

Trade credit insurance

# Set-off clauses put policy holders at a disadvantage

## 1. INTRODUCTION

Suppliers grant their customers credits by allowing long terms for payment. Customers usually do not have to pay their suppliers earlier than weeks or even months after receipt of the goods.

Sometimes, suppliers have to write off a debt if the customer goes bankrupt within the term for payment.

Suppliers often insure such risks by trade credit insurance. Trade credit insurers reimburse unpaid debts to the suppliers, reduced by an agreed deductible.

Set-off clauses often effect that insurers do not compensate for the entire debt. In the following we assess the effectiveness of such clauses.

## 2. HOW TRADE CREDIT INSURANCE WORKS

In the German market, trade credit insurance usually has the following characteristics.

### 2.1 Global policy

Insurer and supplier agree on the legal conditions in a global policy. The parties to the contract refer to the general terms on trade credit insurance ("**AVB WKV**").

The AVB WKV regulate among others the scope of insurance coverage, the requirements for the insured event, the offsetting of payments by the policy holder's customers, etc.

Insurance coverage for individual customer relationships through limit request and credit limit notification

After the global policy is agreed on, the policy holder requests credit limits with his trade credit insurer. By means of limit applications, the policy holder applies for insurance coverage for individual customer relationships.

The insurer analyzes the customer's solvency and the insurability of the business relationship. Through his credit limit notification the insurer declares whether and on which terms he will grant coverage for the relationship.

## 2.2 Sum insured for individual business relationship

The insurer determines the maximum sum insured (credit limit) for each business relationship.

If the debt volume exceeds the sum insured, the exceeding amount of debt is not covered. However, the exceeding amount of debt may be included in coverage as soon as the customer makes payments to older debts (cf. Hoß in "Handbuch des Fachanwalts Versicherungsrecht, 4th edition, chapter 36, no. 16) as long as the business relationship is still insured.

## 2.3 Determination of insurance payment

If a customer of the supplier fails to pay (e.g. in case of insolvency), the insurer calculates the compensation according to the insurance contract.

For this purpose, the insurer sums up the debt owed to the supplier by the customer. Afterwards, the insurer subtracts the agreed deductible and the customer's payments after the occurrence of the insured event.

The insurer pays the result of the calculation (under consideration of the agreed sum insured) as a compensation to the policy holder.

### 2.3.1 Offsetting customer's payments

The insurer usually sets off the payments made by the customer to the insured supplier pursuant to the so-called set-off clause. Sec. 10 cypher 2 b AVB WKV stipulates:

*“Payments/credit notes/profits received after occurrence of the insured event are deducted pursuant to sec. 2 cypher 3 para. 2.”*

Sec. 2 cypher 3 para. 2 AVB WKV stipulates:

*“In the relationship between the policy holder and the insurer, every payment made before the occurrence of the insured event is set off against the oldest insured debt.”*

I.e., the insurer always sets off payments made by the supplier’s customer against the oldest insured debt. Other determinations regarding redemption made by the customer (e.g. “payment of most recent debt”) are to be disregarded for the insurance claim of the supplier.

Example 1:

The customer of the insured supplier owes EUR 1,000.00 from the first delivery, EUR 2,000.00 from the second delivery and EUR 3,000.00 from the third delivery. Despite difficulties to pay, the customer pays EUR 3,000.00 to the insured supplier in order to encourage him to continue the business relationship. The customer determines that he made the payment of EUR 3,000.00 on the debt arising from delivery 3 (in the amount of EUR 3,000.00).

This determination by the customer has the effect that the debt arising from the third delivery is redeemed within the relationship supplier/customer.

Pursuant to the set-off clause, the first debt and not the third debt is redeemed despite differing determination by the customer. This also applies if the third debt (EUR 3,000.00) is not covered by the policy.

### 2.3.2 Offsetting according to law

The clause deviates from statutory provisions on the offsetting of payments pursuant to sec. 366 German Civil Code (“BGB”). Pursuant to sec. 366 para. 1 BGB, the obligor’s (customer’s) determinations regarding redemption have to be considered as a matter of priority (e.g. offsetting of due debts before offsetting of less secured debts, cp. sec. 366 para. 2 BGB).

### 3. INEFFECTIVENESS OF SET-OFF CLAUSES

In a pending case, the Higher Regional Court (OLG) Hamburg held that general set-off clauses in trade credit insurances are ineffective (cf. OLG Hamburg, judgement of 16 October 2012, file no. 9 U 48/12, VersR 2013, 310 et seqs).

#### 3.1 Compliance with law is requirement

General set-off clauses do not comply with the legal provisions on standard business terms.

Set-off clauses usually are conditions set unilaterally by the insurer and can thus be qualified as standard business terms. As such, set-off clauses must comply with the legal provisions of sec. 305 et seqs. BGB in order to be effective.

Pursuant to sec. 307 para. 1 s. 1 BGB, standard business terms are ineffective if, contrary to the duty of utmost good faith, they unreasonably disadvantage the other party to the contract (policy holder/supplier).

#### 3.2 Unilateral inappropriate disadvantage of the policy holder

In the case at hand, the OLG Hamburg assumed the relevant set-off clause to unreasonably disadvantage the policy holder.

An unreasonable disadvantage is given if the insurer improperly tries to assert his own interest at the policy holder's expense by unilateral contract drafting without duly taking into account the policy holder's interests and without providing for appropriate compensation (cp. BGH, VersR 2012, 1149).

After weighing the interests of the parties to the insurance contract, the OLG Hamburg concluded that an unreasonable disadvantage of the policy holder was given.

##### 3.2.1 The insurer's interest

The OLG Hamburg assumed that the insurer pursued a legitimate interest by making use of the set-off clause.

The trade credit insurer intends to make sure that payments received by the policy holder reduce the insured debt. Thus, the amount of the insured debt decreases if no new debts add to it.

The policy holder and his customer might otherwise cooperate collusively to the detriment of the insurer. In case of obvious payment difficulties of the customer, they could agree that payments are always made on the last due debts. Consequently, the amount of debts covered by the insurer would not decrease. The policy holder would profit from the low financial capacity of the customer, the insurer would not. The protection against such collusive agreement between supplier and customer is a legitimate interest of the insurer according to the OLG Hamburg.

### 3.2.2 The policy holder's interest

However, the insurer's interest does not outweigh the policy holder's interest in considering his customer's determination regarding redemption:

The policy holder often has a justified interest in maintaining the business relationship with his customer even if the customer is suffering payment difficulties. The legislator supports the maintenance of such business relationships by regulations of the German Insolvency Code (e.g. sec. 142 German Insolvency Code).

If the supplier maintains business relationships with his customer and the customer pays for old debts, the payment may be contested by the insolvency administrator pursuant to sec. 130 et seqs. German Insolvency Code. The supplier then might have to return received payments to the insolvency administrator even though the consideration (delivery) of the policy holder's performance was unobjectionable.

Customers with payment difficulties know that their suppliers need to be protected against contest and reclaim by the insolvency administrator in order to maintain the business relationship.

The supplier is protected against contest if the customer makes cash transactions in the meaning of sec. 142 German Insolvency Code. A cash transaction is given if the customer pays soon after receipt of delivery. This requires that the customer determines redemption of the most recent – instead of the oldest – debts. In this case, the insolvency administrator usually is not entitled to reclaim payments made by the customer.

The maintenance of business relationships between the policy holder and his customer is often only advisable if the customer can determine redemption of the most recent debt.

Consequently, a problem arises for the policy holder: with regard to insolvency statutes, the customer's payment needs to redeem the most recent debt, with regard to insurance coverage, it needs to redeem the oldest debt.

It cannot be expected from the policy holder to accept redemption of two open debts by one payment.

As the following example shows, this would cause a coverage gap for the policy holder:

Example2:

A supplier holds a trade credit insurance policy. A set-off clause has been agreed.

Customer X owes the insured supplier two payments of EUR 5,000.00 each (open debts 1 and 2). X suffers payment difficulties. The supplier maintains the business relationship with the customer and informs the insurer about the customer's payment difficulties.

The insurer cancels insurance coverage for the relationship to X for the future. The supplier continues to supply X with goods in the amount of EUR 5,000.00 (debt 3). X pays EUR 5,000.00 to the policy holder. X determines that the payment of EUR 5,000.00 shall redeem debt 3. X still owes the supplier EUR 10,000.00 (debts 1 and 2).

X then declares itself insolvent.

The policy holder informs the insurer about a default on debts with regard to customer X in the amount of EUR 10,000.00 (debts 1 and 2). The insurer argues that there was an insured default of only EUR 5,000 resulting from debt 2. The insurer sets off the last payment of EUR 5,000.00 against the oldest debt 1 – contrary to the customer's determination regarding redemption. The policy holder cannot claim compensation for debt 3. Insurance coverage for the customer relationship was already effectively cancelled when debt 3 arose. Furthermore, the debt was redeemed by payment. Assuming effectiveness, the set-off clause leads to a coverage gap of EUR 5,000.00 (unpaid debt 1).

Thus, the policy holder has the choice to accept the coverage gap or to terminate the business relationship with his customer immediately when payment difficulties come up.

The example above shows that the set-off clause does not appropriately take account of the supplier's interest protected by the insolvency statutes.

### 3.2.3 Weighing of interests

The OLG Hamburg regards the policy holder's interest in maintaining the business relationship and in avoiding coverage gaps more important than the insurer's interest in avoiding allegedly collusive conduct.

The set-off clause counteracts the legislator's aim of sec. 142 German Insolvency Code to allow obligors in payment difficulties to enhance their business situation by cash transactions. Maintenance of business relationships with the customer in payment difficulties may enhance the customer's business situation. An enhancement of the customer's business situation often enables him to pay for old debts. The insurer would benefit thereof as well since the amount of debts insured might decrease. A collusive collaboration between supplier and customer is usually not given when most recent debts are redeemed.

The policy holder's interest in maintaining the business relationship with his customer in payment difficulties outweighs the interest of the insurer. Thus, an inappropriate disadvantage of the policy holder is given. The set-off clause is therefore ineffective pursuant to sec. 307 para. 1 s. 1 BGB.

### 3.3 Legal consequences of the ineffectiveness

If clauses in standard business terms are ineffective, the contractual gap is to be closed by statutory provisions (sec. 306 para. 2 BGB).

Consequently, the provisions of sec. 366 BGB apply. According to this provision, the obligor's determination regarding redemption has to be considered as priority. If the obligor determines upon performance that the most recent debt shall be redeemed, the insurer has to accept this when calculating compensation.

#### Result of example 2:

Consequently, there is no coverage gap of EUR 5,000.00 in example 2. The customer's determination regarding redemption effects that debts 1 and 2 (in the amount of EUR 5,000.00 each) are both covered.

## 4. CONCLUSION

Set-off clauses in trade credit insurances policies are not principally ineffective. If insurers apply set-off clauses which sufficiently consider the policy holder's interest and es-

pecially allow cash transactions in the meaning of sec. 142 German Insolvency Code, such clauses may be effective.

However, general set-off clauses applied by trade credit insurers are often ineffective. A due review of the insurer's calculation of compensation is advisable.

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