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Financial Guaranty Insurance Policies – Keep Your Eyes Open For Potential Pitfalls

The health of monoline insurance companies increasingly has come into question as a result of pressure from mortgage backed security write-downs. As a result, many financial institutions are taking a second look at an instrument more often viewed as a generic triple-A credit enhancement wrap than a true insurance policy. In the current fiscal environment, obligations under these complex policies may need re-examination, particularly as they apply to payment, rights of the monoline, and their potential effect upon the larger transaction.

ROBERT CHUNG

Financial Guaranty Insurance

As a preliminary matter, financial guaranty insurance policies are subject to most of the same laws and principles underlying insurance policies in general. The policies themselves, however, incorporate the terms of the insured transaction. The key documents making up the insurance policy typically will include (1) a master insurance agreement entered into with the issuer/obligor and the indentured trustee setting forth the general terms of the coverage, (2) an insurance certificate issued to the noteholders/obligees as beneficiaries to the insurance coverage, and (3) the indenture agreement.

The conditions precedent to the trigger of the monolines' coverage obligations under their financial guaranty insurance policies arise in the event an obligor fails to meet all or a portion of a scheduled payment at the time due. Actual payment may require demand by a form written notice to the monoline and an assignment irrevocably subrogating to the monoline all the rights of the beneficiary under the related scheduled payments. Although financial guaranty insurance policies contain form notices, compliance with other requirements under the policies may be less clear.

In addition to the failure to receive a scheduled payment, the monolines' coverage obligations also specifically extend to preferences in bankruptcy. If a scheduled payment is avoided as a preference in an insolvency proceeding, the monolines promise to pay an amount equal to such avoided payment. Payment again may be contingent upon receipt of certain documentation.

Master insurance agreements, although they promise unconditional and irrevocable coverage, typically require a wide range of representations, warranties, and affirmative and negative covenants from non-insurance company parties to the transaction such as the seller. Note that in contrast to the myriad provisions protecting the monolines, there is a dearth of provisions protecting parties from altered circumstances surrounding the monolines. Thus, in the event a monoline is financially downgraded by the ratings agencies, for example, typically no remedy runs to the other parties unless the monoline made any prior misrepresentations or fails to meet its coverage obligations.

Monolines' Broad Powers

Although a financially strapped monoline should not be able to use non-compliance provisions to avoid payment to the noteholders, other parties such as the seller should be aware that failure to meet any one of the enumerated provisions could result in a separate lawsuit by the monolines based upon any non-compliance. In seeking to minimize the likelihood of default, "no loss" underwriting, monolines promote the inclusion of policy language maximizing the insurance companies' abilities to take corrective action in the event of credit deterioration. Accordingly, full appreciation for the broad powers given to the monolines requires a close look at related transaction documents. Furthermore, cooperation with the monolines by all of the other parties is set forth explicitly in the policies.

In the event the monolines, despite their "no loss" underwriting practices, find themselves in dire financial circumstances giving them an incentive to avoid payment, protective insurance principles, both statutorily and in common law, should provide additional protection to the parties. Furthermore, in the event a monoline were to become insolvent, a beneficiary would need to be aware of specific state laws regulating, among other things, the payment of claims under any outstanding policies.

Debt Acceleration

Another significant protection to the monolines is the often statutory requirement that every policy contain language limiting the acceleration of the underlying debt. Such laws assist the monolines in maintaining liquidity even in the face of a series of defaults over a short amount of time by allowing the monolines to avoid payment of principal until the maturity of the underlying debt, which typically extends out for a number of years. In the meantime, a monoline will have the opportunity to work out any problems, implement a plan of recovery, and build up any reserves needed to ultimately repay the principal. Consistent therewith, the power to accelerate the underlying debt lies solely in the hands of the monoline and, even if the monoline exercises its option to accelerate, the monoline need not accelerate any of its own payment obligations under the policies.

Termination

In contrast to the non-negotiability of the limitation upon acceleration, the payment of premiums can vary from policy to policy while having a potentially significant impact on the parties upon the early termination for whatever reason. The parties also may find that it is in their best interest to call an issue or otherwise restructure the underlying deal, whether by choice or as provided for in the underlying debt obligations and related transactions. Cancellation provisions typically are found in the description of the effective date or term of the insurance policy. On the one hand, unlike rescission of insurance policies, cancellation only terminates the policies going forward and the beneficiary need not repay any benefits previously received under the policies prior to cancellation. On the other hand, such cancellation, at least when not the fault of the monoline, may not proceed without potential "penalties" such as payment of fees and premium, reimbursement obligations due to the monoline, and indemnification to the monoline.

Premium Payments

Financial guaranty insurance policies typically protect some, if not all, of the premium payments due to the monoline where those premium payments are spread out over a period of time. In those instances, even if the financial guaranty insurance policy properly is cancelled, failure to comply with the terms of the policy at least will not alter the continued payment of the premium over the course of the transaction. Typically the premium is paid out of, and at the same time as, the distribution date of the underlying payments according to a pre-negotiated schedule (possibly accelerated under the insurance policy).

Conclusion

Financial guaranty insurance policies are as complex as the financial transactions they insure with specific payment provisions in the event of default, obligations of parties to the monoline, and the ability to directly affect the larger transaction they insure. Financial institutions should understand the intricacies of their policies with no less detail than the financial transactions they are purchased to protect.

Robert Chung is an attorney in the New York office of Anderson Kill & Olick, P.C. and is a member of the firm's Financial Services Insurance Coverage Group. Mr. Chung has extensive experience in insurance coverage litigation, exclusively on behalf of policyholders. Mr. Chung can be reached at (212) 278-1039 or rchung@andersonkill.com. *The information appearing in this article does not constitute legal advice or opinion. Such advice and opinion are provided by the firm only upon engagement with respect to specific factual situations.*

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