Trade Credit Insurance as Protection from Bankruptcy Preference Risk: Negotiating for the Broadest Coverage

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When purchasing TCI, a creditor should negotiate for the inclusion of policy provisions that grant the broadest possible protection from the risk of nonpayment of its accounts receivable and bankruptcy preference liability. Consulting with the right broker and attorney could be the difference between obtaining extensive, minimal, or no preference coverage.

A creditor purchases Trade Credit Insurance (TCI) to protect against the risk of a customer's nonpayment of accounts payable owing to the creditor. This risk materializes upon a customer's protracted nonpayment of invoices or bankruptcy filing. A creditor whose customer has filed for bankruptcy is stayed from collecting its pre-petition claim and faces the prospect of a diminished or no recovery on its claim.

Unfortunately, a creditor with unpaid accounts receivable confronts other risks following its customer's bankruptcy filing. These additional risks include having to defend a preference claim that a bankruptcy trustee asserts based on the customer's payments to the creditor within 90 days of the customer's bankruptcy filing date. While the creditor can assert an array of defenses to reduce its preference liability, the creditor might pay some amount, hopefully small, but unfortunately sometimes large, to resolve the claim and avoid litigation risk and the attorneys' fees that would have to be incurred to defend the litigation. As a result, a creditor's bad debt exposure increases when the creditor settles a preference claim and makes a payment to the trustee.

When purchasing TCI, a creditor should negotiate for the inclusion of policy provisions that grant the broadest possible protection from the risk of nonpayment of its accounts receivable and bankruptcy preference liability. Consulting with the right broker and attorney could be the difference between obtaining extensive, minimal, or no preference coverage.

Brief Overview of Trade Credit Insurance

TCI is one of the oldest forms of insurance dating back to the 19th century. TCI was developed in Europe to promote trade and protect companies that sold to customers in other countries. Beginning in the 20th century, governments frequently offered TCI through their export credit agencies as a way to promote exports. TCI's popularity has grown in the 20th and 21st centuries to the point that many private sector insurance companies provide credit insurance coverage. Most trade credit insurers are large global carriers that write policies to cover credit transactions worldwide.

TCI protects a trade creditor from the risk of nonpayment when the creditor extends open account credit terms to its customers. TCI usually insures against commercial risk and political/country risk. Commercial risk includes a customer's insolvency (including bankruptcy or its equivalent in a foreign country) and a customer's protracted nonpayment of its payables to a creditor. Commercial risk also includes preference liability for payments the creditor had received from its financially distressed customer within 90 days of the customer's bankruptcy filing.

A creditor seeking to obtain the broadest TCI coverage for any commercial risk, whether based on protracted nonpayment, the customer's insolvency, bankruptcy, or exposure to preference liability, should make sure the policy covers the risks for which the creditor is seeking protection. There are policy provisions that insure for preference risk, and a proactive creditor

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should make sure this coverage is included in its TCI policy. A creditor should also object to the inclusion of unfavorable policy provisions. Some of these provisions expressly exclude any coverage for preference risk or limit coverage by requiring renewal of the policy with the same insurer to retain preference coverage. A creditor must also be prepared to comply with policy requirements, such as "immediately" providing notice of the preference claim to the credit insurer; pursuing "all defenses" and legal "remedies available;" and obtaining the insurer's approval of "each action" taken to defend the claim and of any settlement of the claim.

Brief Overview of Bankruptcy Preference Risk

Section 547(b) of the Bankruptcy Code allows a trustee to avoid and recover a transfer as a preference by proving the following elements of a preference claim: (i) the debtor transferred its property (usually by tendering payment) to or for the benefit of a creditor. [section 547(b)(1)]; (ii) the transfer was made on account of antecedent or existing indebtedness that the debtor owed the creditor. [section 547(b)(2)]; (iii) the transfer was made when the debtor was insolvent based on a balance sheet definition of insolvency - liabilities exceeding assets [section 547(b)(3)], which is presumed during the 90-day period prior to its bankruptcy filing, making it easier for a trustee to prove; (iv) the transfer was made within 90 days of the debtor's bankruptcy filing, in the case of a transfer to a non-insider creditor, and within one year of the bankruptcy filing for a transfer to an insider of the debtor, such as the debtor's officers, directors, controlling shareholders and affiliated companies. [section 547(b)(4)]; and (v) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor. [section 547(b)(5)]. The latter requirement is easy to satisfy unless the recipient of the alleged preference can prove that it was fully secured by the debtor's assets, was paid from the proceeds of its collateral, or all creditors' claims were (or will be) paid in full.

Once a trustee proves all of the elements of a preference claim under section 547(b), a creditor has the burden of proving one or more of the affirmative defenses to a preference claim contained in section 547(c) of the Bankruptcy Code to reduce or eliminate its preference exposure. The two most frequently invoked defenses as they relate to TCI coverage are the ordinary course of business and new value defenses contained in section 547(c)(2) and (c)(4) of the Bankruptcy Code.

The ordinary course of business defense requires proof, by a preponderance of the evidence, that (1) the alleged preferential transfer paid a debt that was incurred in the ordinary course of the debtor's and creditor's business or financial affairs—which merely requires proof of a trade creditor's extension of credit terms to the debtor—and (2) that the transfer was *either* (a) made in the ordinary course of the debtor's and creditor's business or financial affairs, or (b) made according to ordinary business terms.

The ordinary course of business defense is intended to encourage unsecured creditors to continue doing business with (and extending credit to) an entity that is sliding into, but seeking to avoid, a bankruptcy filing. The defense is supposed to protect a debtor's payments to creditors that were consistent with either the parties' prior course of dealing or industry practice. Nevertheless, the courts have been inconsistent and unpredictable in the manner in which they have applied the ordinary course of business defense, resulting in expensive litigation and a difficulty in predicting the likelihood of proving the defense. This has led creditors to settle many preference claims in order to avoid the risk of incurring the significant attorneys' fees necessary to defend the litigation and then losing the litigation.

A creditor can also assert the new value defense to reduce its preference liability to the extent the creditor provides new value to or for the debtor's benefit after an alleged preference payment. A creditor determines its new value based on the goods the creditor had sold and delivered, and/or services the creditor had provided, to the debtor on an unsecured basis after an alleged preference payment. This defense, like other preference defenses, encourages creditors to continue selling and extending credit to troubled companies. It is also supposed to alleviate the unfairness of allowing a trustee to recover all payments by a debtor to a creditor during the preference period without reducing the amount of any preference claim by the new value the creditor had provided to the debtor after the payment. After applying this defense, the debtor's unsecured creditors should be no worse off by an alleged preference payment where the creditor had subsequently provided new value (e.g., delivered goods or provided services on credit terms) to the debtor.

Insuring Against Preference Risk

TCI coverage for preference risk has evolved over time. Twenty years ago, a TCI policy rarely contained any policy wording that protected the

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insured from the assertion of preference claims. Trade credit insurers were forced to address this risk as preference claims in the United States have multiplied over the past 40 years since the adoption of the United States Bankruptcy Code. Credit insurers initially began providing coverage by adding a preference endorsement to the policy. Creditors/insureds that were not aware of the endorsement, or did not request it, had no coverage for preference risk. Knowledgeable brokers and counsel pushed their clients to obtain the endorsement when available from a carrier. However, for quite some time, many insurance companies resisted adding preference coverage to their policy language. They viewed such coverage as adding an unwanted tail to their risk period.

The market has changed in favor of expanded TCI coverage for preference risk. Many credit insurers are now incorporating preference coverage in their standard policy wording. However, there are still some insurers that continue to provide the coverage by adding it as an endorsement to the policy and other insurers that omit preference coverage altogether.

A trade credit insurer might offer a policy that contains numerous limitations on its coverage for preference risk. Creditors should understand and identify the limitations and negotiate for their removal or for at least some improvements to preference coverage. As an example, a creditor has no preference coverage when its unpaid accounts receivable owing by an insolvent customer equals the approved buyer limit then in effect for that customer. A creditor can maximize the likelihood of at least some preference coverage by having their approved buyer limit exceed the account receivable balance owed by any given customer. This is not always easy to do given the changing nature of accounts receivable balances. It also requires retaining knowledgeable bankruptcy counsel to identify and vigorously assert preference defenses to minimize or eliminate any potential preference liability.

A few insurers are open to providing a separate and additional limit for a creditor's/insured's exposure to preference liability. This additional coverage is less frequently granted, and insurers that provide it usually require the insured to pay an additional premium for the added risks the insurers are assuming.

Creditors should also understand that TCI policies usually require that the insured assume the full cost of defending a preference claim, including the significant defense costs that are incurred in any preference litigation. Most policies also require the insurer's consent to any settlement of a preference claim as a condition for preference coverage. This might lead to a conflict between the insurance carrier and the insured over their approach to defending a preference claim. The carrier might push for the insured, at the insured's expense, to continue to pursue preference defenses that the insured has concluded have little merit. In these circumstances, the insured should be working with knowledgeable bankruptcy and insurance counsel (hopefully from the same law firm). Good bankruptcy counsel will assert all available preference defenses to minimize and hopefully eliminate preference liability. The insured's bankruptcy counsel should also provide the carrier and its counsel with a fair assessment of the risk and expense of litigating the creditor's defenses. This is particularly true for a creditor's ordinary course of business defense where it is often very difficult to predict the likelihood of successfully asserting the defense. Good insurance counsel should also be familiar with the TCI policy to make sure that the creditor complies with all of the policy requirements for preference coverage. Experienced insurance counsel should also make sure that the insured and insurer continue to communicate in a way that protects the policyholder and its rights under the insurance policy and coordinate the defense of the preference action so that the parties can eventually agree on a cost-effective settlement.

Creditors should consider the following best practice points to maximize the likelihood of preference coverage: 1) make sure its TCI policy includes preference coverage; 2) monitor the approved buyer limit and provide for a cushion for preference risk; 3) make sure the creditor continues to have preference coverage, even where the policy is not renewed; 4) be aware of the preference notification periods and request a reasonable period of time to notify the carrier; 5) eliminate clauses that put a short time restriction on filing a claim for preference exposure since preference claims are frequently asserted from one to two years after expiration of the TCI policy; 6) if the policy contains a "no claims bonus" that releases the insurer from all liability under the policy, there should be a carve out for continued preference coverage; 7) include accounts receivable that were paid within 90 days of an insolvent buyer's bankruptcy filing date as part of any insurance claim; 8) retain well-qualified

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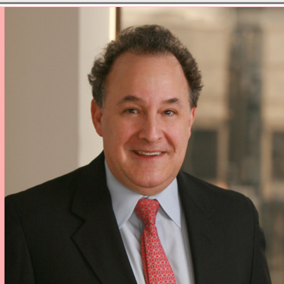
bankruptcy counsel to assist in the defense of any preference claim and make sure the law firm has sufficient insurance expertise to deal with TCI issues concerning preference coverage; and 9) communicate early and often with the creditor's broker, counsel and insurer.

Conclusion

Trade credit insurance is an excellent vehicle for protecting against the risk of uncollectible accounts receivable, including accounts owed by an insolvent customer that has filed for bankruptcy. A creditor, with the assistance of its insurance broker and counsel, should be proactive in negotiating for as broad coverage as possible, including broad coverage for preference risk. Understanding the key provisions of the policy and, with the assistance of a good broker and counsel, negotiating with the carrier to eliminate unfavorable provisions, resolve ambiguities and reach agreement on a credit insurance policy that maximizes the amount of coverage (including coverage for preference risk), will minimize the risk of claim denials.

About the Authors:



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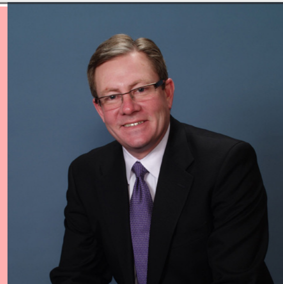

Mark Regenhardt*, is a Senior Vice President for the Credit, Political, and Security Risk Group of JLT Specialty USA, which is part of the Jardine Lloyd Thompson Group plc (JLT), a provider of insurance, reinsurance, and employee benefits related advice, brokerage, and associated services. Headquartered in London, JLT is one of the world's largest Credit and Political Risk brokerage firms.*

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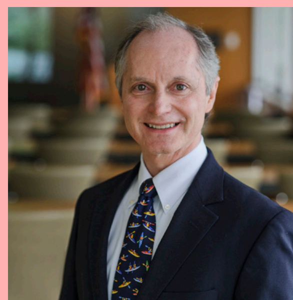

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