SELECTED TOPIC



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Insuring Your Largest Asset, Your Accounts Receivable

Demystifying Credit Insurance and Negotiating the Best Possible Policy

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

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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 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 customer'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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