

Lessons from Recent Successful Rehabilitations

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Panel Discussion Outline

- Introduction
- Monolines: Overview and Background
- Case Studies: FGIC and Ambac
- Lessons Learned
- Legal Principles after FGIC and Ambac
- Application to other Insurance Insolvencies

- As a set of legal principles, monoline rehabilitations broke new ground that changed the way insurance insolvency practitioners view these proceedings
 - Given their size and importance to the financial markets, regulators had to consider a different approach to insolvent monolines
- This panel presentation will discuss two different monoline rehabilitations (FGIC and Ambac), the strategies used in those proceedings, and whether these strategies can be applied in other insolvent insurer contexts

Monolines: Overview and Background

- Monoline insurance companies have only one line of business: issuing policies guaranteeing the payment of contractual debt service in the event of an issuer default.
 - Also called “financial guaranty insurance”; underlying obligations described as being “wrapped”
 - Insurers precluded from insuring other types of risk
 - Financial obligations typically covered include structured finance securities, derivatives, and municipal bonds
 - Policies are irrevocable and unconditional, often expressly waiving all defenses
- Reimbursement rights against issuer via contract, subrogation and/or assignment
- Control rights to direct trustee, enforce remedies, consent to amendments on behalf of noteholders and take other loss mitigation measures

Monolines: Overview and Background (cont'd)

- Benefits to issuer:
 - Investment grade ratings for securities
 - Reduced borrowing costs
 - Better marketability for securities
- Benefits to Investors:
 - Enhanced security and liquidity of securities
 - Insurers' expertise in credit monitoring
 - Avoids risk of bondholder inaction by granting control rights to a single entity with vested interest in minimizing losses

Monolines: Overview and Background (cont'd)

- Historically, monolines primarily insured municipal bonds
 - Premiums paid in full, up front; municipalities rarely defaulted, policy claims rarely asserted
- In 2000's, to enhance returns, monolines began insuring structured finance obligations (i.e., ABS, RMBS, CDS, CDO)
 - Premiums paid over time through waterfall
- Many insured structured finance obligations were hit hard by the financial crisis, resulting in extreme adverse development for most monoline insurers
- More recently, monolines have faced heightened risk from municipal bankruptcies (e.g., Detroit, Puerto Rico)

Monolines: Overview and Background (cont'd)

- Entities involved with monoline products:
 - Banks purchased CDS protection on CDO
 - Mutual funds and insurance companies purchased wrapped corporate and municipal bonds
 - Insurance companies, government sponsored entities, and institutional investors bought wrapped RMBS
 - Distressed buyers, such as hedge funds, entered when financial crisis started

Monolines: Overview and Background (cont'd)

- By 2008, increasing defaults on underlying loans for RMBS resulted in significant losses and claims against monolines
- Credit ratings downgrades created challenges for monolines (loss of new business, requirements to post collateral, increased capital reserves)
- Penalties, mark to market damages for early termination of CDS
- Losses on RMBS and CDS referencing RMBS and liquidity issues after ratings downgrades contributed to the need to restructure monolines

Bankruptcy Tools for Monoline Rehabilitation

- What Bankruptcy Code Chapter 11-type concepts and tools can be employed in a monoline rehabilitation?
 - Modify contracts and policies through court process
 - Mechanism to bind holdouts
 - Prenegotiate plan with significant holders
 - Project assets and liabilities to restructure policy obligations and begin making claims payments sooner
 - Emerge cured of defaults
 - Protect tax NOLs

Case Studies: FGIC

- Historical trend of insurance companies remaining in rehabilitation for decades
- FGIC first financial guaranty insurer in New York to emerge from rehabilitation with restructured policies, to effectuate a wind-down outside of its proceeding
 - FGIC was able to enter and exit rehabilitation in just over one year, and commenced paying claims upon exit (which had been suspended since 2009)
- Policies had a wide range of maturities; some guaranteed obligations were in default prior to filing, others not in default with maturities in forty years
- No guaranty fund protection

Case Studies: FGIC (cont'd)

- In 2008, FGIC voluntarily ceased writing new business and also undertook loss mitigation measures
- In 2009, an order under Section 1310 of the New York Insurance Law suspended all claims payments by FGIC, and required FGIC to submit a plan to cure its financial impairment
- Attempts to reach consensual agreements with creditors were unsuccessful
- Ultimately determined a court-approved rehabilitation was right course of action

Case Studies: FGIC (cont'd)

- Rehabilitation plan process began before filing
- Weil was engaged by New York Liquidation Bureau to evaluate a potential rehabilitation plan and strategies for rehabilitation
- Sought to gain input from NY Department of Financial Services and organized group of beneficial holders of insured obligations prior to filing
- Plan allowed for immediate payment on current and near term claims while preserving assets to pay long-dated claims
- Restructured policy terms to pay in cash only percentage of allowed policy claim (the “Cash Payment Percentage” or “CPP”), with remainder a “Deferred Policy Obligation”
 - CPP to be reevaluated regularly pursuant to Plan

Case Studies: FGIC (cont'd)

- FGIC restored to solvency because restructured policy terms mandated that liabilities would never exceed assets
- Other settlements, commutations, novation of certain municipal policies achieved during case
- Management team with expertise would implement plan outside proceeding
 - Sophisticated surveillance, specialized claims handling
- Defaults under contracts cured, control rights maintained
- Saved costs of, and resources devoted to, maintaining proceeding

Case Studies: Ambac

- Like FGIC, Ambac offered financial guaranty insurance on municipal debt and structured finance debt obligations and indirectly guaranteed certain CDS referencing structured finance obligations
 - Similar “barbell” structure for timing of projected claims
- In early 2010, as a result of Ambac’s financial condition, its regulator requested that Ambac form a “Segregated Account” and allocate to it certain policies (e.g., RMBS, student loan) while keeping others that were considered healthier (e.g., municipal policies) outside of the proceeding in the “General Account”
- Segregated Account was placed into rehabilitation in 2010

Case Studies: Ambac (cont'd)

- Initial plan proceedings marked by litigation contesting Segregated Account structure, injunctive relief
 - Appeals court affirmed the rehabilitation court's orders, discretion of rehabilitator, flexibility of proceedings; clarified "fair and equitable" test
- First amended rehabilitation plan provided for an upfront CPP and Deferred Amounts for Segregated Account policy claims, to be run off within court proceeding
- During proceeding, Ambac, as service provider, was successful in significantly reducing actual and projected liabilities of the Segregated Account since 2010; investment returns also exceeded expectations

Case Studies: Ambac (cont'd)

- Second Amended Plan designed to facilitate a larger series of transactions to allow Segregated Account to exit from rehabilitation
- Result of negotiations between Ambac and an ad hoc group (“AHG”) of holders of beneficial interests in Deferred Amounts and Surplus Notes issued by General Account, and conforming to parameters established by regulator for a durable exit
 - AHG signed Rehabilitation Exit Support Agreement
 - Regulator preferred broadly consensual exit
- Durable meant that Ambac as a whole would have adequate capital to continue operations and pay in full post-Effective Date claims; causes of the rehabilitation proceeding resolved

Case Studies: Ambac (cont'd)

- Under Second Amended Rehabilitation Plan, holders of Deferred Amounts received a package of consideration comprised of cash, notes secured by future recoveries in reps & warranties litigation, and Ambac Surplus Notes; package equal to 93.5% for each dollar of accreted value of Deferred Amounts.
 - 6.5 % discount to the total accreted Deferred Amount, applied first to accretion amounts
- Upon approval, Segregated Account merged with General Account
- Post-exit claims to be paid in full and in cash for both the General Account and merged Segregated Account post-exit liabilities

Case Studies: Ambac (cont'd)

- Rehabilitator determined plan was fair and equitable to policyholders under the circumstances because:
 - present value of payments made to Deferred Amount holders under Second Amended Plan were greater than would be the case if First Amended Plan continued to run off over time;
 - consideration provided was almost entirely insulated from future adverse developments in Ambac portfolio; and
 - cash payment in full for future claims offered material benefit for many policies with Deferred Amounts outstanding
- Second Amended Plan approved in January 2018

Lessons Learned: FGIC

- Coordination between regulatory and receiver functions helpful
- Chief Restructuring Officer (FGIC) can be helpful to guide process on Company side
- Negotiation works! Consider stakeholders that may technically be outside the proceeding but have ability to raise objections and litigate (e.g., ad hoc group of beneficial holders)
- Coordination with related entities (e.g., holding company) to preserve value
- Judicial process can restructure policy obligations
 - Restore to solvency; causes of rehabilitation removed
- Once approved by court, plan can be implemented over time outside a proceeding

Lessons Learned: Ambac

- Use of “good bank/bad bank” model to allocate liabilities that are the source of insolvency and minimize their impact on rest of portfolio
- Leverage company’s management as service provider to mitigate losses through commutations, settlements and restructurings during the proceeding
- Negotiations with stakeholders to obtain restructuring support agreement to secure participation in transactions to facilitate exit
- Flexibility to design instruments that can be used to meet policy obligations
- Success may depend on regulatory and judicial environments

Legal Principles after FGIC and Ambac

- Priority
- The Absolute Priority Rule
- The Best Interests of Creditors Test
- Transferring Liabilities
- Third party relationships
- Insurance Federalism

Future of Insurance Insolvency

- Life insurance, long-term care insurance, and potentially financial guaranty insurance could be the next frontiers of insurance insolvency
- Can we apply “prepackaged” insolvency principles outside of the financial guaranty context?