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Column
Last in Line

*18 ANALYZING CREDIT INSURANCE: THE DEVIL IS IN THE DETAILS

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Even in good economic times, vendors consider buying credit insurance when dealing with certain customers. In this troubled economy, vendors may be dealing with customers that have recently emerged from chapter 11, and are thus more likely to consider credit insurance. Some vendors are reluctant to sell to customers who are already in bankruptcy and thus, having been burned once on their pre-petition claim, look to credit insurance for additional protection.

Often, vendors believe that credit insurance is structured like car insurance or health insurance, so that the vendor simply pays a premium and the insurer pays the vendor if the troubled customer cannot do so. In reality, however, credit insurance might operate as a "standby claims assignment" agreement, pursuant to which the vendor pays a fee (the "standby fee") for the right, during a specified time period, to assign to the "insurer/assignee" certain *eligible* receivables owing to the vendor from the troubled customer for an agreed upon percentage of their face value. In this context, the insurer/assignee will then be the holder of the vendor's claim against the troubled customer and will try to collect on that claim.

Obviously, the insurer/assignee will carefully define terms like "eligible receivables," "customer," "triggering or specified event," etc. The "standby fee" can be significant, and vendors' credit managers might believe that, in exchange for such a large price, the credit insurance (or "standby claim assignment agreement") will *surely* protect them from a loss if the troubled customer fails to pay. However, this is a non-sequitur. Often, these documents are complicated, and the vendor is well-advised to seek the advice of counsel in analyzing (and negotiating) the credit insurance or standby agreement to determine whether it will actually provide the vendor with the desired protection.

When analyzing credit insurance, the vendor (and its counsel) needs to analyze the entirety of the situation and a wide spectrum of issues, including the following:

1. *Are "vendor" and "customer" defined properly and broadly enough*? If the vendor's affiliates are also selling to the troubled customer, then the definition of "vendor" must be broad enough to cover all of its affiliates. Conversely, if the troubled customer's affiliates are also buying from the vendor, the definition of "customer" must be broad enough in order to trigger protection, if any one of them sustains an event that triggers the credit insurance, and the definition of "eligible accounts" must include the vendor's sales to those affiliates.

2. *What "specified event" will trigger the insurance/assignment of the receivable*? If the customer is already in chapter 11, the "specified event" might be conversion to chapter 7. If the customer has already emerged from chapter 11, the vendor might assume that the credit insurance will pay as soon as the troubled customer winds up in bankruptcy again, but this assumption might be misguided. For example, some agreements will not cover an involuntary bankruptcy petition (or even a voluntary petition filed by the troubled customer after the involuntary petition is filed against it). Obviously, it is critical for the vendor and its counsel to understand which events will—and won't—trigger the insurance.

3. *What are the eligible accounts that the insurance will cover?* This is a key provision in the contract, and the devil *is* in the details. Credit insurance contracts may state that they will pay only against "undisputed indebtedness" and require a representation from the vendor that none of the claims that will be sold to the insurer/assignee will be subject to any "dispute"—thus requiring a careful analysis of what constitutes a "dispute." Because in the context of a standby claims assignment agreement the assignee/insurer is actually taking an assignment of the vendor's claim against the troubled customer, it should not be surprising that the definition of "dispute" and "eligible account" will be drafted in tandem so that, taken together, the insurer/assignee is virtually assured of getting paid on that claim. Consequently, if the troubled customer is already in chapter 11, the definition of "eligible accounts" might recite that an account is eligible *only* to the extent that it is (or will become) an allowed administrative expense claim against the troubled customer under 11 U.S.C. § 503(b)(1)(A). Some contracts define "disputed" to include "all disputes, bona fide and otherwise!" In this scenario, who decides?

Sometimes "disputed" is defined to include any vendor claim that might be disallowed under Bankruptcy Code § 502(d). Although this type of provision is understandable from the insurer/assignee's standpoint, it can be a rude awakening for vendors. For example, if a vendor has any preference exposure, the credit insurance will not pay off as much as the vendor expected (if it pays off at all). From the vendor's standpoint, this can be an ironic twist. Indeed, the vendor who purchases the credit insurance is the most likely to continue supplying the troubled customer through its preference period, only to find out later that the vendor's preference exposure may negate the credit insurance coverage that it thought it had.

4. *What are the conditions precedent to the vendor's receiving payment from the insurer/assignee, and how much time does the vendor have in which to satisfy those conditions?* This provision must be read carefully to make sure that the vendor is capable of fulfilling all of the conditions precedent to receiving payment *if* a triggering event occurs. The phrase "jumping through hoops of fire" may come to mind because the contract might state that the vendor/insured *must, as a condition to payment*, produce mountains of material including all purchase orders and proof of delivery. This can be a tall order if the vendor is a big supplier to the troubled customer, or if the vendor delivers directly to the troubled customer's stores, as opposed to a centralized warehouse. Worse yet, the contract may require the vendor to produce these items within a relatively short time, and if these conditions cannot be met, then the insurer/assignee is released from its obligations under the contract (in which case the vendor will have paid a large fee for no protection whatsoever). It is also critical that the conditions precedent be clearly drafted. Phrases such as "any other documents that might affect the value or collectibility of the accounts receivable" are imprecise and give the insurer/assignee the opportunity to argue that the vendor/insured failed to satisfy a condition precedent, and therefore, the insured/assignee is released from its obligations.

5. *May the insurer/assignee cancel the insurance or standby agreement?* Sometimes, the contract permits the insurer/assignee to cancel the agreement at any time *23 and refund a *pro-rata* share of the stand-by fee or premium. This is problematic because the vendor wants to be able to *rely* on the insurance or standby agreement and because the vendor's shipments to the troubled customer in reliance on the insurance could significantly exceed the amount of the refund—especially if the insurer/assignee cancels late in the game. If the contract contains such a provision, vendor's counsel needs to determine when the cancellation becomes effective and to what the cancellation applies. For example, it does not seem fair that the insurer/assignee should be able to cancel the contract unilaterally and have that cancellation apply to accounts/invoices for goods that the vendor already shipped to the troubled customer in reliance on the insurance. Perhaps it makes sense for vendor's counsel to negotiate for a "lag time" between the insurer/assignee's cancellation of the contract and the effective date of that cancellation to give the vendor time to send the customer invoices for goods that were shipped out before the insurer/assignee cancels the contract.

6. *May the insurer/assignee delegate its duties under the agreement?* Obviously, the vendor wants to know that it is dealing with an entity that has the financial resources to pay if the troubled customer sustains a triggering event. Thus, credit insurance or standby agreements that permit the insurer/assignee to freely assign can spell trouble. Vendors and their counsel may want to try to limit the universe of entities to whom the insurer/assignee may delegate its obligations, and they should then do appropriate due diligence to make sure that the vendor is not buying the proverbial "pig in a poke."

Although risk-weary vendors might view credit insurance or standby agreements as a hedge against disaster, they tend to be complex documents that the vendor and its counsel must carefully analyze and negotiate. This article merely scrapes the surface of the myriad of issues that vendors and their counsel need to consider when analyzing credit insurance and standby agreements. Because the contracts themselves are the product of negotiations, anything is possible, and vendors with a good understanding of what to ask for will be in a better position to negotiate credit insurance or a standby agreement that will provide the desired protection to enable that vendor to go from "last in line" to "first in line."

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