Demystifying Credit Insurance: A Guide to Understanding and Negotiating Your Credit Insurance Policy

NACM’S 120TH CREDIT CONGRESS AND EXPOSITION
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What Is Your Company’s Largest Uninsured Asset?
Demystifying Credit Insurance

• Part I: Overview of Credit Insurance:
  – What is Credit Insurance?
  – What Risks are Covered?
  – Types of Credit Insurance
  – Benefits, Uses, & Costs

• Part II: Understanding a Credit Insurance Policy

• Part III – Key Issues
PART I: Overview Of Credit Insurance
Overview: What is Credit Insurance?

Credit insurance helps protect sellers against the risks of extending credit to their customers.

- Insurers agree to reimburse the policyholder for unpaid amounts due to a customer’s default, insolvency, or in the case of export sales, occurrence of a stated political event.
- Valuable for companies of various sizes/industries, and important to customize policy to protect against company’s unique risks (e.g., political risk, services, advertisers, partial finished goods, etc.).
- Like any line of insurance, it is designed to protect against unexpected loss.
- Not intended to make the policyholder whole – deductibles and co-insurance obligations apply.
- Historically used by European companies and domestic companies with overseas sales, where payment enforcement could be problematic.
- Increasingly used by U.S.-based companies to cover domestic sales.

Overview: What risks are covered?

- **Commercial Risks**
  - Insolvency (i.e., bankruptcy)
  - Default
  - But disputed transactions may not be covered or coverage may be conditioned on obtaining a judgment against the defaulting customer.
Overview: What risks are covered?

• **Political/Country Risks**
  - Customer may be solvent, but unable to pay you because of instability in its home country.
    - Frozen currency inconvertibility
    - Government action, legislation preventing payment
    - War, insurrection, disaster
  - Examples:
    - Greece
    - Russia/Ukraine - Sanctions
    - Argentine debt default.

Overview: What types of Coverages are Available?

**Credit insurance can be tailored to specific needs:**

• **Multiple Accounts**
  - All Accounts (aka Whole-turnover)
    - Ground up
    - Excess of Loss
  - Key Accounts
    - High/Large Concentration Accounts

• **Single Debtor**

• **Single Contract/sale**

• **Preference Risk**
“Cancelable” Coverage

- Insurer acts as an extension of the Policyholder’s credit department.
  - Insurer measures creditworthiness of Policyholder’s customers.
  - Insurer approves credit limits above discretionary credit limit (“DCL”), if applicable.

- Credit limits for customers are cancelable – but it’s not an all or nothing proposition.
  - Instead of cancelling credit limits, Insurer may gradually reduce them.
  - For ‘typical’ cancelable coverage, cancelation applies only to goods shipped/delivered/orders accepted after notice of cancellation.

(continued)

- Policyholders have limited DCL.
  - The DCL is also dependent on the policyholder’s credit procedures, loss history, payment terms, etc.

- Carriers provide on-line systems for quick action on raising buyer-DCLs.
Overview: Two Basic Approaches to Credit Insurance

“Non-Cancelable” Coverage

- Market is moving towards “non-cancelable” coverage
- Insurer is initially underwriting and trusting the Policyholder’s credit management practices.
- Insurer usually “Hands Off” – control lies with Policyholder.
  - Typically there is a larger DCL for buyers than cancelable coverage:
    - Insurer will approve credit limits to larger customers.
    - Insurer cannot cancel buyer credit limits during the policy period.

Benefits and Uses of Credit Insurance

- **Protect Against High/Large Concentration Accounts**
  - For most companies, 80% of business comes from 20% of customers.

- **Enhance Credit Management**
  - Some insurers maintain extensive databases of the creditworthiness of various companies and industries, monitor accounts, and will alert policyholders about positive and negative developments regarding customers’ creditworthiness.

- **Improve access to financing due to lender reassurance regarding policyholder’s ability to collect receivable.**

- **Allow for credit-based sales to new customers, without taking on full risk of unfamiliar customer’s default.**
Benefits and Uses of Credit Insurance

- Complying with policy requirements can improve discipline in policyholder’s sales, credit, and collection practices.
- In the event of a slow pay situation, the Insurer will attempt to work with the Policyholder to prevent a claim.
  - Bottom line: the insurer will work with you, but you must request permission to alter credit terms in advance if the alteration is contrary to the policy terms.

Cost of Credit Insurance

- Typical cost factors:
  - Degree of risk the Insured retains: deductible and coinsurance
  - Insured’s sales volume
  - Limits (overall coverage limit; customer credit limits)
  - Customers’ creditworthiness
  - Loss history
  - Collection history/Past Due A/R
  - Insured’s credit practices
  - Location of customers (esp. for overseas buyers)
  - Number of accounts covered & concentration of risk within accounts
  - Insured’s industry
Cost of Credit Insurance

Major cost variables are deductible and co-insurance

- Co-insurance is a percentage of the overall loss that the policyholder must bear. Specific application will vary by policy.
- Deductible is the fixed amount the policyholder must pay before the insurer starts to pay.
  - Deductibles are generally provided on an aggregate basis.
  - Sometimes policies will have per account deductibles instead.
- May be able to negotiate with the Insurer to recoup deductibles and co-insurance if the Insurer recovers from the customer.
- Order of application matters – co-insurance first or deductible first!

Cost of Credit Insurance

- Example:
  - Claim for $1 million; co-insurance is 10%; deductible is $100,000.
  - Deductible First: Insured recovers $810,000.
    - Subtract $100,000 from $1 million loss = $900,000; apply 10% co-insurance to $900,000.
  - Co-insurance First: Insured recovers $800,000.
    - Apply 10% co-insurance to $1 million loss = $900,000; subtract $100,000 from $900,000.
PART II: Understanding A Credit Insurance Policy
Understanding a Credit Insurance Policy

• Policy language may initially be drafted in favor of the Insurer.
  – Best to work with your broker or legal professional to help explain the benefits and pitfalls, as they act as your agents.

Understanding a Credit Insurance Policy

• Policyholders must be proactive in understanding their policy before a claim arises (behave as if uninsured).
  – Insured may have obligations throughout the policy period (e.g., notification requirements, providing A/R past due summaries) that can preclude coverage if not met.
  – Insured must understand how the insurance policy intersects with contracts with buyers.
• Negotiate policy terms with the insurer to maximize coverage and avoid uncertainties.
Understanding a Credit Insurance Policy

- **Declarations Page**
  - First page(s) of policy
  - Summarizes key terms

- **Coverage Grant / Insuring Agreement**
  - Standardized language
  - Describes the insurance offered

- **Definitions**

- **Exclusions**
  - Identifies risks excluded from coverage.

- **Endorsements**
  - Amendments to the policy – a means to customize coverage.
    - Additional coverage, additional exclusions, other terms (e.g., the approved buyer list)

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**Declarations Page**

- First page(s) of policy
- Identifies the “Named Insured”
  - Other insureds (e.g., parent, subsidiaries, affiliates) may be listed on endorsements or added via general definitions.
- Premium: Minimum premium; calculation of premium
- Policy Period
- Limits of Liability
- Deductible
- Co-insurance
- Insured percentage
Understanding a Credit Insurance Policy

**Coverage Grant**

- Also known as the “Insuring Agreement.”

- Standardized Policy Term that describes the insurance offered.
  - Language varies based on insurance company.

- Commencement of Coverage: Typical trigger is the date of sale/shipment/delivery (for goods) or the date services are provided or invoiced (for services), rather than default date.

Example of Potential Coverage Issues

**Insuring agreement:**

Insurer will pay “in respect of goods sold and Dispatched and Services Provided within the Policy Period . . . Insured Loss in the event of the Buyer failing, due to Insolvency or Protracted Default, to pay you an Insured Debt up to the Policy Amount.”

- “Dispatched” defined to mean the time when:
  - a. in the case where the Buyer is located in the same country as your country, [goods] physically pass from you into the exclusive physical control of the Buyer (which transaction must be completed within the Policy Period).

- What does this mean? Completed delivery? Delivery to warehouse in which buyer rents space but does not own or control?
  - Risk re: drop shipments.
Definitions

- Policies contain numerous defined terms that explain the scope of coverage.
  - Terms and definitions vary among carriers.
- Definitions impact coverage.

Common Exclusions

- No credit insurance policy covers disputes.
  - “[A]ny bona fide dispute of any kind between the Insured and a Buyer.”
  - “[A]ny indebtedness of a BUYER to the Insured [that] is disputed in whole or in part.”
  - “This Policy does not cover . . . any loss: which is subject to any form of dispute between you and the Buyer, unless and until each dispute shall have been finally adjudicated in your favor.”
Common Exclusions – Disputed Accounts (continued)

• Seek clarification during negotiation and renewal.
  – Insurer’s payment of undisputed portion of Insured’s claim
• Be sure the policy at least provides coverage for disputed accounts once Insured obtains a judgment.

Common Exclusions (continued)

• Losses because of the Insured’s failure to comply with Contract terms or other provisions of law.
  – Keeping current with A/R reporting.
  – Back up documentation for DCL coverage.
  – Known material insolvency issues.


**Common Exclusions (continued)**

- Losses from goods sold after seller learns of certain circumstances that may affect a buyer’s ability to pay.
  - E.g., Buyer’s cash-flow difficulties; past-due accounts
- Losses arising from delivery/dispatch of goods to customers located in certain countries (not approved).
- No coverage for sales to customers in Chapter 11 or other bankruptcy cases.

**Endorsements**

- Additional policy forms attached to the “main” policy.
- Endorsements “customize” the standard “main” insurance policy to the needs of the policyholder:
  - Add/Exclude coverage.
  - Impose additional rights or duties upon the policyholder or insured.
PART III:
Key Issues
Key Issues

Sample Timing & Reporting Requirements

• “Claims … must be made within 6 months of the expiration of the Maximum Extension Period, using the Claim form we will provide.”

• Notification of customer default:
  – Typically, a policyholder must promptly notify insurer of not just failure to pay, but also circumstances that might precede a customer default.
    • Policyholders should try to negotiate narrow set of conditions that trigger a notification obligation.

• Waiting too Long to Report Claims may affect the amount that is insured.

Key Issues

Coverage Components To Be Aware Of

• Sale must be to covered account: policyholder must ensure that sale is to an approved buyer.
  – Know who you are selling to and invoicing.
  – Beware of sales to entities affiliated with approved buyers.
    • In case law, this has been upheld as basis for denying coverage. Make sure the correct buyer is invoiced.
  – See Delta Mills, Inc. v. GMAC Commercial Finance, LLC, 404 B.R. 95 (Bankr. D. Del. 2009) (factor’s credit insurer refuses to pay upon discovery of discrepancy between insured buyer and invoiced buyer [an affiliate], resulting in factor charging loss back to seller).
  – Similarly, sale must be from policyholder – not an affiliate not named in the policy.
Coverage Components To Be Aware Of

Preferences: Customer pays you within 90 days of bankruptcy filing and the Trustee seeks to recover that payment as a preference.

- In the United States, there is usually a statute of limitations of 2 years after the bankruptcy filing date to commence a preference lawsuit.
- Are preferences covered in your company’s policy?
- Will your company be covered when a preference lawsuit is commenced after you have switched carriers?

Example of Broad Coverage Term:

- Refund of preferential payments
  - In the event you are obliged or forced to return alleged preferential payments . . . You may submit a claim for any subsequent loss you may sustain.”
  - Policyholder must meet stated requirements, such as:
    - No knowledge that payment would be treated as preferential;
    - Timely assertion of all defenses available under Bankruptcy Code;
    - Obtain insurer consent to settle.
Coverage Components To Be Aware Of

Preferences

Example of Narrow Coverage Term:

• “In the event that you receive a request to return an alleged preferential payment(s) . . . Involving a Buyer covered by an insurance policy . . . in effect on the date of Insolvency and provided that a policy has continuously been maintained by you through us, you may file . . . a claim.”

• Just as under the policy with a broader coverage term, the policyholder must meet stated requirements.

Example of No Coverage:

• No coverage for loss “arising from or related to any Preference claims or demands from insolvency administrators . . . to recover monies paid by the Buyer to you and which monies are defined as a Preference.”

• Since policy also requires strict enforcement of customer credit terms, policyholder should seek removal of this exclusion as enforcing credit terms can give rise to preference liability.
Takeaways

• Know your risks that you want covered by your policy.
• Know your policy to make sure it covers anticipated risks.
• If you have policy questions, seek clarity and answers to make sure that you are fully aware of what you are agreeing to.
• Seek the help of a legal professional and broker for the following:
  – To negotiate new and renewal policy terms.
  – Ensure compliance during the policy period.
  – Help in filing a claim under the policy.

Questions?

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SUPPLEMENT

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2. Credit Insurance – Dispelling The Myths
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Chances are your company has insurance that protects it from the risks of major losses for its significant assets (like its buildings and equipment) and various other risks (such as employment or professional liability claims). But, in many instances, a company’s largest asset and a major source of risk goes uninsured: the company’s accounts receivable. Credit insurance is an option for companies wishing to insure against that risk. Credit insurance has the potential to be a useful tool to manage, and better understand, your company’s credit risk and to protect against nonpayment by customers. However, realizing that potential requires policyholders to be proactive by understanding the key provisions of their credit insurance policies. It also involves negotiating with carriers to resolve uncertainties and obtain an insurance contract that maximizes the amount of coverage and minimizes the risk of claim denials.

What is Credit Insurance?
At the most fundamental level, credit insurance protects a seller against the risk of nonpayment that arises from the seller’s extension of credit terms to its customers. The specific circumstances that will trigger credit insurance will be spelled out in the policy itself. However, credit insurance is usually tailored to insure against commercial risks or political or country risks. Commercial risks include customers’ insolvency (including bankruptcy), nonpayment and other defaults and, if identified in the policy, preference claims asserted by a bankruptcy trustee. Political or country risks include the risk that a policyholder’s foreign customer, even if solvent and willing to pay, is unable to make payment because of some foreign government action preventing payment (i.e., an embargo), decisions regarding currency valuation, or war or insurrection.

Companies purchasing credit insurance can also tailor the policy to certain accounts. While insurers usually do not insure just the risky accounts that a company has “cherry-picked” for coverage, insurers will frequently insure categories of accounts. Typical policies will insure all of the company’s accounts (including the creditworthy and credit-risky accounts) which is known as “whole-turnover.” For many companies, the majority of their business comes from a small segment of customers making a default by one of those customers a threat to the company’s continued viability. In that situation, the company might be able to insure its key or high concentration accounts. A company might also be able to insure a single account or a single contract or sale.

Two Basic Types of Credit Insurance Policies
There are two basic types of credit insurance policies: cancelable and non-cancelable. When a policyholder purchases cancelable insurance, the insurance company becomes a credit management resource that can work with the other protocols the policyholder already has in place. Credit insurers maintain databases on millions of companies, including the policyholder’s customers, and the insurers monitor their customers’ creditworthiness and alert policyholders of changes in their customers’ outlook.

When a company purchases cancelable insurance, the insurance company sets the credit limits for each of the policyholder’s accounts based on the insurer’s rating of the account’s credit risk. Typically, a policyholder requests a credit limit for a particular account through the insurer’s online system. If the credit limit requested is at or below the insurer’s predetermined limit, approval is provided instantaneously. If the amount requested exceeds the predetermined limit, the insurer’s underwriters review the request and decide whether to approve it.

If, in the course of monitoring a given account, the customer’s creditworthiness diminishes, the insurer may reduce or cancel the credit limits it had previously approved, hence the term “cancelable.” So long as the insurer is acting in good faith, and the policy is...
appropriately drafted, such a reduction in or cancelation of credit limits will only apply to future transactions, but should not affect transactions that precede the insurer’s notification of the cancelation or reduction. In addition, while the cancelation or reduction in credit limits increases exposure to the policyholder for future transactions with the customer, the policyholder is at least aware of potential credit issues, enabling it to make an educated decision as to whether to extend credit going forward.

The second type of insurance is non-cancelable. As the name suggests, an insurer cannot unilaterally cancel or reduce the credit limit assigned to a particular customer. When an insurer sells non-cancelable insurance, the insurer is essentially trusting the policyholder’s credit management practices. As a result, unlike cancelable insurance, where the insurer is actively involved in credit decisions, an insurer’s underwriting of a non-cancelable program tends to be more “hands-off.” Policyholders may also have greater “discretionary credit limits” allowing them to have more control to assign credit limits to their accounts (though larger customers may require insurer approval).

Potential Benefits of Credit Insurance
A properly implemented credit insurance program can provide a company with several financial benefits. However, these benefits are not automatic. Instead, they require a policyholder to be proactive in ensuring that the policy purchased is the best that could be negotiated.

When properly understood and implemented, credit insurance can be a safety net against losses arising from nonpayment of accounts receivable. More pragmatically, it can be a reliable credit management tool, backed by the monitoring resources of multinational insurance carriers. Companies with credit insurance may also be able to increase sales through their ability to extend more favorable credit terms to existing customers or extend credit to new, unfamiliar customers with a carefully crafted insurance policy backstopping those sales. Policyholders might also have increased access to borrowing or lower interest rates as lenders see credit insurance as additional security for their loans.

Understanding a Credit Insurance Policy
A policyholder should be proactive to obtain and maximize the benefits of credit insurance. It is not enough to merely purchase a policy and then place it on the shelf until a loss occurs. Instead, policyholders should review and understand their policies at the purchase and renewal stages. Failure to do so might result in an unwelcome surprise (no coverage) when a customer defaults by becoming insolvent or otherwise failing to make payment to the policyholder.

Because credit insurance policies are drafted in a convoluted manner and contain many “hidden” requirements and limitations, insurers routinely avail themselves of technicalities to avoid paying claims. Proactive policyholders can arm themselves by fully understanding: (i) the policy terms; (ii) the accounts and sales of goods and/or services that are covered; (iii) the accounts and risks that are not covered; (iv) any affirmative obligations required to maintain coverage; and (v) opportunities to change those policy provisions that increase the likelihood of a coverage denial.

Anatomy of a Credit Insurance Policy
A credit insurance policy, like most insurance policies, will be typically comprised of a declarations page, a main coverage (standardized) form, and endorsements. The “dec page” is a summary of the policy’s key terms. It identifies the policyholder, the term of the policy, the premium (or how it will be calculated), the limits of liability (i.e., the maximum financial obligation of the insurer), and the deductible and/or co-insurance (which are amounts the insured must pay in the event of a loss).

The main coverage form is the heart of the insurance policy. In most cases, it is a standardized form that contains the technical policy language, which defines the scope of coverage and imposes obligations on the policyholder. The form includes an insuring agreement that is supposed to delineate the types of losses that are covered and the events that trigger an insurance claim.

What the policy provides through the insuring agreement, it takes away with policy exclusions. Exclusions, in theory, are supposed to clearly articulate those losses that are not covered. Common exclusions include claims that are not filed with the insurer in a timely manner or sales that occur after the policyholder learns about the customer’s default/insolvency. Typically, sales or transactions that are disputed by the customer are also excluded. Usually, disputed transactions only become covered after the policyholder has vindicated its right to payment through a lawsuit against its customer and the entry of judgment that remains unpaid.

Due to the technical nature of insurance contracts, policies rely on terms that are defined in the definition section of the main coverage form. An insurance policy cannot be understood without understanding the definitions; indeed, the ordinary meaning of words can be changed by a specific policy definition. Not surprisingly, terms are often defined in a way that limits coverage.

By way of one example, a policy may insure losses because of “non-payment of amounts due from a covered Buyer for Shipments of Covered Products made by you during the Policy Period.” To fully grasp the meaning of that coverage grant, it is necessary to understand the policy’s definition of each of the bolded terms. In this example, “Buyer” does not mean just any buyer of the policyholder’s goods and/or services. Instead, it is limited to a “legal entity” domiciled in the United States or Canada that “is approved for coverage under this Policy” and it does not include any “subsidiaries or affiliated companies” separate from that “legal entity.” A policyholder may believe that, because ABC Corporation is an approved buyer, sales to its subsidiary are also covered. That is not the case. In sum, a policyholder must be cognizant of the
entities with which it does business (including any affiliated entities) and take steps to include all such entities within the scope of its insurance coverage.

Because the main coverage form generally contains standardized language, policy endorsements, which are amendments to the main coverage form, are used to customize a policy to the needs of the particular policyholder. It is through endorsements that negotiated terms can be added to the policy. For example, an endorsement could be used to amend the definition of “Buyer” above, to encompass subsidiaries and affiliates, thus avoiding a technical gap in coverage and giving the insurer one less ground for denying a claim.

Key Issues and Potential Pitfalls

When reviewing and negotiating a credit insurance policy, there are a few key provisions and issues to which proactive policyholders should be attuned. By way of example:

Avoid Uncertainty. Best practices dictate that the policyholder seek clarity of vague or ambiguous policy provisions at the purchase and renewal stages. Insurance policies are technical, containing “hidden” or unclear provisions that limit the insurer’s obligations. Insurers often use such loose language to their advantage to deny claims. Thus, by seeking clarification from the insurer at the outset, a proactive policyholder can minimize both the risk of the denial of the claim, and the need for subsequent litigation to enforce its rights.

Ensure that the Trigger of Coverage Conforms to Your Company’s Practices. Whether a goods seller or service provider has coverage for its unpaid, insured accounts receivable under a policy will depend on the policy language and defined terms. For example, many policies are triggered upon “shipment” of goods. However, policyholders should ensure that the policy’s “shipment” definition aligns with its practice of selling goods or providing services to their customers. In some policies, “shipment” only occurs when the product leaves the insured’s control and passes into the buyer’s exclusive physical possession. However, for a company that delivers goods via a third party or to a location not owned or controlled by the buyer, a “shipment” may not have been completed, meaning coverage is not triggered. Likewise, companies that accept orders for specialized or customized goods should explore procuring coverage that is triggered earlier than shipment (such as on receipt of purchase orders). Taking such an approach could minimize the impact of customer insolvency that occurs after the policyholder invested significant resources prior to the delivery of goods or provision of services.

Deductible and Co-Insurance. While credit insurance can provide a significant recovery when there is a covered loss, it is extremely rare for a policy to make a policyholder whole. Credit policies almost always contain deductibles and co-insurance. The deductible is a fixed-dollar amount that the policyholder must fund before the insurance company is required to pay and, once insurance is triggered, co-insurance is the percentage of the loss that the policyholder must bear.

The order of applying the deductible and co-insurance affects the policyholder’s recovery. For example, if there is a claim for $1 million where the policy has a $100,000 deductible and 10% co-insurance, the insured recovers $810,000 if the deductible is applied first, in contrast to a recovery of $800,000 if the 10% co-insurance is first applied.

Moreover, because they pay these amounts, proactive policyholders, in an effort to be made as “whole” as possible, should be sure to maximize—through policy terms—their share of any recovery that the insurer obtains from the customer.

Preference Risk. When a customer makes a payment within 90 days of its bankruptcy filing, a bankruptcy trustee can seek to recover that payment as a preference. Some credit insurance policies do not address preference risk while other policies exclude such coverage. There are policies that do insure for preference risk, and proactive policyholders should endeavor to secure that coverage. Regardless of a particular policy’s scope, the policyholder must always comply with the exacting, yet amorphous, policy requirements, such as “immediately” providing notice of the preference claim, pursuing “all defenses” and legal “remedies available,” and securing approval for “each action” taken to defend the claim. In addition, proactive policyholders should be aware of provisions requiring them to renew the policy with the same insurer to retain the insurance for preference risk.

Notice. Policies have strict notice requirements and a failure to comply can be a complete bar to coverage for an otherwise covered claim. As soon as a default occurs, a proactive policyholder must be aware of the notice requirements to make sure that it timely files its claim.

In some cases, a policyholder may want to resolve a custom- er’s default by extending terms or agreeing upon a payment plan. While insurers often encourage such efforts (after all, if successful there will be no claim), it is necessary to obtain the insurer’s written consent to pursue such arrangements. Failure to do so can run afoul of policy terms and result in denial of the claim.

In addition to requiring notice of a given loss or the assertion of a preference claim, the policy may hold policyholders responsible for more general ongoing notice obligations. For example, a policyholder may be required to notify its insurer of certain (usually vaguely defined) circumstances that may precede or lead to a customer’s default or insolvency.

Subrogation. Credit insurance policies usually give the insurer subrogation rights after it pays a particular claim. Subrogation rights allow the insurer to “step into the shoes” of the policyholder to try to recover the unpaid amounts from the buyer. Significantly, such subrogation rights could actually violate provisions in the policyholder’s standard customer
contracts if those contracts contain “anti-assignment” clauses. There are ways to work around the anti-assignment scenario. For example, a policyholder can negotiate for a subrogation provision that allows only an assignment of the policyholder’s right to proceeds instead of an assignment of all of the policyholder’s rights under the contract. Another option is to carve out credit insurance policies from the anti-assignment provision in the seller-buyer contract.

The foregoing are only a few of the key issues facing credit insurance policyholders. Yet there is a common theme that runs through them—knowledge is power. A proactive policyholder should understand and negotiate unclear policy terms, reject a one-size-fits-all approach to policy language, appreciate the interplay between deductibles and co-insurance, and advocate for language that narrows policyholder obligations.

Conclusion
Credit insurance can be a powerful tool for protecting a company’s accounts receivable. But it is a tool that must be negotiated, purchased and handled with care. Coverage is not always what it appears. And the company that fails to fully understand a credit policy’s scope and substance could end up jeopardizing its largest asset.

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Credit Insurance - Dispelling the Myths

Putting the Misconceptions about Credit Insurance to Rest

By Jay Tenney, Credit Insurance Specialty Broker

Every day your largest asset goes out the door. Accounts receivable, which typically represent more than 40% of a company’s assets, are not only your largest asset, but also the most susceptible to unexpected loss and business cycles. There is an inherent risk associated with extending credit to your customers and trusting them to pay you for goods or services. In reality, you may have thousands, maybe even millions of dollars in receivables outstanding at any one time without something to protect your company in the event you’re unable to collect. While there is a relatively clear-cut answer to this all-too-common problem, credit insurance (accounts receivable insurance) has relatively modest market penetration among United States businesses, despite being a well-established product in the global insurance market. While credit insurance enjoys more than 70% market penetration in Europe, there are many misconceptions that keep this valuable and useful product sidelined in North America. To convey a better understanding of this useful product and its benefits, presented here are answers to the top misconceptions about credit insurance:

10. “It’s too expensive.”
Have you looked at it in the past six months? While credit insurance doesn’t come cheap, the influx of additional insurers into the U.S. credit insurance market and relatively strong economic conditions have driven prices down considerably in the past five years. Credit insurance is priced very subjectively, and as a result, users of this product have enjoyed tremendous savings over the past few years due to considerable rate reductions. By evaluating the entire market, you will certainly find an insurance company that can protect your A/R against loss without breaking the bank.

9. “We don’t have any bad debt.”
You’ve never taken a loss in the history of your company? If that’s true, let me be the first to congratulate you. But let me ask you this: Is your company achieving the levels of success that it should be? Lack of losses, while the sign of prudent credit management, is also the sign of a company that is relatively conservative with customer credit. Perhaps you are restricting or turning away customers because you’re not comfortable with extending larger credit limits for fear of suffering a larger loss if your buyer is unable to pay. You may be turning away millions of dollars a year in business because you’re not comfortable taking the risk.

Credit insurance is as much about growing your sales and profits as it is about protecting your current outstanding receivables. By insuring your accounts receivable, you can extend larger credit limits, or more competitive terms of sale, giving you the leg up on your competition while actually reducing or eliminating your risk. Credit insurance is an operational tool that provides you with a blanket of protection that allows you to grow sales and profits, reduce bad-debt reserves, increase bank financing, stabilize your cash flow, and virtually eliminate bad-debt losses. This coverage can pay for itself due to the increase in sales you can generate as a result of insuring your A/R.

8. “Our Credit Manager does a good job.”
So does your Plant Manager, but you still have fire insurance, don’t you? You offer great products and services, but you’ve got liability coverage as well. Like all insurance products, credit insurance is designed to protect you from the financial loss caused by unforeseen events.

Many have the misguided notion that credit insurance is designed to replace seasoned credit managers, which is not the case; there is no substitute for sensible credit management, and a good Credit Manager can help your company make or break financial goals year after year. By providing information, credit support, and payment assurance, credit insurance helps Credit Managers do their job better by improving their ability to make wise choices regarding customer credit.

7. “It’s too much extra work for me to handle.”
Unlike your auto or homeowners insurance, credit insurance is not a policy that you shove in a drawer and forget about until you have a potential claim. There are responsibilities associated with having a credit insurance policy, such as reporting past due accounts and updating the customers who are covered under your policy; these tasks are easily handled by any member of your staff. Today, credit insurance policies come with online policy management systems, allowing you to research new customers, file claims, report past dues, and other various tasks at the click of your mouse. If anything, the tasks associated with your credit insurance policy will keep you on top of your customers’ accounts, without weighing you down.
5. “We factor our receivables.” or “We require Letters of Credit.” Factoring can be a very useful financial tool that can enhance your cash flow and help you manage your accounts receivable, but it comes with a rather hefty price tag, and many factoring arrangements also include “recourse” clauses, meaning any loss on a receivable is charged back to the merchant. Currently, factoring costs range from .5%-1.5% of the total amount factored. Typically, credit insurance costs about ¼ the price of factoring, with costs ranging from .1%- .5% for domestic policies, and .2%- .6% for export or global policies. While you are not fronted the money ahead of time, the savings to your bottom line are substantial.

Where you may have used a Letter of Credit to guarantee payment in the past, credit insurance provides you with the same assurance that you’ll be paid for your goods and services, without the high cost or bump in your supply chain typically associated with an L/C. Credit insurance allows you to offer open terms and rapid turnaround to your customers anywhere in the world and is rapidly becoming the go-to product for companies looking to expand to new markets in a safe and cost-effective manner.

4. “We check our customer’s credit before we ship them.”
That’s a great first step, and you certainly should continue to do so. But everyone reading this report knows that some credit agencies have sparse, outdated or irrelevant information on many of your customers. Remember the online policy management systems mentioned earlier? Those systems contain an insurmountable amount of up-to-date information based on public filings, trade history, visits with corporate officers, bank and mercantile references, and first-hand information from other policyholders that put credit agencies to shame. With credit insurance, shipments to your insured customers are covered in the event of a loss. If they’re not approved for coverage, you’ll learn why. I don’t know of any credit agency that offers that type of guarantee.

3. “We only deal with Fortune 500 companies.”
A.H. Robbins, Adelphia Communications, Agway, Amerco Inc. (UHaul), Bally Total Fitness, Boston Market, Chiquita Brands, Converse, Delphi Corp., Delta Air Lines, Enron, Fruit of the Loom, Hancock Fabrics, Huffy Corp., KB Toys, Kmart, Macy’s, Montgomery Ward, Oneida Ltd., Owens Corning, Polaroid, Top Flite, Tower Records, United Airlines, W.R. Grace, Winn-Dixie, MCI WorldCom…

2. “The underwriters won’t cover the buyers I need covered.”
Coverage and pricing are typically the two most focused-on features of credit insurance, and for good reason; these two features more or less dictate the value you receive from your policy. While the coverage of buyers on your policy is at the discretion of the underwriters, it is largely based upon your needs as a company. If a company is likely to result in a loss (think Kmart in 2001 & 2002), underwriters might not be overly eager to provide coverage on that company. But remember, there are a number of insurers in the credit insurance market, and a good broker can help you find a company that is willing to address your needs.

1. “I’ve got to insure all my accounts.”
For years, companies have been under the false impression that they must insure sales to all of their customers in order to be eligible for credit insurance. Like a new suit, credit insurance is a product that fits best when tailored to the specific needs of the customer. Some companies err to the side of caution and choose to insure all of their accounts; still others choose only to insure their top buyers or certain product lines. In some cases, companies are able to insure a single customer that makes up a disproportionately large part of their sales. Short of insuring only your “questionable” accounts, just about anything can be done. So be creative, and think about how you would write this policy and who you would cover if it were up to you; chances are we can do it.

As with any insurance policy, the best rates are given to policyholders with the largest portfolios and best spread of risk. However, as long as there is a reasonable spread of risk, today’s underwriters are increasingly flexible and willing to create a credit insurance program that will address your needs and concerns.

Trade Risk Group is one of the country’s premier credit insurance specialty brokers. With locations throughout the United States, Trade Risk Group can help you put a credit insurance program in place that will protect your receivables and allow you to grow your sales effectively and safely. Visit our website, www.TradeRiskGroup.com, or call (214) 496-9905 for more information.