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FINANCIAL GUARANTY BONDS AND THE APPLETON RULE

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INTRODUCTION

As a general proposition, under the New York Insurance Law,[1] only "financial guaranty insurance corporations" are permitted to write financial guaranty insurance. Such financial guaranty insurance corporations are called "monoline" insurers because they are permitted to write essentially only one line of business – financial guaranty insurance. "Multiline" companies, by contrast, are generally prohibited by the New York Insurance Law from issuing coverages defined as financial guaranty insurance. The statute carves out from the general proscription certain types of "surety insurance" which multiline insurers may write. Moreover, although financial guaranty insurance is to be written by monoline insurers, those insurers are also permitted to issue certain additional coverages including the types of "surety insurance" which multiline companies are allowed to write. By and large, however, only monoline insurers may issue financial guaranty insurance in New York, and multiline companies – whether incorporated in New York (domestic) or incorporated in another state (foreign) or another country (alien) but licensed in New York – may not.

New York's proscription of the writing of financial guaranty insurance by a multiline company is given extraterritorial effect by operation of the so-called "Appleton Rule." The rule was originally promulgated as an administrative regulation in the early 1900's by the Deputy Superintendent of the New York Department of Insurance after whom it is named and was enacted as part of the New York Insurance Law in 1939.[2] Essentially, the Appleton Rule prohibits a foreign or alien insurer from conducting outside of New York any kind of insurance business which it is not permitted to conduct in New York under pain of losing its New York insurance license. In the context of New York's financial guaranty insurance statutes, the Appleton Rule means that a foreign multiline insurance company may not issue *in any state* a product which comes within the New York definition of "financial guaranty insurance" – at least if it wishes to become or remain licensed in New York.

The prohibition against the issuance of financial guaranty insurance by multiline companies does not extend to the reinsurance of financial guaranty risks. Monoline insurer's may cede such risks to properly accredited property and casualty companies or other reinsurers. Thus, multiline companies may assume through reinsurance financial guaranty risks which they are prohibited from writing directly. In the context of reinsurance, the issues involve understanding and complying with complex, highly technical requirements regarding

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[1] The New York Insurance Law is contained in Chapter 28 of the Consolidated Laws of New York. Chapter 28 is divided into 57 Articles. Provisions from the following four Articles are discussed herein: Article 1 (General Provisions), Article 41 (Property/Casualty Insurance Companies), Article 11 (Licensing of Insurers), and Article 69 (Financial Guaranty Insurance Corporations). All statutory provisions cited are from McKinney's Consolidated Laws of New York Annotated as contained in WESTLAW. As of this writing, the WESTLAW database for the four Articles discussed, is current through L.2000, chs. 2 to 23, 52. Unless otherwise indicated, all citations to New York statutes are to that database and therefore will not include the currency of the database.

[2] Martha L. Perkins, *Financial Guaranty in* THE LAW OF SURETYSHIP, 303, 311 (2d ed., Edward G. Gallagher, ed., 2000). The Appleton Rule is now codified as N.Y. Ins. Law §1106(f).

such matters as reserves, surpluses, collateral, and amount of risk exposure as may be applicable to the various types of permitted financial guaranties. Such issues and the disturbing advent of a proposed rating system for multiline insurers providing bonds in connection with structured finance and capital markets transactions are discussed in a separate section.[3]

I. THE GENISIS AND PURPOSE OF THE NEW YORK FINANCIAL GUARANTY INSURANCE LAW

"Financial guaranty insurance is, in essence, a highly refined kind of surety bond."[4] Generally, it guarantees the payment of principal and interest by the principal under a contract of indebtedness or other monetary obligation or otherwise insures against "fluctuations in interest rates, fluctuations in currency rates, fluctuations in financial or commodity indices or changes in the value of assets and price levels in general."[5] Very often financial guaranty insurance serves as "credit enhancement"[6] to improve the investment grade of the underlying obligation through the credit rating of the insurer issuing the bond.

Financial guaranty insurance seems to have originated as guaranties of municipal bond obligations underwritten primarily by monoline companies.[7] In the 1980's, the market for financial guaranty insurance expanded rapidly and evolved to include a diversity of products. Responding to the demand, multiline property and casualty insurers entered the market. As a result of then-permitted federal tax shelters, a popular product was the limited partnership financial guaranty bond which secured the limited partners' installment payments under their promissory notes.[8] Today, in addition to securing municipal bonds, the largest segments of the financial guaranty market are the asset-backed market and the international market.[9]

In the mid-1980's, a series of defaults led to "catastrophic losses" for issuers of financial guaranties and to insolvency for some.[10] Economic declines, federal tax reform legislation in 1986 and the October 1987 financial market crisis were among the factors contributing to the problem.[11] Alarmed, regulators became concerned that regulating financial guaranty insurance under rules applicable to property and casualty insurance generally was inadequate.[12] The National Association of Insurance Commissioners appointed a Financial Guaranty Insurance Study Group which proposed the Financial Guaranty Insurance Model Act. The primary

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[3] *See infra* Part IV.
[4] Perkins, *supra* note 2, at 303.
[5] 2 McKinney's 1989 Session Laws of New York, *Memorandum of the State Executive Department*, at 2054 (West 1990) [hereinafter *Executive Department Memorandum*].
[6] *Id*. *See also* Perkins, *supra* note 2, at 303.
[7] *Executive Department Memorandum* at 2053-54.
[8] H. Bruce Shreves, *Financial Guaranty Bonds in* THE LAW OF SURETYSHIP, 18-1 (1st ed., Edward G. Gallagher, ed., 1993) which discusses limited partnership financial guaranty bonds in detail and analyzes the legal issues faced by the issuing bonding company upon the failure of a limited partnership. *See also* Perkins, *supra* note 2, at 304.
[9] *Id*. at 305.
[10] *Executive Department Memorandum* at 2055.
[11] *See Id:,* Perkins, *supra* note 2, at 304; Shreves, *supra* note 8, at 18-1.
[12] *Executive Department Memorandum* at 2053; Perkins, *supra* note 2, at 304.

feature of the Model Act was the recognition of financial guaranty insurance as a separate and distinct kind of insurance which should be negotiated as such.[13]

In 1989, the New York State Legislature enacted L.1989, chapter 48, which added Article 69, "Financial Guaranty Insurance Corporations,"[14] to the New York Insurance Law and amended other related portions of it.[15] Article 69 was based on the Model Act,[16] and its purpose was, in part:

> -- To define "financial guaranty insurance" as a separate kind of insurance.
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> -- To authorize the formation and licensing of financial guaranty insurance corporations which would essentially be monoline insurers but would also be permitted to write surety, residual value and credit insurance.
>
> -- To provide a transition period for multiline property/casualty insurers to convert to monoline insurers.
>
> -- To specify the types of obligations for which financial guaranties may be written by a financial guaranty insurance corporation which would include municipal and corporate bonds.
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> -- To prohibit the writing of guaranties for other types of obligations (unless substantially similar) without further enabling legislation.
>
> * * *
>
> -- To unlink fidelity insurance and surety insurance and treat them as separate kinds of insurance so as to permit a financial guaranty insurance corporation to write surety coverage but not fidelity, and *to redefine surety insurance by eliminating the kinds of transactions which become financial guaranty insurance subject to the provisions of new Article 69 (Financial Guaranty Insurance Corporations)*.[17]

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[13] *Id*. at 304-05.
[14] N.Y. Ins. Law §§ 6901-09.
[15] States other than New York have enacted legislation regulating financial guaranty insurance, most notably California, CAL. INS. CODE §§ 12100-12122 (West 1994), Connecticut, CONN. GEN. STAT. ANN. §§ 38a-92a-92n (West 1995), and Florida, FLA. STAT. ANN.§§ 627.971-975 (West 1995), Perkins, *supra* note 2, at 312.
[16] *Executive Department Memorandum* at 2053.
[17] *Id*. at 2045-46 (emphasis added).

The legislative intent animating that purpose may be discerned from the problems which the drafters of the 1989 amendments perceived in multiline insurers' writing financial guaranty insurance and which they sought by those amendments to avoid. According to the New York Executive Department, the drafters recognized the following problems with the multiline format:

> 1. Potential to bankrupt company. When written as a sideline by a multiline insurer, financial guaranty insurance has the potential to bankrupt a company or to so limit its capacity as to prevent it from maintaining its market capacity to underwrite traditional and more essential lines of business. . . [A]t least three multiline companies have been rendered insolvent by their financial guaranty writings. The monoline approach protects property/casualty insurance policyholders from the negative impact of adverse experience in financial guaranty business. Multiline insurers would not be tempted to divert currently insufficient resources to financial guaranty business for the enhancement of cash flow.
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> 2. Burdening the Security Fund. Even if not covered by the Property/Casualty Insurance Security fund, an insolvency of a multiline insurer resulting from financial guaranty losses would expose the Security Fund to claims for all the property/casualty lines written by the insurer. Insurers which did not write financial guaranties and the vast majority of the public who never benefit from the guaranties would be burdened with cost of losses covered by the Security Fund.
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> 3. Lack of accountability. In a multiline operation, capital supports many lines of business. A monoline structure would enable the regulator to readily identify the risks insured and the capital supporting the business. This identification is necessary because of the unique nature of financial guaranties, which are a hybrid of insurance and investment banking.
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> 4. Lack of expertise. Few multiline insurers will have the necessary expertise to write financial guaranties, especially of the new and more exotic products. The expertise required to underwrite financial guaranties bears no relationship to traditional property/casualty underwriting, which utilizes actuarial and loss experience to evaluate and price a risk. Financial guaranty business requires in-depth expertise of investment bankers and economists, as is the case with existing monoline financial guaranty insurers.
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> 5. Regulatory constraints. Because of its nature underwriting financial guaranty insurance in a multiline environment adds undue

> complexity to the analysis and monitoring of an insurer's financial condition with no discernable benefit. It causes unwarranted diversion from the pressing regulatory responsibilities of the Insurance Department in expending finite resources to monitor this line of business in a multiline environment.[18]

II. FINANCIAL GUARANTY INSURANCE AND SURETY BONDS UNDER THE NEW YORK INSURANCE LAW

A. THE STATUTORY SCHEME

Article 11[19] of the New York Insurance Law addresses the licensing of insurers. Section 1113 of that Article identifies and defines "[t]he kinds of insurance which may be authorized in this state."[20] Included are "'[f]idelity and surety insurance'"[21] and "'[f]inancial guaranty insurance'".[22] The latter is described as "the kind of insurance defined in [section 6901(a)(1)]."[23]

Section 6901(a)(1)[24] defines the types of transactions which constitute "financial guaranty insurance" as follows:

> **§ 6901. Definitions**
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> As used in this article: (a)(1) 'Financial guaranty insurance' means a surety bond, insurance policy or, when issued by an insurer or any person doing an insurance business . . . an indemnity contract, and any guarantee similar to the foregoing types, under which loss is payable, upon proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee as a result of any of the following events:
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> (A) failure of any obligor on or insurer of any debt instrument or other monetary obligation (including equity securities guaranteed under a surety bond, insurance policy or indemnity contract) to pay when due to be paid by the obligor or scheduled at the time insured to be received by the holder of the obligation, principal, interest, premium, dividend or purchase price of or on, or other amounts due or payable with respect to, such instrument or obligation, when such failure is the result of a

[18] *Executive Department Memorandum* at 2056.
[19] N.Y. Ins. §§ 1101-21.
[20] § 1113(a).
[21] § 1113(a)(16).
[22] § 1113(a)(25).
[23] *Id*.
[24] N.Y. Ins. Law § 6901(a).

financial default or insolvency or, provided that such payment source is investment grade, any other failure to make payment, regardless of whether such obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted;

(B) changes in the levels of interest rates, whether short or long term or the differential in interest rates between various markets or products;

(C) changes in a rate of exchange of currency;

(D) changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or

(E) other events which the superintendent determines are substantially similar to any of the foregoing.[25]

Thus, the five types of transactions which are included in the section 6901(a)(1) definition of "financial guaranty insurance" are (1) "guaranties of indebtedness," (2) "interest rate guaranties," (3) "currency rate guaranties," (4) "guaranties of financial or commodity indices," and (5) "guaranties of other events determined by the Superintendent to be substantially similar to the foregoing."[26] Section 6902(a) of the insurance statute authorizes the organization and licensing of New York and foreign financial guaranty insurance corporations,[27] and section 6901(b) defines a "'[f]inancial guaranty insurance corporation'" as "an insurer licensed to transact the business of financial guaranty insurance in this state."[28] Section 6904(a) sets out the basic monoline company requirement: "[f]inancial guaranty insurance may be transacted in this state *only* by a corporation licensed for such purpose pursuant to section [6902]."[29]

While all five types of transactions listed in section 6901(a)(1) constitute financial guaranty insurance which multiline insurers are prohibited from issuing, section 6904(b)(1)[30] provides that the only type of financial guaranty insurance which may be written by a financial guaranty insurance corporation is the type defined in subparagraph (A) of section 6901(a)(1) –

[25] *Id*.
[26] *Executive Department Memorandum* at 2046.
[27] § 6902(a).
[28] § 6901(b).
[29] § 6904(a) (emphasis added). "Subsection (a) [of section 6904] limits the doing of financial guaranty insurance to a corporation licensed for such purpose, which corporation may only be licensed to write financial guaranty . . . insurance." *Executive Department Memorandum* at 2048. In 1997, a multiline (property and casualty) insurer was found to have issued financial guaranty insurance without the necessary license and was fined $1 million by the New York Insurance Department. In mitigation, the insurer stated that it treated the policies as credit insurance for which it was licensed, that it had terminated the program, that the subsidiary which arranged the issuance of the policies had ceased doing business, that it was itself the victim of fraud perpetrated by the insured and that it had cooperated with the department's investigation and voluntarily settled the matter. *See* In Re Generali U.S. Branch, State of New York, Insurance Department, Stipulation dated April 17, 1997.
[30] § 6904(b)(1).

the so-called “guaranties of indebtedness.”[31] Thus, even a monoline financial guarantee corporation is prohibited by the statute from writing interest rate guaranties, currency rate guaranties, guaranties of financial or commodity indices, or substantially similar guaranties, which are the types of financial guaranties defined by subparagraphs (B) through (E) of section 6901(a)(1).[32]

Notwithstanding the definition of financial guaranty insurance set out in section 6901(a)(1), section 6901(a)(2) provides that certain enumerated transactions shall *not* be considered financial guaranty insurance.[33] Under subsection (B) of section 6901(a)(2), among the transactions excepted from the definition of financial guaranty insurance are “fidelity and surety insurance as defined in [section 1113(a)(16)].”[34] As a result, the proscription against multiline insurers issuing financial guaranty bonds does not operate to prohibit multiline companies from writing defined types of fidelity and surety bonds. Moreover, even though the theory underlying Article 69 was to isolate financial guaranty insurance and its dangers in companies writing only that kind of insurance, section 6902(a)(1) allows financial guaranty companies to write other kinds of products including the types of surety insurance which are excepted from the definition of financial guaranty insurance and which multiline insurers may write.[35]

Subsection (C) through (G) of section 1113(a)(16) identify the kinds of “traditional types of surety contracts”[36] which may be written by a multiline insurer, under section 6901(a)(2)(B), and (except for subsection (G)) by a monoline financial guaranty company under section 6902(a)(1)(B).[37] Those subsections of section 1113(a)(16) define surety insurance as follows:

> (C) Any contract bond; including a bid, payment or maintenance bond or a performance bond where the bond is guaranteeing the execution of any contract other than a contract of indebtedness or other monetary obligation;
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> (D) An indemnity bond for the benefit of a public body, railroad or charitable organization; a lost security or utility payment bond;

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[31] *Executive Department Memorandum* at 2046. “The plain import of §§ 6901 and 6904, read together, is that only coverage coming within the definition set out in § 6901(a)(1)(A) is authorized to be written in New York.” N.Y. General Counsel Opinion 11-21-91.

[32] Particular examples of authorized and unauthorized financial guaranty insurance are discussed *infra* Part II,B,2.

[33] § 6901(a)(2).

[34] § 6901(a)(2)(B).

[35] N.Y. Ins. Law § 6902(a)(1)(B). Under that provision, financial guaranty companies are permitted to write surety insurance within the definitions of subsections (C) through (F) of section 1113(a)(16), while subsection (C) through (G) of section 1113(a)(16) are excepted under section 6901(a)(2) from the definition of financial guaranty insurance. The other types of “additional kinds of insurance” which a financial guaranty insurer may write are designated types of “residual insurance,” § 6902(a)(1)(A), and designated types of “credit insurance,” § 6902(a)(1)(C).

[36] *Executive Department Memorandum* at 2046.

[37] Subsection (A) and (B) of section 1113(a)(16) define the types of fidelity insurance which a multiline insurer may issue. Those subsections are straight-forward and do not contain the exception for financial guaranty insurance which is found with respect to surety insurance in subsection (E).

> (E) Becoming surety on, or guaranteeing the performance of, any lawful contract, not specifically provided for in this paragraph *except* (i) mortgage guaranty insurance, which may only be written by an insurer authorized to write such insurance pursuant to article sixty-five of this chapter, (ii) *a contract that falls within the definition of financial guaranty insurance as set forth in* [section 6901(a)(1)] *of this chapter*, (iii) any insurance contract unless such guaranty is authorized pursuant to [section 1114(c)] of this article; or (iv) service contract reimbursement insurance as specified in paragraph twenty-eight of this subsection;
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> (F) Becoming surety on, or guaranteeing the performance of, bonds and undertakings required or permitted in all judicial proceedings or otherwise by law allowed, including surety bonds accepted by states and municipal authorities in lieu of deposits as security for the performance of insurance contracts; and
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> (G) Becoming surety on, or guaranteeing the performance of, a bond, which shall not exceed a period greater than five years, that guarantees the payment of a premium, deductible, or self-insured retention to an insurer issuing a workers' compensation or liability policy.[38]

Thus, it seems that the permission to issue surety bonds which was vouchsafed to multiline insurers in section 6901 was annulled by section 1113(a)(16). While section 6901(a)(2)(B) excludes from the definition of financial guaranty insurance "fidelity and surety insurance as defined in [section 1113(a)(16)],"[39] subsection (E)(ii) of section 1113(a)(16) excludes from the types of permissible "surety insurance" any "insurance contract that falls within the definition of financial guaranty insurance as set forth in [section 6901(a)(1)]." The reader is perpetually bounced back and forth between those two provisions. That Ping-Pong effect has caused even the Office of the General Counsel of the New York Superintendent of Insurance[40] to waffle as to the coverages which fall under the broad definition of financial guaranty insurance and yet also meet the definition of one of the permissible types of surety insurance.[41]

B. INTERPRETATION AND APPLICATION OF STATUTORY PROVISIONS

The few published court opinions addressing financial guaranty insurance under the New York Insurance Law shed no light on the issues considered herein. Consequently,

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[38] N.Y. Ins. Law §§ 1113(a)(16)(C)-(G) (emphasis added).
[39] N.Y. Ins. § 6901(a)(2)(B).
[40] Hereinafter OGC.
[41] *See* discussion *infra* Part II,B.

discerning statutory meaning is limited to examining the language of the provisions, legislative history and opinions issued by the OGC.[42]

1. Which "Exclusion" Governs Surety Bonds?

The OGC has considered the interplay between sections 6901(a) and 1113(a)(16) in at least three of its formal opinions, all of which addressed the question whether a multiline insurer could properly issue a bank depository bond. Such bonds typically guarantee to a public entity the repayment of funds deposited by it in a bank. In the first opinion, which was rendered in 1990,[43] the OGC found that a bank depository bond fit squarely within the definition of financial guaranty insurance under section 6901(a)(1) because

> [l]oss is payable, upon proof of financial loss, to an insured obligee (the public entity) as a result of the failure of obligor (the depository bank) to pay amounts due with respect to such obligation (the obligation being the duty pursuant to the contract between the public entity as depositor of funds and the bank as depository to make available the depositor's funds upon proper request) when such failure is the result of insolvency (which must have occurred since the depository bond only provides excess coverage after exhaustion of the Federal Deposit Insurance Corporation coverage).[44]

The OGC noted that section 6901(a)(2)(B) carves out an exception for fidelity and surety insurance as defined in section 1113(a)(16). Nevertheless, the OGC concluded that the exception was unavailing because subsection (E)(ii) of section 1113(a) excluded from permissible surety insurance any coverage which fell within the definition of financial guaranty insurance under section 6901(a)(1).[45]

In 1994, another multiline company proposed to write a bank depository bond which resulted in the OGC's second opinion on the issue.[46] The proposed bond would be issued pursuant to an Ohio statue which required security for repayment of public deposits made with a bank in excess of amounts insured by the Federal Deposit Insurance Corporation.[47] In that

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[42] NY General Counsel Opinions [hereinafter OGC Opinions]. OGC Opinions, collected in OPINIONS OF THE GENERAL COUNSEL (NILS Pub. Co.), are advisory in nature and are not binding on courts or hearing officers conducting administrative proceedings before the Insurance Department. The OGC notes that its opinions are "limited to the facts disclosed in the materials submitted by individuals, law firms, or others. These opinions have been published solely to demonstrate the thinking and evaluation of the Insurance Department attorneys on the date the opinions are issued." *Id*. at iii.

[43] OGC Opinion 6-1-90.

[44] *Id*.

[45] OGC Opinion 6-1-90. The proponent of the depository bond addressed in that opinion argued, unsuccessfully, that the bond should be excepted from the financial guaranty insurance prohibition via section 1113(a)(16)(D) as "'[a]n indemnity bond for the benefit of a public body,' or, alternatively, via section 6901(a)(2)(J) as being 'any other form of insurance covering risks which the superintendent determines to be substantially similar to any of the foregoing [exceptions listed under subsections (A) through (I) of section 6901(a)(2)].'" *Id*.

[46] OGC Opinion 8-11-94.

[47] OHIO REV. CODE ANN. § 135.18 (Baldwin WESTLAW through 2000 portion of 123rd G.A. Files 124, 128, 129, 131 to 133, and 135 to 208, apv. 6/29/2000).

case, the OGC concluded that the multiline insurer would be permitted to issue the proposed bond because that bond met the definition of surety insurance authorized under section 1113(a)(16)(F) ("undertakings required or permitted in all judicial proceedings or otherwise by law allowed") and was therefore excluded from the general prohibition against the issuance of financial guaranty insurance by multiline companies.[48] In so ruling, the OGC necessarily retreated from its earlier opinion and set forth a more refined analysis of the interplay between the "surety insurance" and "financial guaranty insurance" provisions of sections 1113(a)(16) and 6901(a)(1). The OGC conceded that:

> [W]e have in the past opined that to the extent that a product comes within the definitions of both surety and financial guaranty insurance, it was the intent of the legislation to require that the product be considered financial guaranty insurance. *However, we now conclude that such a reading of the exclusion in* [section 1113(a)(16)(E)[49]] *is overbroad*. Since the exclusion for financial guaranty insurance is contained only in subparagraph (E) [of section 1113(a)(16)], it ought not be interpreted to apply to products written under subparagraphs (C), (D), or (F) [of section 1113(a)(16)[50]]. When viewed in this light, the two exclusions no longer appear to be contrary. To the extent that a product overlaps subparagraph (E) and Section 6901(a)(1), it must be treated as financial guaranty insurance. *However, if the product comes within one of the other subparagraphs of paragraph (16), then the Section 6901(a)(2)(B) exclusion takes it out of financial guaranty insurance and places it squarely under surety insurance, even though it would otherwise come within the meaning of Section 6901(a)(1)*.[51]

Thus, the OGC concluded that while at first it might appear that a multiline insurer would be prohibited from issuing a bond that fits within the section 6901(a)(1) definition of "financial guaranty insurance," the multiline company is permitted to issue such a bond if the particular type of bond also fits under subsections (C), (D) or (F) of section 1113(a)(16) and therefore is deemed to constitute "surety insurance."

In determining whether the bond did, in fact, fall within subsection (F) of section 1113(a)(16), the OGC considered the significance of the fact that the Ohio statute did not require that the necessary security be in the form of a bond but merely allowed the posting of a bond as one alternative for satisfying the security requirement. Under section 1113(a)(16)(F),

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[48] OGC Opinion 8-11-94.

[49] That provision authorizes becoming surety on "any lawful contract" not specifically provided for in the other subsections of section 1113(a)(16), with the exception of "a contract which falls within the definition of financial guaranty insurance as set forth in [section 6901(a)(1)]," § 1113(a)(16)(E)(ii), and other specified transactions which do not implicate the definition of financial guaranty insurance.

[50] Applying the same reasoning, the prohibition against financial guaranty insurance should not be interpreted to apply to products written under subsection (G) which was added in 1996 to expand the definition of surety insurance to include so-called cash-flow premium payment retro bonds. Subsection (G) apparently recognizes a difference between cash-flow premium payment retro bonds and financial guaranties.

[51] OGC Opinion 8-11-94 (emphasis added).

surety insurance includes “bonds and undertakings required or permitted in all judicial proceedings or otherwise by law allowed.”[52] The multiline insurer interpreted the phrase “or otherwise by law allowed” to refer to bonds which are allowed, but not required, in satisfaction of a security requirement as was the case under the Ohio statute. The OGC found that the meaning derived from the legislative history of that language was consistent with the multiline insurer’s interpretation. In the past, that phrase read “or by law required.” The OGC found that the following inference could be drawn from the fact that “required” was replaced by “allowed.”

> [T]he “required” obviously contemplates an obligation imposed by law to provide security to the public. The more liberal “allowed” can be read in this context as applying to bonds which are acceptable as security, but where the law permits other methods of satisfying the security. Workers compensation or motor vehicle liability bonds come immediately to mind, and there are many others, including the requirements of Ohio P.L. Section 135.18.
>
> Essentially, to come within subparagraph (F), the bond must provide a benefit to the public that has been identified by an appropriate legislative body as necessary for the public good.[53]

Without the Ohio statutory security requirement, the OGC noted, the bank depository bond would have fallen under section 1113(a)(16)(E) (“[b]ecoming surety on, or guaranteeing the performance of, any lawful contract, not specifically provided for in this paragraph”) and, via the exclusion therein (“except . . . (ii) a contract that falls within the definition of financial guaranty insurance as set forth in [section 6901(a)(1)]”), would have been prohibited from being issued by a multiline insurer as a type of financial guaranty insurance. The statutory security obligation placed that particular bond under section 1113(a)(16)(F) and therefore, via the section 6901(a)(2)(B) exclusion for “fidelity and surety insurance as defined in [section 1113(a)(16)],” under the types of surety insurance which may be written by either a multiline insurer or a “financial guaranty insurance corporation.”

The OGC further noted that it assumed that “laws requiring or expressly permitting bonds for security are usually enacted only for the purposes of the common good, and not to protect or promote private interest.”[54] The OGC declined to address in that Opinion “a law that expressly permits a bond as security for a purely private obligation, not affecting the public interest.”[55] In a third Opinion[56] on the issue of bank depository bonds, the OGC explicitly emphasized that limitation: “[t]he [August 11, 1994] opinion expressly applied only to those bonds intended as security for the public interest, and not to protect or promote private interests.”[57]

[52] N.Y. Ins. Law § 1113(a)(16)(F).
[53] OGC Opinion 8-11-94.
[54] *Id.*
[55] *Id.*
[56] OGC Opinion 12-7-98.
[57] *Id*.

2. Definition of Permissible Financial Guaranty Insurance

Subsections (A) through (E) of section 6901(a)(1)[58] identify and describe the five general categories of risks which comprise the universe of financial guaranty insurance.[59] From that universe, section 6904(b) selects the category defined in subsection (A) of section 6901(a)(1) as the only kind of financial guaranty insurance which a financial guaranty insurance corporation is permitted to write.[60] The permissible financial guaranty insurance is defined, in fairly general terms, as:

> a surety bond, insurance policy or, when issued [by certain insurers], an indemnity contract . . . under which loss is payable, upon proof of financial loss, . . . as a result of . . .:
>
> (A) failure of any obligor on or issuer of *any debt instrument or other monetary obligation* (including equity securities guaranteed under a surety bond, insurance policy or indemnity contract) to pay when due . . ., principal, interest, premium, dividend or purchase price of or on, or other amounts due or payable with respect to, such instrument or obligation . . . [61]

The phrase "any debt instrument or other monetary obligation" was considered by the OGC a September 14, 1992 Opinion entitled "Authority of Financial Guaranty Insurers to Insure Insurance Contracts; Specifically, Guaranteed Investment Contracts."[62] There, the OGC was faced with the question whether an authorized financial guaranty insurer may insure the monetary obligations of life insurers under guaranteed investment contracts. The OCG Opinion concluded that Article 69, despite its authorizing the creation of monoline financial guaranty insurance corporations which are permitted to write certain kinds of financial guaranty insurance, was not intended to exempt financial guaranty insurers from the preexisting prohibition against guaranteeing insurance contracts. In reaching that conclusion, the OGC, discussing the term "obligation" in section 6901(a)(1)(A), stated that "[w]hile some may argue that 'obligation' is limited to stocks, securities or other similar instruments, we think that 'obligation' has its common dictionary meaning; that is, the contract, promise, etc., that compels one to follow a certain course of action."[63] Moreover, the Opinion posited that under a literal reading of section 6901(a)(1)(A), an insurance company's contractual obligation under its insurance contract to pay money constituted a "monetary obligation" and that therefore a guaranty of payment under an insurance contract would come within the definition of financial guaranty insurance which a monoline insurer could issue. The fact that the Opinion declined to adopt a literal reading of the statute in that matter, and approve the proposed coverage, was not based on a conclusion that a contractual obligation to pay was not a monetary obligation; it

[58] N.Y. Ins. §§ 6901(a)(1)(A)-(E).
[59] The statutory provisions are quoted and discussed at Part II,A *supra*.
[60] Under § 6902(a)(1), financial guaranty insurance companies are permitted to issue certain "additional kinds of insurance." *See* discussion *supra* Part II,A.
[61] §6901(a)(1) (emphasis added).
[62] OGC Opinion 9-14-92.
[63] *Id*.

was the result of the Opinion's construction of other provisions, specific to the issue of guaranteeing obligations under an insurance contract, which prohibited such a guaranty even if issued by an insurer authorized to write financial guaranty insurance.[64]

Another component of the definition of financial guaranty insurance is illustrated in a 1996 OGC Opinion entitled "Deficiency Balance Endorsement Upon Repossession of Vehicle."[65] As the title implies, the proposed policy would insure a motor vehicle lender, such as a bank, in connection with the repossession and sale of a vehicle after the buyer defaults on the loan. The lender would be insured against a deficiency in the event that the actual cash value of the vehicle is less than the outstanding balance of the loan. In concluding that the proposed coverage did not constitute financial guaranty insurance, the OGC reasoned:

> A key element of financial guaranty insurance is not present in the revised endorsement since coverage is not conditioned upon the default of the lender. While the vehicle will be repossessed typically only after a default, it is the deficiency amount upon the sale of the vehicle which triggers the coverage. If the vehicle is not sold, there is no coverage. Nor do we think that the policy covers changes in the value of specific assets.[66]

Section 6904(b)(1) contains a second layer of restriction upon the kinds of permitted financial guaranty insurance. Not only are authorized guaranties limited to those insuring payment under "any debt instrument or other monetary obligation" within the meaning of section 6901(a)(1)(A), they are further confined to indebtedness arising from the ten categories of obligation designated in section 6904(b)(1).[67] In a 1992 opinion,[68] the OGC considered the following four of those categories: consumer debt obligations,[69] installment purchase agreements executed as a condition of sale,[70] corporate obligations,[71] and partnership obligations.[72] In that matter, the OGC addressed the issue whether an insurer would be permitted to issue to a lender or lessor a bond guaranteeing performance of a customer's continuing obligation under a lease or finance contract – presumably, the obligation to make payments. According to the Opinion, a bond guaranteeing an obligation under a lease or

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[64] *Id*. In August, 1995, the Insurance Department reconsidered its ban on guaranties of insurance contracts and announced that the Superintendent had determined that there was no statutory prohibition against guaranteeing certain guaranteed interest insurance contracts and guaranties of certain reinsurance recoveries. N.Y. Ins. Circular Letter No. 1995-13 (August 17, 1995).
[65] OGC Opinion 10-24-96,
[66] *Id*. No reasoning or authority is advanced in support of the conclusion that the proposed policy does not cover "changes in the value of specific assets." Insurance against changes in the value of specific assets falls within the type of financial guaranty insurance defined in subsection (D) of section 6901(a)(1). As 6904(b)(1) limits permissible financial guaranty insurance only to the types within subsection (A) of section 6901(a)(1), guaranties against changes in the value of specific assets is not permitted under New York law.
[67] N.Y. Ins. Law §§ 6904(b)(1)(A)-(J).
[68] OGC Opinion 12-1-92.
[69] § 6904(a)(1)(H).
[70] § 6904(b)(1)(G).
[71] § 6904(b)(1)(D).
[72] § 6904(b)(1)(E). The remaining six categories of obligations under § 6904(b)(1) are municipal bond obligations, subsection (A); special revenue bonds, subsection (B); industrial development bonds, subsection (C); certain asset-backed securities, trust certificates and trust obligations, subsection (F); utility first mortgage obligations, subsection (I); and substantially similar debt instruments or financial obligations approved by the Superintendent of the Insurance Department, subsection (J).

finance contract would constitute financial guaranty insurance and would, therefore, be permissible only if it met both criteria under section 6904 (b)(1); i.e., first, that the coverage constitute a guaranty of indebtedness within subsection (A) of section 6901(a)(1), rather than one of the types of guaranty within subsections (B) through (E) thereof, and, second, that the insured indebtedness arise from one of the categories of obligations designated in section 6904(b)(1)(A) through (J). In discussing several of those categories, the Opinion focused on consumer debt obligation guaranty as a permitted category, which suggests that it was retail consumer leasing or financing which was at issue. The Opinion contrasted consumer debt obligation arising from a loan, but not a lease, in connection with the extension of credit to an individual for non-business purposes with a loan for business purposes which would not fall within the permitted category of consumer debt obligation guaranties. The Opinion then stated that "[f]inancial guaranty insurance for a business loan or lease could not be written unless the bond came within one of the other permissible types, for example, where the obligor is a corporation or a partnership that defaults on its obligation (either a loan or a lease)."[73] Under subparagraphs (D) and (E) of section 6904(b)(1), corporate and partnership obligations are two of the categories of transactions defined in section 6901(a)(1)(A) as to which a financial guaranty insurance corporation may issue a guaranty. It appears clear from the quoted sentence that the OGC holds the opinion that where an obligor on a business lease is a corporation, guaranteeing its obligations under the lease would constitute financial guaranty insurance which a monoline financial guaranty insurer is permitted to write.[74]

On several occasions, the OGC has found that although a proposed insurance product constituted financial guaranty insurance, and therefore could not be written by a multiline insurer, the product was also of a type which was not permitted under section 6904(b)(1), and therefore could not be written by a monoline company either. Such products could not be issued at all by an insurance company authorized by New York. For example, the OGC found that a synthetic guaranteed interest contract, also know as a "wrap contract," constituted an unauthorized type of financial guaranty insurance.[75] Under such a contract, the insurer would guarantee to pay the book value of assets held by a pension plan regardless of the actual market value of the supporting assets. The OGC rejected the insurer's argument that the coverage was an annuity or a funding agreement. Instead, the OGC concluded that under such a "wrap contract," the insurer's obligation is to pay a loss as a result of changes in the levels of interest rates or changes in the value of specific assets or commodities. The former obligation would fall within the definition of financial guaranty insurance under subsection (D) of section 6901(a)(1), and the latter within the definition under subsection (C). As section 6904(b)(1) limits authorized financial guaranty insurance to that defined in only subsection (A) of section 6901(a)(1), the proposed coverage was not permitted.[76] Proposals aimed at guaranteeing the performance of mutual funds have twice be found by the OGC to constitute not only insurance, but also guaranties of changes in the value of specific assets or

[73] OGC Opinion 12-1-92.
[74] Another OGC Opinion, dated October 1, 1992, follows the same reasoning and employs almost identical language regarding business leases.
[75] OGC Opinion 6-13-94.
[76] *Id*.

commodities within the meaning of subsection (D) of section 6901(a)(1) and hence not permitted in New York under section 6904(b)(1).[77]

The OGC has also concluded that "stop loss" insurance covering unemployment compensation claims may not be written by an insurer authorized to do business in New York.[78] Non-profit corporations in New York may elect, in lieu of paying the state unemployment tax, to reimburse the state for actual benefits paid to former employees. "Stop loss" insurance would indemnify the non-profit corporation for the reimbursement payments. The OGC found that the proposed coverage did not fall within any of the kinds of insurance authorized under section 1113(a) and, in particular, did not constitute permissible financial guaranty insurance under section 6901(a)(1).[79] "[T]he event which triggers the insurer's liability is not a financial default or insolvency and thus this [proposed insurance] is not financial guaranty insurance."[80] As such "stop loss" insurance is not an authorized kind of insurance, it may not be written in New York.

III. EXTRATERRITORIAL EFFECT

As a general proposition, "[t]he New York Insurance Law does not govern a contract of insurance, including a contract of guaranty or surety, entered into outside the state."[81] Article 69,[82] which regulates financial guaranty insurance corporations, does not include an express prohibition against the writing, by either a New York domestic multiline insurer or a foreign (or alien) multiline insurer, of financial guaranty insurance in other states or countries. Nevertheless, licensing provisions, including the now-codified "Appleton Rule," which appear in Article 11 of the New York Insurance Law[83] place restrictions on the kinds of insurance business in which an insurer licensed in New York may engage and thereby effectively operate to prohibit multiline companies from issuing financial guaranty insurance outside of, as well as within, New York.

In order for an insurer to do insurance business[84] in New York, it must be licensed. Section 1102 of Article 11 sets out the basic requirement: "[n]o person, firm association, corporation or joint-stock company shall do an insurance business in this state unless authorized by a license in force pursuant to the provisions of this chapter."[85] That language is mandatory and comprehensive. Any insurer, whether domiciled in New York or elsewhere, must obtain a license to conduct an insurance business in New York.

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[77] OGC opinion 2-29-96; OGC Opinion 5-31-95.
[78] OGC Opinion 10-26-94.
[79] Section 1113(a), which enumerates the kinds of insurance permitted in New York, defines "financial guaranty insurance" by reference to section 6901(1)(a), *see* § 1113(a)(25).
[80] *Id*.
[81] OGC Opinion 3-15-90 (citing N.Y. Ins. Law § 1101).
[82] N.Y. Ins. Law §§ 6901-09.
[83] N.Y. Ins. Law §§ 1101-1121.
[84] *See* § 1101 (defining "doing an insurance business").
[85] § 1102(a). "[T]his chapter" is Chapter 28 of the Consolidated Laws of New York which is the New York Insurance Law. *See supra* note 1.

A. NEW YORK DOMESTIC INSURERS

The New York Insurance Law defines a "domestic insurer" as one which was incorporated or organized under the law of New York.[86] Among the licensing provisions of section 1102 there are two which bear upon a New York domestic insurer's doing business outside of the state:

> (b) No corporation organized under any law of this state shall do an insurance business outside this state unless so authorized pursuant to the provisions of this chapter . . .[87]
>
> * * *
>
> (d) Except as otherwise provided in subsection (h) hereof [insurers controlled by another state or foreign government], the superintendent may issue a license to any insurer to do in this state the kinds of insurance business for which such insurer is qualified under the provisions of this chapter and under its charter. Every such license shall contain the name of the licensee, . . . the kinds of insurance business, as defined in this chapter, which it is authorized to do in this state, . . .[88]

The language of subsection (b) of section 1102, by itself, seems to limit the kinds of insurance which a domestic insurer may write outside of New York to those for which it is authorized under the New York Insurance Law. Thus, as a New York multiline insurer is not authorized to issue financial guaranty insurance in New York, it would be precluded from doing so elsewhere.

In a very recent Opinion,[89] the OGC reached such a conclusion through a more elaborate analysis which ignored section 1102(b). The matter involved a proposed merger between a New York domestic financial guaranty insurer and a property and casualty insurer licensed in almost all states to issue most kinds of property and casualty insurance. The surviving entity would be the property and casualty company which proposed to adopt the charter of the financial guaranty insurer and to have its own foreign licenses restricted to the lines of business for which the financial guaranty company was authorized. The question was whether the Superintendent of Insurance could approve the merger before the surviving entity obtained the revisions to its foreign licenses and removed from its books all of its non-financial guaranty business. The OGC answered in the negative. It noted that "[a]n insurer's powers under its charter must be consonant with its powers under its license."[90] Therefore, the charter's authorization of financial guaranty insurance is subject to the statutory limitations on

[86] N.Y. Ins. Law § 107(a)(19).
[87] § 1102(b).
[88] § 1102(d).
[89] OGC Opinion 4-4-2000.
[90] *Id*.

the kinds of coverages for which a financial guaranty insurer may be licensed in New York. Although the Opinion offers no authority for that proposition, the language of section 1102(d) requires that conclusion. Thus the merger as proposed could not be approved because it would result in the surviving entity's being in violation of its adopted charter and, accordingly, of the statutory provisions under which a financial guaranty insurer is restricted to writing financial guaranty insurance and only certain other coverages.[91] The OGC summarized its reasoning as follows:

> The courts have stated that wherever a corporation goes for business, it carries its charter and the charter is the same abroad as it is at home. Sliosberg v. New York Life Ins. Co., 244 N.Y. 482 (1927), cert. denied 275 U.S. 526; Myles v. Cuba R. Co., 182 Misc. 169, 48 N.Y.S.2d 148 (New York City Mun. Ct. 1943). Consequently, if London [the surviving property and casualty insurer] were to adopt XLCA's [the New York domiciled financial guaranty insurer's] charter, it could only do those kinds of business enumerated therein. *It could not be licensed as a financial guaranty insurer in New York and then do business [footnote omitted] outside of New York that would be ultra vires of its charter, pursuant to its broader continuing foreign licenses*.[92]

There is no reason to suppose that the converse is not also true. That is, that the statutory ban against a New York domestic multiline insurer's writing financial guaranty insurance in New York would follow that insurer out of state and prohibit its issuing financial guaranty insurance elsewhere.

B. FOREIGN AND ALIEN INSURERS – THE "APPLETON RULE"

Under the New York Insurance Law, a foreign insurer is one which was incorporated or organized under the laws of a state other than New York,[93] and an alien insurer is one incorporated or organized under the laws of any foreign nation or province or territory thereof.[94] Section 1106 of Article 11 imposes "[a]dditional requirements for [a] foreign or alien insurer's license"[95] which operate to prohibit such insurers from writing elsewhere kinds of insurance which they may not issue in New York. That prohibition, known as the "Appleton Rule," originated in the early 1900's as an administrative regulation and is named after the Deputy Superintendent of the New York Insurance Department who created it.[96]

Subsection (c) of section 1106 limits the authority of foreign insurers to do business in New York as follows:

[91] *See* N.Y. Ins. Law §§ 6901(b), 6902(a)(1) and 6904(b).
[92] OGC Opinion 4-4-2000 (emphasis added).
[93] N.Y. Ins. Law § 107(a)(21).
[94] § 107(a)(5).
[95] N.Y. Ins. Law § 1106.
[96] *See* Perkins, *supra* note 2, at 311-12.

> (c) No foreign insurer shall be licensed to do in this state any kind of insurance business, or combination of kinds of insurance business, which are not permitted to be done by domestic insurers hereafter to be licensed under the provisions of this chapter.[97]

Thus a foreign insurer may issue in New York only those kinds of insurance which a New York domestic insurer may issue. Accordingly, foreign multiline insurers, as well as New York multiline insurers, may not issue financial guaranty insurance in New York. The same restriction is placed on the authority of alien insurers.[98]

New York also seeks to limit the kinds of insurance which foreign and alien insurers may write outside of New York, and it uses its control over access to the New York insurance market to do so. Section 1106(f), the current codification of the Appleton Rule,[99] provides:

> (f) No foreign insurer and no United States branch of an alien insurer which does outside of this state any kind or combination of kinds of insurance business not permitted to be done in this state by similar domestic insurers hereafter organized, shall be or continue to be authorized to do an insurance business in this state, unless in the judgment of the superintendent the doing of such kind or combination of kinds of insurance business will not be prejudicial to the best interests of the people of this state.[100]

New York domestic multiline insurers are clearly prohibited from issuing financial guaranty insurance. Consequently, under the language of section 1106(f), non-New York multiline insurers risk losing their New York license if they write financial guaranty insurance outside of New York unless the Superintendent of Insurance finds that doing so will not prejudice the people of New York.[101]

The prohibition against foreign insurers issuing outside of New York a product which was not permitted in New York was alluded to in connection with financial guaranty insurance in a 1995 OGC Opinion.[102] In that matter, an automobile dealer association proposed to act as an administrator of a program whereby dealers undertook to provide a discount to purchasers whose vehicles were declared a total loss due to accident or unrecovered theft. The dealers were to pay fees to the administrating dealer association which intended to purchase insurance to cover risks from uncollectable fees. The contemplated insurance would not insure New York dealers or provide any benefit to them, and it would be purchased outside of

[97] § 1106(c).
[98] § 1106(d).
[99] Perkins, *supra* note 2, at 311.
[100] § 1106(f). *See also* section 1106(e) which requires foreign and alien insurers "to comply substantially with any requirement or limitation of this chapter, applicable to similar domestic insurers" upon pain of loss of license.
[101] The OGC recommends that a foreign insurer, which wishes to issue outside of New York insurance which may not be written in New York, seek in advance a determination that the issuance of such insurance will not be prejudicial to New York. OGC Opinion 7-9-93 (so advising a foreign insurer proposing to issue aircraft title insurance, which is not permitted in New York, because section 1106(f) would bar it from doing so without such a determination).
[102] OGC Opinion 6-26-95.

New York by the dealer association which was also located outside of New York. The OGC noted that the proposed insurance appeared to constitute financial guaranty insurance under New York law but that the proposal did not specify whether the insurer would be licensed in New York. As a result the OGC concluded: "If the insurer is authorized in New York, it would have to be licensed as a financial guaranty insurer. If the insurer was not authorized in New York, it would not be subject to New York Insurance Law."[103] Thus, even where financial guaranty insurance had virtually no connection to New York, the insurance could not be written by an insurer which was authorized to conduct insurance business in New York unless that insurer was licensed as a financial guaranty insurance corporation under New York law. Although neither section 1106(f) nor its moniker, the "Appleton Rule," was mentioned, the OGC's analysis drew no distinction between domestic and foreign insurers. The operative issue was whether or not the proposed insurer was authorized in New York.

IV. REINSURANCE OF FINANCIAL GUARANTY RISKS

Article 69 of the New York Insurance Law provides for the establishment of monoline financial guaranty insurance corporations and limits the authority to write financial guaranty insurance to such corporations.[104] Section 6906 of Article 69, however, permits monoline financial guaranty insurers to cede financial guaranty insurance risks to a "property/casualty insurer or other accredited reinsurer licensed or accredited to reinsure risks of every kind or description . . . as set forth in subsection (c) of [section 4102][105] of this chapter."[106] Thus, under section 6906, if a multiline property/casualty insurer is licensed to reinsure risks pursuant to section 4102(c), then it is authorized to assume risks on financial guaranties, written by monoline insurance companies, which that multiline company could not have written directly under the prohibition of Article 69.[107]

Section 6906, however, also limits the authority of property/casualty insurance companies to reinsure financial guaranties to those situations in which the reinsurance agreement with the ceding company requires that the reinsurer:

1. Have and maintain a surplus to policyholders of at least $35 million;

2. Establish and maintain the reserves required in section 6903 of Article 69, except that if the reinsurance agreement is not pro rata, the contribution to the contingency reserve shall be equal to 50 percent of the quarterly earned reinsurance premium;

[103] *Id*.
[104] *See* N.Y. Ins. Law §§ 6901(b), 6902(a) and 6904(a) discussed *supra* Part II,A.
[105] N.Y. Ins. Law § 4102(c). Section 4102 is part of Article 41 (Property/Casualty Insurance Companies) of chapter 28, the New York Insurance Law.
[106] N.Y. Ins. Law § 6906(a)(2).
[107] *See* § 6904(a) discussed *supra* Part II,A.

3. Comply with the provisions of section 6904(c), except that the maximum total exposure reinsured, net of retrocessions and collateral, shall be one-half of that permitted for a financial guaranty insurance corporation; and
4. Assume less than 50 percent of total exposures net of collateral remaining after deducting any reinsurance with monoline companies as authorized by the statute.[108]

It is important to note that the contingency reserve requirements set forth in section 6906 are only required if the reinsurance agreement requires the reinsurer to maintain such reserves, or the ceding insurer is not maintaining such reserves. Section 6906(a)(2)(B) states that the "assuming insurer need not establish and maintain such reserve to the extent that the ceding insurer has established and continues to maintain such reserve."

Further, section 6903(a)(5) permits a ceding insurer to establish the contingency reserve "net of reinsurance" provided that the reinsurance agreement requires that the reinsurer establish and maintain a reserve in an amount equal to the amount by which the ceding insurer reduces its contingency reserve. Thus, it appears that if a licensed monoline company maintains statutory reserves and does not require the reinsurer to post the appropriate statutory reserves hereinafter discussed, then no such reserves need be established by the reinsurer. It would have to be presumed, however, since such a result is nonsensical, that the reinsurer, regardless of whether it is aware that the ceding insurer is or is not properly setting reserves and regardless of whether the reinsurance agreement requires, in accordance with section 6903(a)(5), that reserves be set in at least the amount of the reduction in the ceding company's reserves, would still have to establish proper reserves as hereinafter discussed and/or require its retrocessionaires to establish proper reserves in order to set its contingency reserves net of its reinsurance.

A. RESERVE REQUIREMENTS UNDER SECTION 6903

If the $35 million threshold general reserve requirement of section 6906(a)(2)(A) has been met, the next question is how should reserves be calculated. A "contingency" reserve is defined in section 6901 as a reserve in addition to surplus that must be set aside in order to protect policyholders.[109] The amount of the contingency reserve for the various types of financial guaranties are set forth in section 6903.[110] That provision states that contingency reserves for guaranties shall be established in an amount equal to the greater of 50 percent of the "premiums written" for each of the financial guaranty categories listed below <u>or</u> the following amounts for each of those categories:

1. Municipal obligation bonds - 0.55% of the principal guaranteed;

[108] § 6906(a)(2).
[109] § 6901(j).
[110] § 6903(a).

2. Special revenue bonds and their functional equivalents - 0.85% of the principal guaranteed;

3. Investment grade industrial development bonds, secured by collateral or having a term of seven years or less, and utility first mortgage obligations - 1.0% of the principal guaranteed;

4. Other investment grade industrial bonds - 1.5% of the principal guaranteed;

5. All other industrial development bonds - 2.5% of the principal guaranteed;[111]

6. Investment grade obligations (other than set forth above), secured by collateral or having a term of seven years or less 0 1.0% of the principal guaranteed;

7. Other investment grade obligations - 1.5% of the principal guaranteed;

8. Non-investment grade consumer debt obligations - 2.0% of the principal guaranteed;

9. Non-investment grade asset-backed securities - 2.0% of the principal guaranteed; and

10. Other non-investment grade obligations - 2.5% of the principal guaranteed.[112]

Section 6903 requires that for the investment types 1 through 5 listed above, contributions to the contingency reserve shall be made on a quarterly basis for 20 years in the amount of one-eightieth (1/80) of the total reserve required for each reinsured guaranty.[113] For investment types 6 through 10 listed above, Section 6903 requires that contributions to the contingency reserve shall be made on a quarterly basis for 15 years in the amount of one-sixtieth (1/60) of the total reserve required for each reinsured guaranty.[114] Those contributions may be discontinued if the aggregate contingency reserve for the specific risks exceeds the required percentages as set forth in section 6903. Section 6903(a)(7) states that the contingency reserve amounts may only be invested in classes of securities or types of investments specified in sections 1402(b)(1)-(3) and 1404(a)(1)-(3).

B. COMPLIANCE WITH SECTION 6904

Section 6906 also requires that the reinsuring company comply with section 6904(c), except that the maximum total exposures reinsured net of retrocessions and collateral shall be

[111] §§ 6903(a)(3)(B)(i)-(v).
[112] §§ 6903(a)(4)(B)(i)-(v). For the statutory definition of the 10 listed types of investments, *see* § 6901.
[113] § 6903(a)(3)(C).
[114] § 6903(a)(4)(C).

one half of that permitted for licensed monoline companies.[115] Section 6904(c) requires the following minimum surplus and contingency reserves (in the aggregate) relating to those risks in the sum of the following items:

1. 0.333 % of the aggregate net liability under municipal bond guaranties and investment grade utility first mortgage obligation;

2. 0.666% of the aggregate net liability under guaranties of investment grade asset-backed securities;

3. 1% of the aggregate net liability under guaranties secured by collateral are having a term of seven years or less relating to investment grade industrial development bonds and other investment grade obligations;

4. 1.5% of the aggregate net liability under guaranties of other investment grade obligations;

5. 2% of the aggregate net liability under guaranties under non-investment grade consumer debt obligations and non-investment grade asset-backed securities;

6. 2.5% of the aggregate net liability under guaranties of non-investment grade obligations secured by first mortgages on commercial real estate and having a loan to value[116] ratios of 80% or less;

7. 4.0% of the aggregate net liability under guaranties of other non-investment grade obligations; and

8. Any additional surplus to policyholders determined by the superintendent to be adequate to support the writing of residual value insurance, surety insurance and credit insurance if the reinsurer is conducting this type of business.[117]

Further, 6904(d) limits the amount of risk, net of collateral and reinsurance, that can be undertaken in any single reinsurance transaction. Those limitations are as follows:

1. For municipal obligation bonds, special revenue bonds, and their functional equivalents - the insured annual debt service with respect to a single entity and backed by a single revenue source shall not exceed 10 percent of the aggregate of the insurer's surplus to policyholders and contingency reserve in the insured unpaid principal issued by a single entity and backed by a single revenue source shall not exceed 75 percent of the aggregate of the insurer's surplus to policyholders and contingency reserves;

[115] § 6906(a)(2)(C).
[116] Loan-to-value ratios are also defined in § 6901.
[117] § 6904(c).

2. For asset-backed securities issued by a single entity and for each pool of consumer debt obligations, the lesser of the insured average annual debt service or insured unpaid principal shall not exceed 10 percent of the aggregate of the insurer's surplus for policy holders and contingency reserve, provided that no asset in the pool supporting the asset-backed securities exceeds the single risk limits prescribed if directly guaranteed;[118]

3. For obligations issued by a single entity and secured by commercial real estate and not meeting the definition of asset-back securities, the insured unpaid principal less 50 percent of the appraised value of the underlying real estate shall not exceed 10 percent of the aggregate of the insurer's surplus to policy holders and contingency reserves;

4. For utility first mortgage obligations, the insured average annual debt service shall not exceed 10 percent of the aggregate of the insurer's surplus to policy holders and contingency reserves; and

5. For all other policies providing financial guaranty insurance with respect to obligations issued by a single entity and back by a single revenue source, the insured unpaid principal shall not exceed 10 percent of the aggregate of the insurer's surplus to policy holders and contingency reserve.

Section 6906 further provides that the maximum "total exposure" reinsured net of reinsurance and collateral shall be one-half that permitted for monoline companies. The statute does not contain any aggregate limitations for risks undertaken by monoline companies since it only sets, as described above, minimum reserve requirements and single transaction limits. Accordingly, it is not clear whether this limitation of "total exposure" relates to the single transaction limitation in 6904. Because this provision is inartfully drafted, the best educated guess is that on a per transaction basis, only 50 percent, net of collateral, may be reinsured by multiline reinsurers licensed under section 4102(c). This interpretation, if correct, would prohibit pure fronting arrangements for the issuance of financial guaranties.

C. COMPLIANCE WITH ULTIMATE LIMITATIONS OF 6906

The final limitation of section 6906 is exceedingly ambiguous. It appears that the statute "assumes" that it is allowing multiline companies to reinsure only 50 percent of all financial guaranty risks (net of collateral and reinsurance). However, it is impossible for any single insurer to know the aggregate of financial guaranty risks being reinsured at any given time. It appears that the 50 percent limitation relates to the overall reinsurance of the ceding company and that if this rule is violated, the ceding company will lose the effect of its

[118] For the definition of "asset-backed securities" and "average annual debt service," *see* § 6901(e) and §6901(f), respectively. In addition, section 6904 also sets out other limitations for asset-back securities when the insurer is a "special purpose corporation."

reinsurance above the 50 percent limitation on its surplus. Thus, this is a condition that will have to be monitored by the ceding company.

The last two conditions of Section 6906 raise an important issue. All of the restrictions on the amount of reinsurance taken by a multiline reinsurer are enforced not against the reinsurer, but against the ceding company. Accordingly, the ceding company loses credit for reinsurance from a multiline company if it cedes more of a given financial guaranty risk to a reinsurer than the law permits or if it fails to ensure that the reduction in its reserves are offset by an increase in the multiline reinsurer's reserves. Whether a multiline insurer might be subject to regulatory punishment for failing to abide the requirements of 6906 is still an open issue.

D. FINANCIAL GUARANTIES AND STANDARD & POOR'S "FER" RATINGS

Recently, Standard & Poor's announced the roll-out of a new product aimed at multiline insurers that are providing guaranties to capital markets transactions. That "product" is a proposed assessment by S & P of a multiline insurance company's willingness and ability to make payment on guaranties provided for credit enhanced and financial guaranty transactions. This product, and its acceptance by the capital markets could create serious issues for multiline insurance companies which provide bonds in relation to structured finance transactions.

S & P has written three papers which outline the problems that have generated the creation by S & P of this new product. The papers entitled, "Financial Guaranties: Beware the Land Mines" and "New Providers of Bond Insurance Broaden The Market . . . But Investors Should Beware," are available on the S&P website. They lay out the problems perceived by S&P with multiline insurance companies' issuing bonds or guaranties related to structured finance and capital markets transactions. The gist of the concern is that the capital markets expect immediate payments on bond demands, while insurance companies are more inclined to investigate, delay and pay only when absolutely obliged. This broad-brush concern has supposedly been voiced by a sufficient number of investors to prompt S & P to propose the "FER" (Financial Enhancement Rating) product as a response.

The paper entitled, "Insurer Financial Enhancement Ratings: The Analytic Process," lays out the concept behind the FER rating. As explained by S & P, multiline insurance companies would be reviewed to determine their willingness and commitment to make payment in line with capital markets requirements, and their payment history would be reviewed to determine whether they can and will make such payments. In addition, S & P will review the multiline insurance company's capital retention to determine whether or not the capital retention practices of the company are sufficient to assure prompt, immediate and full payment under its obligations. The representatives at S & P have explained that the FER rating would be either equal to the existing financial rating of the company or be nonexistent.

The rating or lack thereof would be periodically published by S & P as it publishes its financial ratings.

These proposed rating structures, if accepted by the capital markets, could pose serious problems for multiline insurance companies. First, the FER rating is intended to be a rating of the ability of the multiline insurance company to participate in credit enhanced or financial guaranty transactions. This raises the immediate spectre of financial guaranty prohibitions in New York and other states. It should be noted that at least one member of the New York Insurance Department was present in the audience for the S & P promotion. The published FER ratings will at least highlight which multiline insurance companies are involved in transactions that might be viewed as financial guaranties.

Second, the review of capital retention practices as regards these transactions is likely to require insurance companies to retain more capital than currently required by law or currently maintained by multiline insurance companies. S & P has indicated that it is highly likely that most multiline insurers do not retain capital sufficient to provide confidence to the capital markets that prompt payment could or would be made. Clearly, this is designed to bring capital retention practices of sureties and multiline insurers more into line with bank capital retention practices. It is not clear whether the capital retention requirements will exceed those required for financial guaranties by the Article 69 of the New York Insurance Law.

Finally, S & P indicated that if, as a consequence of their review of a multiline insurer for FER purposes, S & P discovered information suggesting that the insurer's overall credit rating should be adjusted, S & P would make such adjustments at that time. Accordingly, a multiline insurer might find its existing credit rating jeopardized if, during a FER credit review, S & P discovered additional information as to amount of risks, capital retention and other practices which might have affected their earlier credit rating analysis.

Accordingly, this proposed product may create serious problems for multiline insurers. It is not currently known whether this product will ultimately be required by the capital markets. That is an issue which all sureties who provide bonds in connection with structured finance products will have to keep a close eye on.

CONCLUSION

The New York statutory scheme governing financial guaranty insurance and reinsurance is intricate, complex, sometimes confusing, and occasionally simply ambiguous – perhaps unavoidably, given that the market encompasses such a variety of transactions and continues to develop so rapidly. Moreover, aside from some legislative history, there is little in the way of authoritative interpretation to provide guidance. There are very few reported court decisions, and they do not address the central issues. Meanwhile, the opinions of the Office of the General Counsel consider only those questions which are presented to the Insurance Department and therefore do not constitute a comprehensive commentary. In any event, they are non-binding. As to many key matters, those responsible for evaluating the impact of statutory provisions on contemplated transactions will be left with only the statutory language.

The "Appleton Rule" compounds compliance issues because an insurer authorized by New York must consider New York's Article 69 in connection with nationwide and even worldwide transactions. As the importance of financial guaranties as a vehicle for enhancing the investment grade of underlying obligations continues to grow and evolve, so will the challenges posed by New York's financial guaranty insurance law.