

A Look At Credit Agreements In Insurance: Part 1

By **Daniel Rabinowitz and David Berg**

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Not all loan parties are the same: depending on the industry in which they operate, they will be subject to different laws, regulations and market conditions. Insurance companies or insurance holding companies are especially subject to a tangle of such complications, and they therefore need specialized provisions in their credit agreement.

This article explains how to modify certain representations and warranties, conditions, and events of default of a standard credit agreement to account for a borrower that is an insurance company or an insurance holding company. This article includes examples that illustrate, but are not necessarily exhaustive of, the specific types of provisions that may be appropriate for such a borrower. Next, we'll take a look at the negative and financial covenants in these agreements.

At the outset, in structuring these transactions, lender's counsel should be aware that, as a general matter, unsecured loans made to an insurance company or an insurance holding company will be subordinated by law to insurance policy claims. In all U.S. jurisdictions insurance policy claims rank senior to unsecured bank debt and other general, unsecured creditor claims in a liquidation proceeding. Where the borrower is an insurance holding company that relies on its operating subsidiary for liquidity, bank debt would be structurally subordinated to policy claims at the subsidiary level. We would note also that where you are lending to such an insurance holding company, you should be mindful of regulatory restrictions on the subsidiaries' ability to distribute profits up to the borrower as a dividend.

Representations and Warranties

An insurance company or, to a lesser extent, an insurance holding company is subject to a regime of state law rules and regulations not applicable to other borrowers. For this reason, a standard set of representations and warranties may be insufficient, or inappropriate, for this kind of borrower.

Compliance with Laws

As lender's counsel, you should ensure that the representation on compliance with applicable laws covers insurance-specific, standard-setting bodies such as the National Association of Insurance



Daniel Rabinowitz



David Berg

Commissioners (NAIC) and, where applicable, supranational bodies such as the European Union. This representation typically covers compliance with “laws,” “requirements of law,” or an equivalent term, the definition of which begins with a litany of types of legal mandates (e.g., federal, state, local and foreign statutes, treaties, rules, guidelines, regulations, ordinances, codes, and administrative or judicial precedents). The overall term “law” or the equivalent will then be defined to mean these types of mandates promulgated by a defined “governmental authority.” Lender’s counsel should make sure the NAIC and/or other appropriate bodies are included in this latter definition. For example:

any nation or government, any state or other political subdivision thereof, any agency, authority, instrumentality, regulatory body, court, central bank or other entity exercising executive, legislative, judicial, taxing, regulatory or administrative functions of or pertaining to government (including any supra-national body such as the European Union or the European Central Bank), any securities exchange, any self-regulatory organization (including the National Association of Insurance Commissioners).

However, as counsel for the borrower, you might resist such provisions (which are not uncommon but not necessarily customary). The argument here is that pronouncements of such bodies do not have the force of law and are often aspirational in nature. Thus, borrower’s counsel would argue that inclusion of such bodies in requirements of law may be overbroad and result in technical defaults.

Financial Statements and Accounting Standards

Lender’s counsel should consider whether GAAP is the appropriate standard in the representation covering the financial statements previously delivered by the borrower. A borrower typically represents and warrants that its financial statements “were prepared in accordance with GAAP consistently applied throughout the period covered thereby, except as otherwise expressly noted therein.” GAAP typically will still be appropriate where the borrower is an insurance holding company (as opposed to an operating insurer).

However, as lender’s counsel, you should consider whether the representation, in the case of a holding company borrower, ought to cover not only GAAP financials of the borrower but also statutory accounting-based financials of the borrower’s key insurance operating subsidiaries. In general, statutory accounting, or SAP, is a distinct accounting regime for U.S. insurers promulgated by the NAIC. It differs from GAAP in material respects. SAP tends to focus primarily on an insurer’s ability to pay policyholder obligations and related balance sheet items such as surplus and loss reserves. SAP by definition does not consolidate legal entities and measures performance and financial position only at a single entity.

In the event that the borrower is itself an insurer, it might not produce GAAP financials at all, and therefore SAP might be the only available financials on which to give representations. In that case, it is appropriate for the borrower to represent only that the financial statements “were prepared in accordance with SAP.” The term SAP can be defined as:

the statutory accounting practices prescribed or permitted by the insurance commissioner (or other similar authority) as of the date hereof in the jurisdiction of incorporation of such Subsidiary for the preparation of annual statements and other financial reports by insurance companies of the same type as such Subsidiary

Avoiding a Reserve Inadequacy MAE

Borrower's counsel might seek to allocate to the lender all or part of the risk associated with the adequacy of borrower's posted reserves. Generally, "reserves" refers to liabilities on the balance sheet, actuarially determined by the insurer itself, in respect of its insurance-related obligations under policies it has issued. There is always a risk that, even when reserves have been professionally calculated, the amount of reserves held on the balance at a given time are insufficient to absorb losses that occur (for instance, in the event of an unpredicted catastrophic event causing widespread property damage). When this happens, reserves may have to be "strengthened" (i.e., additional liabilities posted), surplus may otherwise be adversely affected, and/or a charge to earnings may be incurred. If such consequences are serious enough, they could rise to the level of a material adverse effect (MAE) for purposes of a representation, covenant or condition, depending on how MAE is defined. This could result in an event of default even where the borrower has determined and is maintaining reserves in a manner well within industry standards.

A borrower might take the position that, as long as generally accepted actuarial standards have been applied in the determination of its reserves (which is a representation that should be unobjectionable to an insurer), and/or financial covenants are being observed, the borrower should not bear the sole risk of losses exceeding reserves. Accordingly, the lender should bear at least part of this risk by virtue of having loaned funds to an insurance company, whose business is by its nature dependent on future events. Such an allocation of risk might be drafted by including a proviso such as one of the following in the definition of material adverse effect:

provided that, so long as no violation of the covenants contained in Section [reference to financial covenant section of credit agreement] shall have occurred and be continuing as a result thereof, the occurrence of losses that give rise to or result in Excess Catastrophe Losses shall not be deemed to have a Material Adverse Effect.

provided, that solely for purposes of determining whether a Material Adverse Effect has occurred at a time prior to the Closing Date, and assuming the accuracy of the [representation that reserves have been determined in accordance with accepted professional standards], a Specified Reserve Increase shall not, by itself, be deemed to constitute a Material Adverse Effect; . . . A "Specified Reserve Increase" means an increase in statutory loss reserves, loss adjustment expense reserves or contingency reserves, which, together with all other such increases occurring within 30 days of each other, equals or exceeds \$.

Events of Default

Regulated insurance companies are not eligible to be debtors under the Bankruptcy Code. Therefore, lender's counsel will want to make sure that the bankruptcy event of default picks up potential non-U.S. Bankruptcy Code proceedings, particularly liquidation and rehabilitation proceedings in a state court under state insurance law. Lender's counsel should ensure the bankruptcy events of default are drafted broadly enough to pick up such proceedings. For example, insolvency proceedings should include "liquidation, reorganization, rehabilitation, conservatorship, delinquency or other relief under any federal, state or foreign bankruptcy, insolvency, receivership, or similar law now or hereafter in effect."

Miscellaneous Provisions

Lender's counsel should keep in mind two additional cautions: One relates to consents and approvals to make sure the borrower is legally allowed to borrow (and to pay back) the loans and the other relates to possible obstacles against exercising remedies against these types of borrowers.

Conditions to Borrowing

Counsel for lenders should take into account any regulatory approvals that might be required in connection with the borrowing. Typically an insurer need not obtain approval of an insurance regulator prior to borrowing funds, but there can be exceptions. This is something that lender and its counsel need to ascertain during legal due diligence. It could be the case that a particular insurer is under heightened regulatory scrutiny because of financial distress, and that therefore the regulator does not permit any new borrowing without its consent. Some states have laws that limit the amount of secured borrowing an insurer can incur; under such laws, exceeding these thresholds might require prior regulatory approval or waiver.

The typical "enforceable obligations" representation and standard conditions in a credit agreement generally require the borrower to certify that it has received all consents prior to borrowing. In most cases lenders are satisfied with such protections. Here, however, lender's counsel should specifically attend to these requirements and be satisfied that they are met, given the heavily regulated nature of this industry.

Pledges

In a borrowing by an insurance holding company, in which the borrower is pledging its shares in downstream insurance companies as security for the borrowing, you should be mindful of regulatory requirements regarding acquisitions of "control" of insurers. It is customary for pledge and security agreements in connection with such transactions to require, as a condition to the lender's exercise of remedies, that any remedy involving a sale of the shares of the insurer shall have received prior approval from all applicable insurance regulators. This could present some significant challenges in exercising remedies against this equity and taking control of operating insurers (see Remedies Provisions [ADD LINK]). An example follows:

Without limiting the generality of the foregoing, if an Event of Default shall have occurred and be continuing, the Secured Party may exercise (i) all the rights of a secured party under the UCC ... ; provided that the right of the Secured Party to sell or otherwise dispose of an Equity Interest in any Regulated Subsidiary shall be subject to the Secured Party's or the relevant Pledgor's obtaining, to the extent necessary under applicable law, the prior approval of such sale or other disposition by the Governmental Authority having jurisdiction with respect to such Regulated Subsidiary.

As finance counsel, you should be aware of all of these issues in reviewing or drafting a credit agreement for an insurance company or insurance holding company. But given the complexity of the regulations underlying this industry, it is always a good idea to consult with a counsel experienced in these matters as early in the process as possible.

Conclusion

A standard form credit agreement is beyond impractical for these loan parties. It is unusable unless certain provisions are revised. These changes should be reflected throughout the credit agreement — here we looked at representations and warranties that reference SAP rather than GAAP and a material adverse effect that excludes specified reserve increases. In the next part of this article, we will look at how these provisions shape financial and negative covenants. This allows greater flexibility in negative covenant baskets balanced against specialized financial covenants.

Daniel A. Rabinowitz and David S. Berg are partners with Kramer Levin Naftalis & Frankel LLP in New York.

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