRREA protections for the enforceability of termination and netting provisions of derivative transactions apply to U.S. insured depository institutions, which do not include insurance companies. The FDICIA protections, however, apply to any “financial institution,” which is defined to include any institution determined by the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) to be a financial institution. The Federal Reserve Board issued Regulation EE (12 C.F.R. Part 231) in February of 1994, pursuant to which a person qualifies as a “financial institution” if the person represents that it will engage in qualified financial contracts as a counterparty on both the buy side and the sell side and meets certain single and aggregate contract valuation levels. This definition of “financial institution” could apply to an insurance company that satisfies the Regulation EE tests.
14. N.J.S.A. 17B: 32-31 et seq.
15. N.J.S.A. 17B: 32-71(a). The New Jersey Act provides for the distribution of assets in a priority that essentially is as follows:
  - Class 1 administrative expenses incurred by the receiver in running the estate;
  - Class 2 outstanding wages of employees due on the date of insolvency;
  - Class 3 claims of policyholders and state insurance guaranty funds;
  - Class 4 claims of general unsecured creditors; and
  - Classes 5-8 others, including stockholders.

The NAIC Model Act (Section 47) and most states have similar, though not necessarily identical, priority of distribution schemes.

Policyholder claims are the largest in number and amount in every insurance company insolvency. It is rare that general unsecured creditors, which are below policyholders in priority, receive any significant distributions out of an insolvent insurance company’s estate.

16. Section 3Q of the NAIC Model Act. In turn, each of the terms “commodity contract,” “forward contract,” “repurchase agreement,” and “security contract” are specifically defined. A “commodity contract” includes a commodity contract traded on the market; an agreement like a margin account, margin contract, leverage account or leverage contract; and a commodity option. A “forward contract” is a contract (other than a commodity contract) for the purchase, sale or transfer of a commodity or other similar good, article or interest which is the subject of dealing in the forward contract trade with a maturity date more than two days after the contract was entered into. A “repurchase agreement” is an agreement that provides for the transfer of certain items (such as certificates of deposit, eligible banker’s acceptances or securities) that are direct obligations of or fully guaranteed by the United States or a governmental agency against the transfer with a simultaneous agreement which provides for the transfer back of these items at a date not later than one year after the original transfer or on demand. A “securities contract” is a contract for the purchase, sale or loan of a security, including options on securities or options on a national securities exchange relating to foreign currencies. “Swap agreement” is broadly defined, referring to numerous kinds of derivative transactions. Section 3Q of the NAIC Model Act.
17. See the Drafting Note that follows Section 3Q of the Model Act. The Drafting Note indicates that it is not the intention of Section 3Q to affect the scope of permissible investments of insurers or the valuation of such investments, or to modify any other regulatory framework applicable to investments of insurers.
18. Section 30 of the NAIC Model Act.
19. Section 5A(1) of the NAIC Model Act. Prior to the adoption of the automatic stay provisions in 1994, the NAIC Model Act provided that a receiver or liquidator of an insurance company was empowered to seek a stay order from

the supervising court after or in conjunction with the filing of the petition with the applicable proceeding, but such an order was not automatic with the filing of such a petition.

20. Section 46A(1) of the NAIC Model Act. “Contractual right” is defined to include “any right, whether or not evidenced in writing, arising under statutory or common law, a rule or bylaw of a national securities exchange, national securities clearing organization or securities clearing agency, a rule or bylaw, or a resolution of the governing body, of a contract market or its clearing organization, or under law merchant.” Section 46G of the NAIC Model Act.

“Limited two-way payment” provisions (stipulating that the non-defaulting party is not required to make any payment of net amounts due the defaulting party) following termination, however, are unenforceable under the NAIC Model Act. Drafting Note following Section 46B of the NAIC Model Act.

21. Section 46A(2) of the NAIC Model Act.
22. Section 34 of the NAIC Model Act permits setoffs of obligations with insurance companies in insolvency proceedings only if the obligations are mutual, and prohibits setoffs against obligations that would not create a claim against the insurer, were created for the purpose of being used as a setoff, or are owed to an affiliate of the insurer or other party, as applicable.
23. Section 46A(3) of the NAIC Model Act.
24. Purposes and Procedures Manual of the NAIC Securities Valuation Office (“Purposes and Procedures Manual”), Part Nine. The eight foreign jurisdictions approved by the SVO are Australia, Canada, England, France, Germany, Japan, Singapore, and Switzerland. Purposes and Procedures Manual, Appendix, Section 7. Other jurisdictions may be approved by the SVO following a determination that there is “adequate legal certainty that upon default of the counterparty, close-out netting could be enforceable.” Purposes and Procedures Manual, Part Nine.

A counterparty that is not organized under U.S. law or under the laws of a jurisdiction approved by the SVO should *not* be prohibited altogether from setoffs with an insolvent insurance company, since Section 34 of the Model Act still applies to such counterparty, but merely will not be permitted to make such setoffs outside the delinquency proceedings.

25. Section 46G of the NAIC Model Act.
26. *See, e.g.*, Section 10 of the NAIC Model Act.
27. *See, e.g.*, Section 10D of the NAIC Model Act.
28. Section 18F of the NAIC Model Act.
29. Section 24A(13) of the NAIC Model Act.
30. Section 18F of the NAIC Model Act.
31. *See, e.g.*, Section 47 of the NAIC Model Act.
32. Secured creditors of an insolvent insurance company are entitled to foreclose on the security to satisfy the obligation. *See, e.g.*, Section 45 of the NAIC Model Act.
33. The risk of adverse market movements related to hedges maintained against outstanding derivative transactions

is to be distinguished from potential adverse movements in the market underlying the derivative transactions themselves. In an effort to address the latter, the Master Agreement provides for payment on early termination as of the “Early Termination Date” or as soon thereafter as is reasonably practicable. Moreover, where outstanding transactions are terminated pursuant to Automatic Early Termination, Section 6(e)(iii) of the Master Agreement provides for adjustments to the final net payment to reflect any payments that may have been made during the period between the Early Termination Date and the date payment is otherwise required to be made pursuant to Section 6(d)(ii) of the Master Agreement (because the party making the payment was not yet aware the transactions had been automatically terminated).