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CORONAVIRUS: CONSIDERATIONS FOR SECURING COVERAGE UNDER NEW YORK-GOVERNED NPI POLICIES

Globally, financial institutions hold tens of billions of dollars in protection for debt obligations through nonpayment insurance ("**NPI**") policies.[1] As discussed below, much of this coverage is structured as a pro-insured product, especially where it is used for capital risk weight mitigation under the relevant implementation of the Basel Accords, such as the Capital Requirements Regulation (the "**CRR**") in the European Union or 12 C.F.R. Part 217 ("**Regulation Q**") in the United States.

NPI policies performed well following the 2008 financial crisis and still enjoy a reputation for a high rate of claims payment, with industry estimates indicating that 97% of all claims are paid. Still, the COVID-19 crisis represents a global challenge of an entirely different magnitude. Therefore, in order to successfully preserve and exercise their rights under such policies, financial institutions should review their operational plans for utilizing NPI policies.

This client briefing outlines some of the key considerations for NPI policies governed by New York law. For a companion piece on key considerations for NPI policies governed by English law, please refer to the briefing prepared by our colleagues in London.

Here, we review three key issues, respectively: (i) establishing a loss under the policy, (ii) operational considerations with filing the claim, and (iii) what to expect during the claim process.

ESTABLISHING A LOSS

NPI policies typically contain straightforward insuring clauses which provide that the insurer will compensate the insured for a loss on a debt obligation suffered for "any reason." While the underlying language of a policy can vary significantly in defining the scope of the loss or the terms and conditions for claiming such loss, this core covenant tends to be simple. Establishing a loss under a NPI policy therefore only requires determining (i) that the nonpayment event is captured by

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[1] NPI policies are also often referred to as "credit insurance." In that credit insurance has a specific meaning under the New York Insurance Law which does not include most NPI policies (though such products are synonymous), we have opted to use the latter term.

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the policy language and (ii) that the unique nature of the COVID-19 crisis does not impact such a loss. For New York law-governed policy, the latter issue should not be a concern.

The New York Insurance Law is famously insured-friendly, which is to say that it contains several provisions which limit an insurer's possible defenses to those expressly contained in the policy. Even then, aside from the invocation of an exclusion, an insurer may only reduce or refuse payment where the representation or warranty was material to either the insurer's decision to underwrite the policy or the applicable risk of loss. Insurers are required to meet substantial evidentiary burdens to exercise such defenses.

Thus, to the extent that a borrower invokes force majeure as a defense against payment, in the absence of an express exclusion for a pandemic (which would not be permissible in any Basel-compliant policy) standard insuring clauses should capture even the extraordinary losses caused by the COVID-19 crisis.

However, establishing a loss is only the first step to obtaining payment. Obtaining payment from the insurer will depend on several operational considerations discussed in the next section.

OPERATIONAL CONSIDERATIONS

As noted above, New York law only permits insurers to raise defenses against payment of a claim based on the express terms of the policy. Aside from simply arguing that a "loss" as defined in the policy had not occurred, insurers have four general lines of defense through the exclusions, representations, warranties, and other express terms of the contract. Insureds should review each possible defense as an operational matter to ensure the success of a claim.

1. Exclusions: Common exclusions capture acts of fraud by the insured, insolvency of the insured, and material default under the applicable loan agreement. To be clear, the exercise of these exclusions is rare.
2. Representations: Under New York law, representations refer to statements of past or present fact, the materiality of which are judged by whether the insurer based its decision to underwrite the policy based on such fact.

   Among other common terms, representations include enforceability of deal documents, the capacity of the insured to enter into the policy, and certain statements regarding the underlying borrower or the documents furnished by the borrower.

   Such factual representations are almost always caveated by the "knowledge" of the applicable deal team, rather than an absolute statement of fact. Accordingly, insureds can verify compliance with such representations through an internal audit of due diligence conducted by the deal team, rather than attempting to prove the absolute truth of a given fact.
3. Warranties: Under New York law, a warranty is distinguishable from a representation in that it is a fact that tends to increase or diminish the risk

of loss. An insurer can only reduce or eliminate its coverage under a policy if such breach by the insured materially increases the risk of loss.

While warranties must be evaluated on a case-by-case basis to assess their materiality for a given exposure, a common example would be the concept of a minimum retention, which guarantees that the insured always retains at least some risk of loss, and hence, an incentive to proactively mitigate losses. Insureds should review compliance with this provision in order to avoid a possible defense by the insurer (though it must be noted that unrelated hedges that do not specifically reference the applicable exposure are almost always carved out from minimum retention provisions as well).

4. Contract Terms: Notwithstanding the protections of the New York Insurance Law referenced above, NPI policies are still fundamentally contracts made between indisputably sophisticated parties for the purposes of New York law. Accordingly, in the event that a given policy invokes a term such as "condition precedent," regardless of whether such a term would be considered a representation or a warranty, it will be enforced by the plain meaning of the term. For example, while simple ongoing reporting requirements are arguably immaterial to the occurrence of a given loss, if such requirements are framed as a condition precedent, coverage under a policy can be lost as a result of a late reporting submission.

   Further, failure to pay premium is almost always stated as a reason that the insurer may terminate a policy, and would equally be enforced by its plain meaning.

NEXT STEPS DURING THE CLAIM PROCESS

Nearly all NPI policies contain waiting periods between the initial date of loss and the payment of a claim, typically ranging from 90–180 days. During that period, insureds must consider two factors.

First, NPI policies almost always include an express duty to minimize losses. In that NPI policies typically only cover a portion of the applicable exposure and nearly all NPI policies contain minimum retention requirements, insureds are naturally incentivized to minimize losses accordingly. Still, insureds should be prepared to demonstrate the reasonable steps implemented to mitigate losses.

Second, and crucially related to the above, NPI policies typically require the insurer's consent for any material amendment, restructuring, or acceleration under the insured loan (though such consent is typically waived when a majority vote of the applicable lenders overrules the insurer's preferred course of action). Failure to obtain such consent could provide the insurer an argument that the insured has breached a representation, thereby reducing or eliminating coverage.

Given restructuring teams at major financial institutions are often separate from the original deal teams, ensuring proper communication concerning these requirements is vital. Restructuring teams should be fully briefed on the applicable notice and consent requirements under a policy in order to preserve coverage.

BOTTOM LINE

Notwithstanding the unique nature of the COVID-19 crisis, financial institutions with New York law-governed NPI policies will very likely be able to establish a loss. To successfully claim losses under such policy, financial institutions should begin taking steps to secure their claims now through the following actions:

- Reviewing policy terms, such as exclusions, representations, warranties, and other policy terms.
- Continuing premium payments and reporting requirements outlined in the policy.
- Preparing an operations plan for making a claim, especially by looping-in restructuring teams to ensure they are aware of the notice-and-consent provisions of policies on applicable exposures.

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