MEMORANDUM

TO:     Stewart Guerin, Chair, Valuation of Securities (E) Task Force  
        Members of the Valuation of Securities (E) Task Force  

FROM:  Bob Carcano, Senior Counsel, NAIC Investment Analysis Office  

CC:     Charles Therriault, Director, NAIC Securities Valuation Office  

DATE:  February 19, 2015  

RE:     Legal and Credit Risk Assessment Criteria for Transactions Supported by Letters of Credit or Guarantees

1.  Introduction – The SVO was asked to describe the standards and criteria to be met before a transaction could be considered “bond-like” by the Valuation of Securities (E) Task Force where the financial obligation of an obligor to make specified payments is assumed by a 3rd party through the issuance of a letter of credit (LOC), guaranty or other similar instrument. The request was made in support of a project of the Life Risk Based Capital (E) Working Group to develop charges for letters of credit or guaranties which would qualify as “other security” under the XXX/AXXX Reinsurance Model Regulation. The Life Risk Based Capital (E) Working Group was considering permitting insurance companies to choose, in defined circumstances, to submit a reinsurance obligation backed by a LOC or a guaranty to the SVO for an NAIC Designation. The requested research would permit the Life Risk Based Capital (E) Working Group, the Valuation of Securities (E) Task Force and industry to evaluate that approach. This memorandum discusses legal and credit standards and criteria used to determine whether a LOC or a guaranty effectively substitutes the credit risk of a 3rd party for that of the obligor. Only a transaction that substitutes the 3rd party’s credit risk could be considered bond-like.

2.  Credit Substitution – Credit substitution is an analytical technique in which an NAIC Designation is assigned to a transaction not on the credit quality of the obligor but of a 3rd party who has agreed, in a written instrument having the legal formality necessary to be legally enforceable against the 3rd party, to pay the amount owed by the obligor.

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1 The charge is as follows: Develop an appropriate “RBC cushion” for an insurer ceding XXX/AXXX policies when the assuming reinsurer does not file an RBC report using the NAIC RBC formula and instructions. Essential

2 The definition of “other security is contained in Actuarial Guideline XLVIII - Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830).
3. **Legal Framework Governing Letters of Credit, Guaranties and Other Surety Arrangements**

a. **Letters of Credit** - A letter of credit (LOC) is an undertaking (i.e., obligation) obtained by an applicant for the benefit of a beneficiary in which an issuer agrees to pay a stipulated amount of money against the presentation of documents that comply with the terms and conditions of the credit. A properly drafted LOC provides reliable payment because the issuer of a LOC cannot refuse to pay the beneficiary on the basis of a dispute between the applicant and beneficiary or a dispute between the issuer and applicant. The issuer’s obligation to pay is a primary obligation “independent” of the transactions that give rise to it. A LOC issuer’s defenses to paying a draw on the LOC are very limited in scope.

b. **Guaranties and Surety** - A guaranty is an instrument in which a third party agrees to be secondarily liable on an obligation. A guaranty can be “of payment” (the third party agrees to pay if the primary obligor defaults) or “of collection” (the creditor must exhaust efforts to collect from the primary obligor before having recourse to the third party). A surety is the legal name used for guaranty like arrangements in which a third party agrees to be jointly and severally liable with the principal obligor. A suretyship arrangement (i.e., a guaranty or surety) creates a secondary dependent obligation. Because the guarantor or surety is potentially liable to pay the creditor for the obligor’s obligation, the law grants the third party the right to cause the principal obligor to perform its obligation and provides the third party with defenses; i.e., the ability to avoid paying the obligation (suretyship defenses) if activity between the creditor and the primary obligor increases the third party’s cost of performance or lessens its ability to cause the primary obligor to perform. An agreement to pay the obligation of another in which the third party can assert defenses to payment does not provide the certainty of payment necessary for credit substitution. However, contact law generally permits parties to structure an agreement anyway they choose. Accordingly, the obligor and the third party can structure the suretyship agreement to waive suretyship defenses and create an absolute (the third party agrees to pay the creditor without any pre-condition to performance) or a conditional (the third party agrees to pay upon the occurrence of a stated event such as default) agreement.

4. **Credit Substitution Analysis - Process and Standards**

a. **Elements of the Third Party Instrument** - Only a LOC containing only documentary conditions to payment is suitable for use in credit substitution. Although, the law directs the issuer of a LOC to ignore non-documentary conditions to payment, non-documentary conditions may transform the issuer’s primary and independent obligation to pay into a suretyship agreement. To be a suitable basis for credit substitution, a guaranty or surety agreement must be “of payment,” rank pari-passu with the third party’s senior unsecured obligations, be payable on the due date and provide for reinstatement if payments made to the creditor are clawed back by a bankruptcy court. The guaranty should be unconditional, waive suretyship defenses and defenses that may accrue under the guaranty, such as validity and enforceability of the guaranteed obligations (a blanket disclaimer of “any other circumstances that might constitute a defense to the guarantee” is likely to be construed as sufficient to waive defenses). The term of the guaranty or surety agreement would also have to be available for a specified time with provision made for replacing the LOC or guaranty if and when the original third party withdraws from the transaction.

b. **Overview of the Assessment Process** – Credit substitution methodology combines operational, mechanical, financial and legal analysis. Operational analysis involves an evaluation of the scope and size of the obligor’s financial and performance obligations; the persons who will administer the transaction and the rules and procedures that govern performance of the payment obligation. Mechanics involve a detailed evaluation of the procedures established for critical transaction functions such as payments, draws on the third party, reinstatement of the support document after draws and default leading to a conclusion whether or not the specified procedures result in full and timely payment. Financial analysis evaluates the long term economic and financial viability of the obligor and the third party; the likelihood that the obligor will default and trigger the third party’s obligation and whether the support instrument is appropriately sized to cover the obligor payment obligation. Legal analysis begins with an evaluation of the third party instrument to determine
its suitability as a substitute for the obligor’s promise as discussed above; encompasses whether the support instrument is the legal and valid obligation of the 3rd party and considers preference risk (i.e., the risk that the obligor becomes bankrupt immediately after making a payment to investors and that debt service payments made before the obligor's bankruptcy filing may be clawed back from investors by a bankruptcy court,) and other insolvency risks suggested by the structure.  

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Legal formalism is the practice of Courts to imbue words and instruments with a presumptive legal meaning and to impute to the parties the result ascribed to those words or instruments by law. Legal formalism provides a way to judge whether an instrument would be enforced because judicial expectations and the rules of interpretations courts employ can be analyzed. Less legal formalism introduces litigation risk because it leads parties to create unique instruments and or vary known instruments introducing greater subjectivity to the transaction. For example, English law provides that “anything in writing is a guarantee if it contains...some promise or assurance...that defects will be made good.” However, the focus of an English court will be on what the parties think the words mean - not the historical legal significance of the terms used.” DiMatteo and Sacasas, Credit and Value Comfort Instruments: Crossing the Line From Assurance to Legally Significant Reliance and Toward a Theory of Enforceability, 47 Baylor L. Rev. 357, 367-372 (1995). For further analysis of legal formalism, see Ernest J. Weinrib, Legal Formalism: On the Immanent Rationality of Law, 97 Yale L.J. 949 (1988). “The decision to use a particular instrument has frequently been driven not by the legal underpinnings of the instrument but rather by the user’s need for differing tax, regulatory, or accounting treatment. The problem...is that each instrument was created in a very different environment...that defined their utility in differing ways. The failure to fully understand the nuances...has resulted in an unintended clash of cultures among the different day-to-day worlds from which these instruments emerged...financial instruments are not all created equal and the failure to understand this simple fact may prove disastrous for both the unwary purchaser and the intended beneficiaries...” Robert D. Aicher, Deborah L. Cotton, TK Khan, Credit Enhancement: Letters Of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures), 59 Business Lawyer 897, May, 2004.

Parties to a transaction may choose to obtain from at least four LOC law frameworks: the Uniform Commercial Code, the Uniform Customs and Practices; The United Nations Commission on International Trade Law’s Uniform Customs and Practice for Documentary Credits and Standby Letter(s) of Credit mean any arrangement, however, named or described, whereby a Bank, (the issuer) undertakes to make a payment against presentation of documents, but upon the determination of an extrinsic fact such as applicant's failure to perform...and where that condition appears on its face to be fundamental and would, if ignored, leave no obligation to the issuer under the document labelled letter of credit, the issuer's undertaking is not a letter of credit. It is probably some form of suretyship or other contractual arrangement and may be enforceable as such... undertakings whose fundamental term requires an issuer to look beyond documents and beyond conventional reference to the clock, calendar, and practices concerning the form of various documents are not governed by Article 5... Although Section 5-108(g) recognizes that certain nondocumentary conditions can be included in a letter of credit without denying the undertaking the status of letter of credit, that section does not apply to cases where the nondocumentary condition is fundamental to the issuer's obligation. Note, however, that no particular phrase or label is necessary to establish a letter of credit. It is sufficient if the undertaking of the issuer shows that it is intended to be a letter of credit. In most cases the parties' intention will be indicated by a label on the undertaking itself indicating that it is a "letter of credit," but no such language is necessary...”

UCP Section A General Provisions and Definitions, Article 2 – Meaning of Credit – For the purposes of these Articles, the expressions Documentary Credits and Standby Letter(s) of Credit (hereinafter referred to as Credits mean any arrangement, however, named or described, whereby a Bank, (the

End Notes

1 Credit substitution analysis is identified as an NAIC methodology in Part Three, Section 2 (c) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

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"Issuing Bank") acting at the request and on the instructions of a customer (the "Applicant") or on its own behalf, i.e. to make a payment to or to the order of a third party (the "Beneficiary") or to accept and pay bills of exchanges (Drafts) drawn by the Beneficiary, or ii. Authorizes another bank to effect such payment, or to accept any pay such bills of exchange (Drafts) or iii. Authorizes another bank to negotiate against stipulated document(s) provided that the terms and conditions of the Credit are compiled with...

UCP Section A General Provisions and Definitions, Article 3 –Credits v. Contracts – Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertakings of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil and other obligation under the Credit is not subject to claims or defenses by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.

The issuer of a letter of credit cannot assert lack of consideration as a defense to payment. The law also provides that a letter of credit that is silent on the issue of revocability is deemed to be irrevocable. A letter of credit is only revocable if it explicitly states so. By law, a letter of credit that is silent as to expiration expires 1 year after issuance. And, a letter of credit that is stated to be perpetual expires 5 years after its stated date of issuance. See, U.C.C. 5-105; U.C.C. 5-106 (a); U.C.P. Article 6; U.C.C. 5-106 (c); U.C.P. Articles 42. Article 42 provides that every Credit should stipulate an expiry date for presentation of documents and that an expiry date stipulated for payment, acceptance or negotiation would be construed to express an expiry date for presentation of documents.

11 A surety agreement is created when a 3rd party (the secondary obligor), by contract (the secondary obligation), grants a creditor recourse to its property or person in connection with an obligation of another person (the principal obligor); regardless of the form of instrument or name given to the agreement. All of the rules of contract formation apply to the formation of secondary obligations. RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY, Section 7. Suretyship agreements (guarantees or surety) must be in writing to be enforceable and are interpreted in accordance with the general law of contracts. RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY - Section 14. For “in writing” requirement see
because it incorporates non-documentary conditions. See, for example, Article 9 of the U.C.C. would govern a transaction in which the third party agrees to grant the creditor a security interest in specific debtor only if the contract is intended to benefit the creditor, or by the third party granting the creditor a security interest in its property to secure the surety or guarantor (or whatever other name is given to the third party entity protecting the creditor,) must be created by contract. Section 2 of the Restatement states that the contract can be between: the third party and the creditor, the third party, the debtor and the creditor or the third party and the debtor only if the contract is intended to benefit the creditor, or by the third party granting the creditor a security interest in its property to secure the obligation to the creditor. Also, either obligor can contract with another person by which the other agrees to assume the obligation, the surety or guarantor (or whatever other name is given to the third party entity protecting the creditor,) must be created by contract. Section 2 of the Restatement states that the contract can be between: the third party and the creditor, the third party, the debtor and the creditor or the third party and the debtor only if the contract is intended to benefit the creditor, or by the third party granting the creditor a security interest in its property to secure the obligation to the creditor. It is possible that the principal obligor does not have to reimburse the secondary obligor, for example, when the principal obligor had a defense against payment not available to the secondary obligor. RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY, Section 18.

RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY - Section 37 discusses acts of the creditor that fundamentally alter the risks of the third party and those acts that impair recourse of the third party against the debtor. When the act fundamentally alters the risks that the third party agreed to take, the rule is to discharge the third party from the secondary obligation. However, if the act only impairs the third party’s right, then the rule is that the third party is not discharged but only excused from so much of the secondary promise as corresponds to the impairment. If the creditor has received performance then the third party is granted a claim against the creditor. Acts that are deemed to fundamentally alter the third party’s risk are: releasing the debtor from a duty other than the payment of money or agreeing to a modification of the duties of the debtor that is either a substituted contract or one that imposes risks fundamentally different from those existing prior to the modification. In these cases, the rule requires discharge of the secondary obligation. Acts that are deemed to only impair the third party’s recourse against the debtor include: releasing the debtor from a duty to pay money, granting an extension of time for performance in other than the way discussed above, modifying the duties of the debtor, impairing the value of collateral, failing to institute action before the expiry of applicable statute of limitations or any other omission that impairs the debtor’s duty of performance. In these cases, the third party is discharged to the extent necessary to prevent a loss. See RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY - Sections 21 and 22. It is possible that the principal obligor does not have to reimburse the secondary obligor, for example, when the principal obligor had a defense against payment not available to the secondary obligor. RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY, Section 18.

RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY - Sections 6 and 48; “(1) The secondary obligation is not discharged . . . to the extent that, in the contract creating the secondary obligation or otherwise, the secondary obligor consents to acts that would otherwise be the basis of the discharge, agrees that such discharges are unavailable to the secondary obligor, or waives such discharges. Consent may be express or implied from the circumstances. Such consent, agreement, or waiver, if express, may be effectuated by specific language or by general language indicating that the secondary obligor waives defenses based on suretyship (2) Under these circumstances indicate otherwise, when the secondary obligor either controls the principal obligor or deals with the obligee on behalf of the principal obligor, consent by the principal obligor to an act that would lead to discharge pursuant to § 37 constitutes consent to that act by the secondary obligor.”

ALCES, INDEPENDENCE, INTERDEPENDENCE AND THE SURETYSHIP PRINCIPLE, 1993 U. ILL. L. REV. 447, 453; See, the discussion in RESTATEMENT (THIRD) of SURETYSHIP AND GUARANTY referenced supra. To some extent, phrases such as “absolute” and “conditional” used to characterize a guaranty or a surety agreement are linguistic handles intended to orient analysis or convey expectations. The practitioner-analyst may use the phrase to convey that the contractual provisions in a specific agreement convey an absolute or a conditional commitment to pay. Such phrases may also be used to convey an expectation of the specifics of an agreement necessary to permit credit substitution or some other objective of parties to a transaction. In practice, however, the practitioner-analyst is concerned first with reading all of the language used in the agreement to assess its legal consequences. “[W]hatsoever the title of the guaranty, the important element is to delineate (1) what obligations are covered, and (2) what preconditions for liability are imposed.” Drafting Effective Contracts: A Practitioner’s Guide, Robert A. Feldman and Raymond T. Nimmer, Part II, Chapter 8, § 8.03 TYPES OF GUARANTIES AND PERFORMANCE. See also, the credit rating agency literature identified in end-note 23. As an important practical matter, the creditor is unlikely to be able to assert that the guarantor waived defenses to payment if such waivers are not incorporated into the guaranty. And because surety defenses exist for the protection of the guarantor/surety and because the guarantor/surety have the right to shape the agreement in any way they wish the guarantor/surety should be independently motivated to ensure that any waiver of defenses is clearly expressed in the guaranty or surety agreement. A guarantor may assert two general types of defenses against a creditor: those of the principal obligor and those that may exist in respect of the guaranty itself. The kind of defenses to be waived in a guaranty are reflected in the following concepts: whatever rights the guarantor has to escape liability due to the creditor’s release of the primary obligor or the modification of the primary obligation; guarantor will remain liable even if the obligor is found not to be liable; guarantor agrees that the obligation to pay under the guaranty is not affected by fraud; the guarantor authorizes the creditor without notice or consent from the guarantor to release the underlying debt and/or the collateral securing it without in any way affecting or discharging the guarantor; the guarantor agrees that the obligation is not affected by lack of enforceability of any of the obligations of the obligor, release of any obligor or other guarantor, and any other circumstances which might constitute a defense available to, or a discharge of, the obligor or any other guarantor with respect to any of the guaranteed obligations; the guarantor waives the right to interpose counterclaims or set-offs of any kind in litigation to enforce the guaranty; the guarantor consents to allow the creditor to extend the borrower’s liability and to sell or surrender the
collateral security without impairing or effecting in any way the liability of the guarantor. The necessary result of the foregoing text and waiver of defense is to make the guarantor’s liability independent of the underlying obligation. See, Glen Banks, 28 N.Y. Prac., Part VIII, Chapter 25, Section 25.14 (Database updated April 2014). See also, Neil B. Cohen, Striking the Balance: The Evolving Nature of Suretyship Defenses, 34 Wm. & Mary L. Rev. 1025 (1993).

17 U.C.C. 5-108 (g) - If an undertaking constituting a letter of credit under Section 5-102 (a) (10) contains nondocumentary conditions, an issuer shall disregard the nondocumentary conditions and treat them as if they were not stated. U.C.P. Article 13 (c). Article 13 (c) provides that “[i]f a Credit contains conditions without stating the documents to be in compliance therewith, banks shall deem such conditions as not stated and disregard them.”

18 See, Soshuk, The Consequences of Non-Documentary Conditions, 56 Brooklyn L. Rev. 33 (1990) and U.C.C. 5-108 (g) above. UCC 5-108 (g). Official Comment 9 The responsibility of the issuer under a letter of credit is to examine documents and to make a prompt decision to honor or dishonor based upon that examination. Nondocumentary conditions have no place in this regime and are better accommodated under contract or suretyship law and practice. In requiring that nondocumentary conditions in letters of credit be ignored as surplusage, Article 5 remains aligned with the UCP (see UCP 500 Article 13c), approves cases like Pringle-Associated Mortgage Corp. v. Southern National Bank, 571 F.2d 871, 874 (5th Cir. 1978), and rejects the reasoning in cases such as Sherwood & Roberts, Inc. v. First Security Bank, 682 P.2d 149 (Mont. 1984). Subsection (g) recognizes that letters of credit sometimes contain nondocumentary terms or conditions. Conditions such as a term prohibiting “shipment on vessels more than 15 years old,” are to be treated as surplusage. Similarly, a requirement that there be an award by a “duly appointed arbitrator” would not require the issuer to determine whether the arbitrator had been “duly appointed.” Likewise a term in a standby letter of credit that provided for differing forms of certification depending upon the particular type of default does not obligate the issuer independently to determine which kind of default has occurred. These conditions must be disregarded by the issuer. Where the nondocumentary conditions are central and fundamental to the issuer’s obligation (as for example a condition that would require the issuer to determine in fact whether the beneficiary had performed the underlying contract or whether the applicant had defaulted) their inclusion may remove the undertaking from the scope of Article 5 entirely. See Section 5-102(a)(10) and Comment 6 to Section 5-102. Subsection (g) would not permit the beneficiary or the issuer to disregard terms in the letter of credit such as place, time, and mode of presentation. The rule in subsection (g) is intended to prevent an issuer from deciding or even investigating extrinsic facts, but not from consulting the clock, the relevant law and practice, or its own general knowledge of documentation or transactions of the type underlying a particular letter of credit. Even though nondocumentary conditions must be disregarded in determining compliance of a presentation (and thus in determining the issuer’s duty to the beneficiary), an issuer that has promised its applicant that it will honor only on the occurrence of those nondocumentary conditions may have liability to its applicant for disregarding the conditions.


20 See, Drafting Effective Contracts: A Practitioner’s Guide, Robert A. Feldman and Raymond T. Nimmer, Part II, Chapter 8, § 8.03 TYPES OF GUARANTIES AND PERFORMANCE and cases cited in the footnotes in paragraph (C). The teaching is not that the use of words such as unconditional alone will be interpreted as a full waiver of defenses. The meaning to be accorded words such as absolute, irrevocable and unconditional in a guaranty or surety agreement must be determined functionally: i.e., in the context of the totality of the words used in the instrument and the nature and purpose of the guaranty or surety. Thus, the words used in the transaction must be considered in context, but the context will depend upon the language of the guaranty or surety agreement. A requirement to payment of a default indicates a secondary and conditional obligation so that the phrase unconditional is in effect to waive suretyship defenses; RESTATEMENT (THIRD) OF SURETSHIP AND GUARANTY, Section 48 and comment d. See “Reporter’s Notes, Section 48, Paragraph 4. “The authorities are in conflict as to whether suretyship defenses may be waived by the use of phrases such as ‘unconditional guaranty’ or ‘absolute guaranty.’” (The RESTATEMENT adopts the view of U.C.C. § 5-605 (c) (1995), which indicates that the language used must “indicate[s] that parties waive defenses based on suretyship or impairment of collateral. See, e.g., Langleveld v. L.R.Z.H. Corp., 74 N.J. 45, 376 A.2d 931 (N.J.1977); but see, e.g., Istituto Mobiliare Italiano, S.p.A. v. Motorola, Inc., 689 F.Supp. 812 (N.D.III.1988).

In New York a third party instrument stated to be unconditional is fully enforceable and would deprive the guarantor of suretyship defenses if the totality of the transaction demonstrates that the guarantor agreed to be primarily liable. A guaranty that provides that Capitano irrevocably and unconditionally guaranteed Chemical for any and all obligations incurred by New York Pillow, was fully enforceable in accordance with its terms and the guarantor could not claim as defense to payment that he did not know that one additional extension of credit. Preferred Equities Corporation v. Chemical Bank v. Meltzer, 93 N.Y.2d 296 (N.Y. Ct. of App. 1999). This result obtains because the claimed defense of fraud contradicts the meaning of the words used in the waiver. But the Court’s focus remains on what was specifically agreed. For example, a guarantor could not claim that the failure of the creditor to perform an oral promise extrinsic to the written instrument provided it with a defense to payment based on fraud when the agreement was by its terms unconditional. See, Citibank, N.A. v Plapinger, 66 N.Y.2d 90, (NY Ct. of App., 1985. Also, Citizens and Southern Commercial...
Clause declaring the agreement absolute and unconditional, and containing a waiver of affirmative defenses, "reinforces" the specificity of the fraud in the inducement, where the guarantor specifically disclaimed reliance on the very information which it now claims caused it to be misled…a between sophisticated business people" involved in a "multimillion dollar" transaction.

**MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.**

Defendants' negotiations with the lenders…"

...the specific representations that form the basis of the fraud claim ... in Plapinger, even though the disclaimer language may have been broad and general,...the corporate officers had to know that, at a minimum, the disclaimers precluded reliance on any specific oral promises made during the defendants' negotiations with the lenders...” JPMorgan Chase Bank v. Liberty Mut. Ins. Co., 189 F. Supp. 2d 24, 27 (S.D.N.Y. 2002).(emphasis added). See also, MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc., 27 Misc. 3d 1233(A), 911 N.Y.S.2d 694, (Sup. Ct. 2010) (“In Plapinger... the Court of Appeals set down the ... doctrine that a specific (rather than general) disclaimer in a guarantee bars the guarantor’s claim for fraud in the inducement, where the guarantor specifically disclaimed reliance on the very information which it now claims caused it to be misled...a clause declaring the agreement absolute and unconditional, and containing a waiver of affirmative defenses, “reinforce[es]” the specificity of the disclaimer...The Plapinger Court also noted the importance of the fact that the guarantee in question had been the product of "extended negotiations between sophisticated business people" involved in a “multimillion dollar” transaction.”).

21 Manufacturer’s Hanover Trust v. Yanakas, 7 F.3d 310 (2d Cir. 1993). See EN 19 analysis; See also: Valley Nat. Bank v. Greenwich Ins. Co., 254 F. Supp. 2d 448, 458 (S.D.N.Y. 2003) (“Furthermore, the issue of specificity of the disclaimer, viewed as so crucial to the court in Yanakas, is less applicable in this situation where the drafter and more sophisticated party in the transaction now claims that the disclaimer is too broad and not specific enough. All of the cases that the Yanakas court relied on to build its rule of specificity involved situations where the non-drafting and typically less sophisticated party accepted a contract containing a disclaimer defendant later asserted did not waive its defense of fraud in the inducement.”); Commercial Money Ctr., Inc. v. Illinois Union Ins. Co., 508 F.3d 327, 343 (6th Cir. 2007).

22 The obligor may be required to make payment beyond interest and principal for debt service. Payments may include interest, principal, premium, pre-payment fees, make-whole payments, steps up in interest, penalties, amounts clawed back by a bankruptcy court and fees. Sometimes performance obligations can trigger remedies and either other payments or a disruption of the transaction. Sizing refers to a calculation of type and frequency of payments and the maximum possible payment due under formulas embedded in the document.

23 The evaluation will identify the accounts established to receive, manage and distribute cash; the sources of the funds deposited in such accounts; the insolvency risks associated with such sources; time periods given the paying entity to determine if funds are insufficient to make payment when due; instructions on when and how to draw on the 3rd party, whether funds received are commingled or deposited in a separate trustee account and whether they are invested and in what. Mechanics also evaluates how 3rd party draws, reimbursement and reinstatement of the amount of the support instrument are coordinated. If a draw on the 3rd party triggers acceleration, mechanical procedures must provide for a draw for the full amount of the outstanding obligation.

24 SVO credit substitution methodology generally follows those used by Credit Rating Providers but is adjusted to reflect: the specific structure, mechanics and legal considerations in a given transaction; the regulatory objectives for which the NAIC Designation is assigned and that SVO credit quality assessments occur after the insurer has purchased the transaction. Adjustments due to post-purchase filing might mean the SVO would not, for example, insist on legal opinions with respect to insolvency or enforceability issue, assessing that issue by reference to the insurer’s and SVO internal legal assessment and by noting the designation if and as indicated. The SVO also has the option of not assigning an NAIC Designation if the structure of the transaction and or of the 3rd party credit support instrument is deemed to be materially defective. Credit and legal standards and the credit substitution methodology used by the CRPs are described in the following literature, which was consulted for this memorandum: DBRS Methodology – Rating U.S. Structured Finance Transactions, December 2014. DBRS, Criteria: Guarantees and Other Forms of Explicit Support, July 2013. DBRS Methodology Rating U.S. Structured Finance Transactions Backed by Direct Pay Letters of Credit, May 2012. Moody's Investors Service, Sector in Depth Banking – Global Moody’s Proposed Counterpart Risk Rating: Frequently Asked Questions, January 20, 2015. Moody's Investors Service, Cross Sector Rating Methodology - Rating Transactions Based on the Credit Substitution Approach: Letter of Credit-backed, Insured and Guaranteed Debts, March 5, 2013. Moody’s Investors Service, Special Comment: Frequently Asked Questions on Rating Bonds Backed by Bank-Issued Standby Letters of Credit, August 5, 2013 (at page 8 discussing LOC, Liquidity Facilities and 3rd party Support Agreements); Moody's Investors Service Rating Methodology Applying Global Joint Default Analysis to Letter of Credit Backed Transactions in the U.S. Public Finance Sector, October 18, 2010 (this piece describes assignment of credit ratings when the risk of default depends on the performance of both the primary obligor and a secondary obligor). Standard & Poor’s Ratings Services, Ratings Direct, General Criteria: Methodology And Assumptions Approach To Evaluating Letter Of Credit-Supported Debt, July 6, 2009. Standard & Poor’s Ratings Services, Ratings Direct: Legal Criteria for U.S. Structured Finance Transactions: Select Issues, October 1, 2008. Standard & Poor’s Ratings Services, Ratings Direct, General Criteria: Criteria Update: Joint-Support Criteria Refined, February 3, 2006.