IDENTIFYING AND MINIMIZING PREFERENCE AND FRAUDULENT CONVEYANCE RISK FROM INSURER INSOLVENCIES IN CDOs

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Since 2003, almost $1.5 trillion in collateralized debt obligations ("CDOs") have been issued worldwide. Insurers are involved in CDOs in two primary ways: (a) as investors/parties; and (b) as "guarantors" of the assets on which the CDO is based. As underlying assets in CDOs lose value, the risk of a CDO default rises, and investors—including banks, brokerage firms, and insurance companies facing continued liquidity crises—look to protect their positions. The potential for insurer insolvency and liquidation creates potential peril for investors. Under certain circumstances, adding to a CDO's asset pool may (at least temporarily) prevent the deal from liquidating and locking in losses, but an insurer's contribution may be clawed back in the event of an insolvency. Similarly, if there is a financial guaranty insurer behind the assets of the CDO structure, commuting the financial guaranty insurance policy in exchange for a lump-sum payment may enhance the asset base, but it may also create a voidable transfer.

Insurers that may become insolvent pose clawback risks that must be identified by careful analysis. That analysis includes a review of timing of new transfers to the CDO, the nature of the entity making those transfers, and the obligations and financial condition of the parties to the transaction. The standards against which these transactions will be measured vary widely by jurisdiction, and the law is sparse. Experienced counsel can assist in determining the wisest course to handle the potentially insolvent insurer in these complex and difficult deliberations.

CDO STRUCTURES

As its name suggests, a "collateralized debt obligation" is a structured investment of notes backed by collateral in the form of financial assets such as corporate bonds, residential mortgage-backed securities, commercial mortgage-backed securities, or asset-backed securities. Typically, the assets are held by a special purpose vehicle that finances the purchase of assets by issuing various classes (or tranches) of debt securities and a class of equity securities. Each tranche of debt securities is separately rated on the basis of its attributes, including the tranche's priority to distribution of income from the collateral. Prioritizing payments creates a "waterfall" of distributions, with the highest-rated tranche typically entitled to full payment of interest or principal before similar categories of payments can be made to lower-rated tranches.

CDOs can be classified in various ways, including cash or synthetic, static or managed, and cash flow or market value. Each classification affects how the CDO is constructed, its business purpose, and the remedies and risks its investors have if the asset pool deteriorates in value. For purposes of this discussion, we focus on three aspects of these vehicles that can present voidable transfer issues where insurance companies are involved.

Supplemental Funding. Most CDOs require the maintenance of a certain level of assets or cash flow to provide debt service and principal protection to at least the senior tranche of issued securities. Two types of CDO have very different mechanisms for ensuring that protection, one with potentially drastic consequences for all but the senior noteholders, which may lead subordinate investors to "sweeten the pot" with additional contributions, raising the risk of clawback in the event of a subsequent insurer insolvency.

CDOs use various "coverage tests"—ratios designed to measure the ability of the available assets to service the principal and interest obligations of the CDO to its senior noteholders. In a cash flow CDO, these ratios are relatively simple comparisons of income to expenses and par value of assets to principal obligations under the notes. Shortfalls under either ratio lead to a suspension of payments to the waterfall until the ratios are met or the senior noteholders are paid in full. Once the tests are met, payments to subordinate holders resume.

In contrast, a market value CDO that fails its coverage tests not only will suspend payments to the lower tranches of debt, but may be required to liquidate its entire portfolio if it cannot bring itself into compliance with its coverage tests in a specified period of time. These types of CDOs employ coverage tests using advance rates assigned to categories of investments by the rating agencies and mark-to-market values for the financial assets. If, applying those advance rates to the mark-to-market values, the portfolio's value falls below a specified percentage of the outstanding principal amount of the CDO notes, assets must be sold and senior notes paid down to rebalance the ratio. If the portfolio value test is not satisfied within a specific period of time, many market value CDOs require that the entire portfolio must be liquidated.

Because the premature and forced sale of assets to satisfy these market value tests can lead to diminished or nonexistent returns for the lower-rated securities, particularly in a market such as that which prevails today, market value CDO transaction documents will often allow equity or subordinated security holders to contribute supplemental funds, which can be used to purchase additional assets to improve the valuation ratio and forestall liquidation of the deal. However, since the value of the CDO may nevertheless continue to deteriorate, it is critical that the supplemental contribution be irreversible. If assets purchased with a supplemental contribution are used to satisfy a ratio test, and those assets are subsequently clawed back from the deal, the senior noteholders may well be in a worse position than they would have been in had the deal liquidated when the ratio test was first failed.

Guaranteed Investment Contracts. In a synthetic or hybrid CDO, the cash raised from the sale of securities is not used to buy financial assets directly. Rather, the CDO sells credit protection with respect to a portfolio of "reference securities" in the form of credit default swaps ("CDS") or other derivatives to counterparties. In this structure, the cash raised from the sale of securities is used to buy conservative investment instruments, often guaranteed investment contracts ("GICs"), and the income generated by those investments, as supplemented by the premium paid by the credit protection buyer, is used to pay the CDO's debt service and other expenses.

GICs simply guarantee a specified rate of return on the invested amount and the return of principal. GICs generally require the GIC counterparty to maintain a minimum amount of collateral for its obligations, tied to the rating of the GIC counterparty. Although GICs are not insurance products, insurers are frequently GIC counterparties, and because their ratings fluctuate in turbulent markets, they may be contractually required to post additional collateral to support their GIC exposures. This collateral posting may create preference or fraudulent transfer risks if the insurer is in hazardous financial condition.

Commutations of Financial Guaranty Insurance Policies. Most CDOs, whether cash, synthetic, or hybrid (or, in some cases, their investors), will utilize CDS or other credit derivatives and may use some form of credit enhancement, such as financial guaranty insurance. In these instances, the insurance company stands behind the financial asset and, in the case of default, will step into the shoes of the obligor to make interest and principal payments as and when due. This insurance is written by a relatively small group of monoline insurance companies, almost all of which are New York-domiciled (Ambac, domiciled in Wisconsin, is the notable exception).

These companies took on large amounts of exposure to CDOs in the last five years and, once financial markets started to slide, began to experience extraordinary deterioration in their surplus as they strengthened the loss reserves related to their structured finance book of business. As their surplus eroded, their ratings fell. As a result, the beneficiaries of their policies—counterparties to CDS—began to review available options to reduce their exposure. One option for a financial guaranty policyholder is commutation of the policy, under which, in exchange for a payment, the policy would be terminated. If a CDO, as the credit protection seller, chooses this course to enhance its asset pool and reduce its exposure to a particular monoline, there are attendant clawback risks associated with it, and they must be recognized and guarded against.

Uncertainty in financial markets has made predicting insolvencies more difficult than ever. Large financial institutions are not immune. Thus, there is real value in attempting to "preference-proof" payments received from insurers at risk of becoming insolvent. In each of the three scenarios discussed above, there is a transfer of assets that, if made by an insurer, will be scrutinized by a subsequent receiver if the insurer is subject to insolvency proceedings in the near term. After a review of the applicable legal provisions, we will discuss how the threat of insurer insolvency should affect the decision making and documentation surrounding these different types of transfers.

PREFERENCES AND FRAUDULENT TRANSFERS

"Preferences," generally speaking, are payments made by an entity that subsequently enters into receivership, insolvency, or bankruptcy proceedings, which payments actually or may have the effect of "preferring" one creditor over others—*i.e.*, giving one creditor a greater share of its due than other similarly situated creditors. Preferences are creatures of insolvency statutes, and the statute that governs the insolvency proceedings of the entity making the payment will define which of its transfers were preferences. The consequence of having received a preference is that it can be "clawed back" by the debtor or its representative (trustee, receiver, liquidator, etc.) if it meets certain statutory criteria. "Attempting to preference-proof payments" refers to taking the steps necessary to create transactions that fall outside the technical statutory definition of "voidable preference."

"Fraudulent conveyances" are also payments by an entity at or near the point of insolvency, and although a subsequent insolvency proceeding is not necessary to obtain redress for a fraudulent conveyance, most insolvency schemes include provisions addressing fraudulent conveyances. Generally, conveyances are deemed fraudulent when they are made while the transferee is insolvent, for less than fair consideration, or with the intent of hindering creditors from collecting on their debts. As stated above, a creditor can seek to avoid a fraudulent conveyance by the debtor without the need for formal insolvency proceedings. Among the remedies available to creditors is a setting aside of the conveyance, or a "clawback."

Although federal bankruptcy laws apply to most business entities, they specifically do not apply to insurance companies. 11 U.S.C. § 109(b)(2). The business of insurance, and regulation of insolvent insurers, is governed by state—not federal—law and thus varies from state to state. *See* the McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015. However, nearly all states follow either the Uniform Insurers Liquidation Act, promulgated in 1939, or the more comprehensive Insurers Rehabilitation and Liquidation Model Act, promulgated by the National Association of Insurance Commissioners ("NAIC"). In 2006, the NAIC issued the Insurer Receivership Model Act, which has not yet been adopted by any state.

The Uniform Insurers Liquidation Act does not include provisions relating to fraudulent transfers or preferences. Thus, we review here only the Insurers Rehabilitation and Liquidation Model Act. Three sections govern or relate to preferences and fraudulent transfers in the context of insurer insolvency.

Section 29(A) addresses fraudulent transfers and provides, in part:

> Every transfer made or suffered and every obligation incurred by an insurer within one year prior to the filing of a successful petition for rehabilitation or liquidation under this Act is fraudulent as to then existing and future creditors if made or incurred without fair consideration, or with actual intent to hinder, delay or defraud either existing or future creditors.

The statute provides that such fraudulent transfers may be avoided by the receiver except as against a good faith purchaser who gives fair equivalent value and further provides that anyone receiving a fraudulent transfer from an insurer is personally liable for it.

Section 32(A) addresses preferences and provides, in part:

> A preference is a transfer of any of the property of an insurer to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the insurer within one year before the filing of a successful petition for liquidation under this Act, the effect of which transfer may be to enable the creditor to obtain a greater percentage of this debt than another creditor of the same class would receive.

This section goes on to provide that preferences may be avoided if the insurer was insolvent when it made the transfer, if the transfer was made within four months of the filing of the petition, if the creditor had reason to know or believe that the insurer was insolvent (or about to become insolvent), or if the transfer was to an insider.

Section 46(E) insulates certain transactions from attack by a receiver as fraudulent transfers or preferences:

> Notwithstanding any other provision of this Act, a receiver may 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) that is made before the commencement of a formal delinquency proceeding under this Act. However, a transfer may be avoided under Section 29A of this Act 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.

This provision, dealing with qualified financial contracts, was added to the Model Act by the NAIC in 1997, to bring it into alignment with provisions of the federal bankruptcy code and federal banking laws that exempt derivative and netting agreements from the "automatic stay" that protects the assets and positions of a debtor immediately upon entering insolvency proceedings. *See*, *e.g.*, 11 U.S.C. § 362(b)(17). The intent was to ensure that the derivatives markets move freely and that unnecessary losses were not taken by any market participant as a result of an insurance company insolvency. Section 46 creates an absolute shield for transfers made pursuant to a "qualified financial contract," defined as "a commodity contract, forward contract, repurchase agreement, securities contract, swap agreement and any similar agreement that the [regulator] determines to be a qualified financial contract for purposes of this chapter."

These "model" and "uniform" laws are far from the endpoint in determining how to avoid creating a preference or fraudulent transfer. The important starting point is determining the jurisdiction in which the subject insurer is domiciled. That jurisdiction has primary authority to oversee insolvency proceedings, and its preference and fraudulent transfer statutes will apply. While most states have based their statutory schemes on the Insurers Rehabilitation and Liquidation Model Act, there is significant variation from state to state.

For example, the preference statutes of Arkansas and New York do not follow the Model Act at all and are driven solely by intent:

> Any transfer of, or lien created upon, the property of an insurer within twelve months prior to the granting of an order to show cause under this article with the intent of giving to any creditor or enabling him to obtain a greater percentage of his debt than any other creditor of the same class and which is accepted by such creditor having reasonable cause to believe that such a preference will occur, shall be voidable.

N.Y. Ins. Laws § 7425(a). *Accord* Ark. Code Ann. § 23-68-125 (limiting preference period to four months). On the other hand, California, Connecticut, Michigan, and Wisconsin, for example, do follow the Model Act in defining preferential transfers, and thus the focus of the analysis is on whether the transfer was made on account of an antecedent debt, within the prescribed time period. Cal. Ins. Code § 1034; Conn. Gen. Stat. § 38a-930; Mich. Comp. Laws § 500.8128; Wis. Stat. § 645.54. The insurer's intent in those states appears to be irrelevant.

New York has not adopted an insurance-specific fraudulent transfer provision. A New York-regulated insurer is subject to New York's fraudulent transfer statutes, found in the debtor creditor laws. N.Y. D&C Laws §§ 270 et seq. New York's insurance laws do, however, specifically vest the superintendent of insurance, as receiver, with authority to seek to avoid any fraudulent transfer that the insurer's creditor could have sought to have avoided. N.Y. Ins. Laws § 7425(c). Arkansas follows this same approach. Ark. Code Ann. § 23-68-125(c). California, Connecticut, Michigan, and Wisconsin have adopted versions of the fraudulent conveyance provisions of the Model Act. Cal. Ins. Code § 1034.1; Conn. Gen. Stat. § 38a-928; Mich. Comp. Laws § 500.8126; Wis. Stat. § 645.52.

Only six states have adopted Model Act Section 46(E)—the exemption for transfers pursuant to qualified financial contracts. Significantly, the Model Act defines "qualified financial contracts" to include securities contracts and swaps, creating a preference and fraudulent transfer shield for CDO counterparties that are willing to invest in negotiating and documenting a side arrangement. That few states have adopted this provision is not surprising. When the NAIC was drafting the Model Act, some commentators "suggested that Subsection E [of Section 46] be deleted because it creates a dangerous exception to the voidable preference provisions of the model act." 1995 Proc. 4th Quarter 727. Nonetheless, Connecticut, Iowa, Maryland, Michigan, Texas, and Utah have adopted Section 46(E) of the Model Act. Conn. Gen. Stat. § 38a-944a; Iowa Code § 507C.28A; Md. Ins. Code Ann. § 9-229.1; Mich. Comp. Laws § 500.8115a; Tex. Ins. Code Ann. § 443.261; Utah Code Ann. § 31A-27a-611.

STRUCTURING TRANSACTIONS TO MINIMIZE PREFERENCE AND FRAUDULENT TRANSFER RISK

In an earlier section, we described three specific situations in which money or assets could be transferred into a CDO in an attempt to enhance the financial viability of the structured investment. In each of those situations, the transfer could be deemed either a preference or a fraudulent conveyance if the transferor is subsequently placed in insolvency proceedings. As just described, insurance insolvency statutes give broad authority to a receiver to claw back insurer assets transferred prior to the receivership if certain statutory criteria are met. And, depending on the jurisdiction, those criteria can turn completely on the intent of the parties or can be wholly blind to that intent.

Therefore, while there may be good reasons to augment the asset portfolio of a CDO to prevent liquidation or to satisfy contractual requirements, parties must proceed with care when those additional assets are transferred from an insurance company. If the transfer of an insurer's assets into a vulnerable deal is reversed at a future date, there is substantial risk that the vulnerabilities will become fatal, and investors who might have survived an earlier liquidation with minor losses in the higher tranches will, in the event of a clawback, find themselves seriously out of the money in a subsequent, delayed liquidation.

In the few states that protect qualified financial contracts from preference and fraudulent transfer claims in insurance insolvencies, minimizing risk may be accomplished by effecting a transfer under or in connection with a qualified financial contract. For example, an insurer that purchases notes from a CDO pursuant to a securities contract is transferring assets to the CDO pursuant to a qualified financial contract. The transfer of money into escrow for the purchase of notes if certain events arise in the future could also be made in connection with a securities contract. For insurers domiciled in states that have adopted Section 46(E) of the Model Act, that transfer would not be subject to a clawback, absent actual intent to defraud the insurer or its other creditors.

However, for insurers in states without Section 46(E) protections, and whose home-state statutes define preferences in terms of antecedent debt, the task may be more difficult. A straightforward purchase of CDO notes that involves a contemporaneous exchange of assets for notes is not a transfer on account of antecedent debt and thus would not be a preference. On the other hand, a contract that obligates an insurer to purchase notes in the future if certain contingencies arise does create preference risk. We have seen this when a junior noteholder, anticipating an untimely but imminent liquidation, seeks forbearance from the senior noteholders in exchange for a commitment to "shoring up" the deal if the deterioration continues and the coverage ratios are breached, to protect the value of the senior tranche.

A receiver may argue that such a commitment, when given, created a debt and, when the contingency arose and the assets were transferred, the transfer was on account of an antecedent debt, creating a preference that should be clawed back for the benefit of the insurer's estate. While there is room for debate about whether that transfer is on account of an antecedent debt, there is virtually no law interpreting "antecedent debt" in the context of the insurance statutes, giving courts a blank slate on which to write. Federal bankruptcy law has an enormous body of law on antecedent debt, but that law is neither controlling nor dispositive of this issue. Thus, to minimize preference risk, the transaction structure should avoid hidden (and outright) exchanges based on existing obligations. Structures based on contemporaneous exchanges minimize risk.

In states like New York, where the preference analysis is driven by intent to favor one creditor over others in the same class, a transfer of assets from an insurer to a CDO should not be a preference unless the CDO is a creditor. In the context of an insurer simply purchasing notes, there should be no preference because the insurer is not a creditor. In the context of a GIC, however, where the insurer is required by contract to make payments to the CDO and post additional collateral, the CDO is a creditor and there is preference risk. Minimizing the risk of a clawback requires the parties to ensure that the transfer is not and does not appear intended to put the creditor in a position superior to what it would have been in under receivership proceedings. This is difficult. Evidence of intent can include statements made in press releases, annual reports, internal business forecasts, and ever-pervasive email traffic. As a practical matter, little can be done to evaluate the risk because the parties will not know what intent the insurer has manifested internally.

Transferring assets into a distressed portfolio can also be accomplished through commutations of financial guaranty insurance policies. Commutations raise preference concerns but may also be at risk for fraudulent transfer analysis. A commutation involves payment to terminate the insurance coverage, which involves estimating the value of the claims that would have arisen under the policy had it not been terminated. A commutation can be vulnerable to fraudulent transfer claims because a receiver can determine, in hindsight, whether the commutation was to the insurer's benefit. If not, *i.e.*, if the commutation amount exceeded the value of claims that would have been made, the receiver has ammunition to argue that the transfer was not supported by fair consideration and thus was a fraudulent transfer. CDOs that commute insurance policies can reduce their risk by documenting the basis for commuting the policy with calculations that demonstrate an exchange of fair consideration.

CONCLUSION

There is no algorithm for minimizing risk when transfers are made from insurance companies to CDOs. Indeed, the countless variations in deal structure, coupled with the variations in state law and the goals of the parties involved, make it impossible to create an instruction manual for protecting assets from an insurance company receiver's clawback powers. The most important task is to identify the risk in advance, and then evaluate the proposed transaction from the standpoint of an insurance receiver with the statutory tools available to challenge transactions of this type.

There are structures that can be devised—once the risks are known. It takes patience, understanding of the rules and the client's objectives, and creativity. What is crucial, however, is that all involved understand the risk and manage it from day one, particularly in those jurisdictions—including New York—in which intent is paramount. A business purpose for the strategy must be articulated and adhered to throughout, in both internal and external communications, and an affirmative case for the deal must be documented at all stages. ■

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