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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Look At Credit Agreements In Insurance: Part 2

By **Daniel Rabinowitz and David Berg**

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Credit agreements are not one-size-fits-all, and significant changes to the standard form must be made for borrowers in certain specialized industries. This is especially true of borrowers and loan parties in the insurance space. For example, in part 1 of this article, we looked at how these entities may have to prepare their financial statements using statutory accounting practices (SAP), in addition to accounting for "reserves," or insurance-related obligations under policies it has issued, on their balance sheets. We saw how these factors have to be reflected in provisions throughout the credit agreement — including representations and warranties that reference SAP rather than GAAP and a material adverse effect that excludes specified reserve increases. Now we will take a look at allowing greater flexibility in negative covenant baskets for operational reasons while balancing that with tighter financial covenants.

Daniel Rabinowitz

David Berg

Fine-Tuning Financial and Negative Covenants

As with representations and warranties, financial and negative covenants should be fine-tuned for insurance companies and insurance holding companies. These borrowers may need certain carveouts from the restrictions in credit agreements to allow them to operate — from a competitive and a regulatory standpoint. While lenders will generally agree to such allowances, they will impose additional financial covenant tests on these borrowers.

Financial Definitions

As with other borrowers, insurance companies are generally subject to financial covenants so lenders can monitor the borrower's ongoing ability to repay the loans. In fact, these tests are generally more important for insurance companies, given that these borrowers are granted more leeway in their negative covenants (see Allowances in Negative Covenants, below). Certain financial covenants are often used for insurance entities:

- a maximum leverage ratio (in this case, maximum ratio of adjusted consolidated indebtedness to adjusted total capitalization or tangible net worth of the loan parties) — and —
- a minimum tangible net worth (or similar measurement of owners' equity)

Borrower's counsel may seek to modify certain defined terms in order to make compliance with these tests less onerous. Lenders are often amenable to such changes, although negotiation is usually required on these points. Specifically, as borrower's counsel, you should try to include in tangible net worth (or consolidated net worth) so-called hybrid-capital instruments. Generally, these are securities with both debt- and equity-like features that are treated as capital by rating agencies, regulators, or others. An example of such instruments are surplus notes, which are specifically recognized under state insurance laws and SAP as part of an insurer's surplus rather than as balance sheet liabilities. Historically, surplus notes have been a key way for mutual insurers (nonstock insurers whose policyholders are effectively the equity holders of the company) to raise surplus insofar as stock issuances are legally impossible. However, stock insurers can use surplus notes too, and they are a common part of insurance company capital structure because of their familiarity to regulators and their hybrid nature.

For that reason, insurers have a good argument for including surplus notes in tangible net worth. Doing so bolsters a borrower's balance sheet for purposes of meeting the minimum tangible net worth test on its own and in creating a more favorable leverage ratio (as tangible net worth is a component of the denominator of that test). You can include hybrid-capital instruments in net worth by defining "consolidated tangible net worth" as:

> the consolidated stockholders' equity (including Hybrid Capital) of the Company and its Subsidiaries less their consolidated intangible assets, all determined on a consolidated basis as of such date in accordance with GAAP

and where "hybrid capital" is defined as:

> at any time, all subordinated securities, instruments or other obligations issued by the Company to the extent that such securities, instruments or other obligations (i) are accorded equity treatment by [rating agencies] at issuance and (ii) mature no earlier than the date which is six months after the Termination Date.

As borrower's counsel, you should correspondingly exclude hybrid instruments from the adjusted consolidated total debt prong of the test. For example, the definition of "consolidated total debt" might specifically exclude hybrid capital in the example presented above. For example:

> "Consolidated Total Debt": at any date, the aggregate principal amount of all Indebtedness of the Company and its Subsidiaries at such date, determined on a consolidated basis in accordance with GAAP; ... For the avoidance of doubt, Consolidated Total Debt shall not include Hybrid Capital.

Whether and to what extent such modifications are appropriate will hinge on the specific capital structure of the borrower and its regulatory regime. For instance, a borrower with little hybrid capital may be less insistent that such instruments be counted as equity for purposes of the credit agreement unless such borrower wants to maintain the flexibility of utilizing hybrid capital in the future.

Risk-Based-Capital Financial Covenants

Often a lender may seek to impose additional financial covenants based on risk based capital (RBC). RBC is a regulatory framework administered by the NAIC and adopted in all 50 states for most types of insurers. RBC measures the total capital of an insurer against certain benchmark thresholds of required capital, as determined by a company-specific analysis. Of the benchmarks, "Authorized Control Level"

(ACL) is the absolute minimum amount of capital that an insurer must hold based on its particular risk profile, as determined from prescribed calculations. Other benchmarks are multiples of ACL. For instance, “Company Action Level” (CAL) is two times ACL. Certain remedies are available to the regulator in the event the insurer falls below CAL, and more severe remedies are available if capital falls below ACL. Similarly, a lender may wish to include a covenant based on maintaining some minimum RBC ratio. An example of a financial covenant based on RBC is:

> Minimum Risk-Based Capital The Borrower will at all times cause each Significant Insurance Subsidiary to maintain a ratio of (a) Total Adjusted Capital (as defined in the Risk-Based Capital Act or in the rules and procedures prescribed from time to time by the NAIC with respect thereto) to (b) the Company Action Level RBC (as defined in the Risk-Based Capital Act or in the rules and procedures prescribed from time to time by the NAIC with respect thereto) of at least [xxx]%.

Finally, as borrower’s counsel, you should ensure that the credit agreement makes clear that “indebtedness” does not include any liabilities incurred by the insurer under insurance or reinsurance contracts. Such savings clauses are typical and are necessary for financial covenant compliance, unless otherwise built into the ratios. For example, you can incorporate the following exception into the definition of indebtedness:

> For the avoidance of doubt, Indebtedness shall not include the obligations of any Insurance Subsidiary under any Primary Policy, Reinsurance Agreement, Retrocession Agreement or Other Insurance Product which is entered into in the ordinary course of business.

Allowances in Negative Covenants

Insurance companies may also ask for industry-specific exemptions to the restrictions in their negative covenants. This flexibility could be critical from either a business or a regulatory standpoint — and in any event may be necessary to allow the insurance company to operate within the constraints of the credit agreement. A few significant carveouts are described below.

Prohibition against Indebtedness

In its covenant not to incur additional indebtedness, the borrower may seek a basket for letters of credit that it procures in order to secure reinsurance obligations. Here is an example of such a basket, providing for a carveout from the covenant against the incurrence of indebtedness:

> Indebtedness for letters of credit which have been issued on behalf of any Insurance Subsidiary to or for the benefit of reinsurance cedents or insurance clients in the ordinary course of business.

Alternatively, the definition of indebtedness could specifically exclude “issued, but undrawn, letters of credit which have been issued to reinsurance cedents in the ordinary course of business.”

Generally, by way of background, insurance regulatory authorities, rating agency guidance or market conditions might require a reinsurer to post collateral in support of its obligations to an insurer that obtained the reinsurance under a reinsurance arrangement that the reinsurer is providing. This insurer obtaining the reinsurance, called the “ceding” insurer or cedent, is exposed to the underlying policyholder. The pledged assets are intended to be recoverable by the ceding company in the event that the reinsurer defaults on its obligations. Therefore, a borrower which is a reinsurer subject to such collateral-posting requirements may be party to arrangements where it pledges assets in the ordinary

course to secure obligations to counterparties (thus requiring this carveout).

In addition, as a diligence matter, a lender should consider the borrower's exposures on collateralized insurance or reinsurance it has assumed and its methods of posting such collateral. In this regard, you should be aware of the regulations on "credit for reinsurance." These are the rules governing under what circumstances a cedent can record its ceded reinsurance as a valid asset, which might require that the reinsurer be licensed or otherwise qualified and/or that the reinsurer post collateral at 100 percent or some lesser portion of the ceded liability. These regulations are complex and in recent years have been evolving in many jurisdictions, both in the U.S. and elsewhere, to reflect regulatory reforms on reciprocity between jurisdictions.

Covenant against New Investments

In the covenant not to make new investments, the borrower will want appropriate carveouts for ordinary course investment portfolio activities. In general, an insurer's assets comprise investment assets held against policy obligations, making such a carveout a reasonable request by the borrower and fairly customary. However, lender's counsel should seek to limit this exception to:

- investments made pursuant to borrower's investment guidelines that lender will have seen and approved
- investments in conformity with relevant insurance laws (which impose diversification, credit quality and similar requirements) — or —
- investments below a certain dollar threshold

The extent and scope of any such exceptions are subject to negotiations based on the insurer's particular facts and circumstances. For example, a borrower that engages in active trading may require even more flexibility here.

Asset Dispositions

Borrower's counsel may seek to qualify any prohibitions on "asset dispositions" by carving out specific types of reinsurance transactions. Reinsurance of existing risks on the borrower's balance sheet is typically accompanied by a transfer of assets to the reinsurer to support such liabilities. Borrowers may engage in these transactions to meet certain financial objectives, such as risk management or improving surplus, and not primarily to divest such assets. Therefore, as borrower's counsel you should make sure these transactions are not restricted by the covenant against dispositions; lenders will be amenable to these as long as they are persuaded that these provisions are needed for the normal operation and capital management of the borrower. For example, if that covenant broadly prohibits "asset dispositions," you can revise that definition by excluding these transactions as in the following parenthetical clause:

> "Asset Disposition" means any sale, transfer or other disposition (excluding any loss portfolio transfer or any surplus relief transaction (within the meanings prescribed by SAP) through assumption, reinsurance, cancellation and rewriting of insurance business or otherwise) of any asset of a Borrower or any Subsidiary in a single transaction or in a series of related transactions ...

Conclusion

Using the same standard credit agreement provisions for all types of borrowers and guarantors hurts both the borrower and its lenders: A borrower has to be able to navigate a regulatory and business regime while operating within the confines of a credit agreement, and lenders should ensure that any exceptions and allowances are finely tuned to the borrower's needs. This is especially true of borrowers and loan parties subject to insurance regulations and market conditions. Counsel for both sides, therefore, should be familiar with these industry-specific provisions of credit agreements.

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

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