Cooley

Supply Chain Finance and Trade Credit Insurance in Spotlight

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As struggling companies continue to look for liquidity amid the COVID-19 pandemic, many have turned to supply chain financing (SCF) solutions to shore up their balance sheets and to mitigate risk. SCF is a financial transaction in which a bank or third party provides funding to pay a company's supplier of goods and services. This type of transaction has the potential to benefit all parties: the supplier is paid earlier – but less – than it would otherwise be paid; the company benefits from extended payment terms and reduced working capital requirements; and the bank or third party pockets the difference.

However, SCF is not without significant risks to the various parties, including the risk that the company defaults on its extended payment terms. Trade credit insurance (TCI) seeks to solve this problem by protecting these parties against losses from non-payment, and demand for this type of insurance has continued to climb in recent years. Over the last few months, there has been significant news coverage concerning both SCF and TCI involving the non-renewal of a high-profile company's insurance policies and its subsequent insolvency. Given these developments, it is more critical than ever for policyholders to take a renewed look at their TCI policies to understand – and have the chance to improve – any early cancellation or termination risks, non-renewal provisions (including the timing for any required notice) and other potential coverage gaps.

Trade credit insurance

In its most basic form, TCI is insurance against the risk of non-payment. It is an important risk management tool for all types of businesses with accounts receivables, and banks, lenders or investors often require this type of coverage in SCF transactions. While coverage under a TCI policy ordinarily applies after a customer has been in default for a certain number of days or filed for insolvency, TCI policies vary significantly in policy terms and the exact scope of coverage they offer. This includes, among other things, any coverage for losses resulting from political risks (e.g., government actions or political unrest); how the policies may define "default" or "insolvency"; the number of coverage exclusions (including the scope of any coverage afforded for disputed debts); and any cooperation and reporting requirements. Thus, policyholders must be proactive in understanding their coverage and ensuring that it meets the actual needs, structure and capabilities of their business.

Early cancellation, termination and non-renewal provisions

If you rely on an insured credit limit for a significant customer and that insured credit limit were reduced to zero effective tomorrow, how would that impact your business? What if your insurance policies were unexpectedly cancelled or non-renewed with little notice?

Recent news coverage has highlighted the potential impact an unexpectedly cancelled or non-renewed policy can have on a business, particularly one that relies on money from lenders or investors that require TCI coverage as a condition of funding. Many policyholders might be surprised to learn that their TCI policy may permit the insurer(s) to vary, reduce or withdraw a customer's credit limit at any time and for any reason. Given the significant impact TCI can have on a business, it may be prudent for a policyholder to take a fresh look at key policy provisions and try to negotiate certain limitations, such as only being able to make credit limit changes on an annual basis or after a certain, defined notice period. Similarly, policyholders can benefit from negotiating narrow termination provisions and carefully reviewing the scope of such provisions, particularly as it relates to insurance misrepresentations or other misconduct. Finally, it is imperative to negotiate provisions relating to the timing of any notice of non-renewal, providing the policyholder with sufficient time to try to find alternative coverage.

Conclusion

TCI can be a valuable risk management tool in connection with SCF. However, TCI is not like most insurance policies that a policyholder purchases, files away and only subsequently reviews in the event of a claim. Instead, policyholders must pay careful attention to the coverage terms at the outset and continue to act with diligence in making sure that the exact scope of coverage is understood and updated periodically in order to address any changes in credit risk and safeguard the long-term viability of the business.