CHAPTER 1

CREDIT MANAGEMENT

INTRODUCTION

The traditional approach to credit is reactive. Once there is a credit problem, the business reacts by enforcing legal rights. The ability to react *is* an important part of credit management and will eventually be discussed at length in this book. True credit management, however, *also* involves prevention. In fact, prevention is far more important than reaction. It comes first in time and will come first in this book. It is important to understand legal rights as a planning tool in order to evaluate your strength or risk position and to preserve your rights. Preservation of legal rights includes the ability to review legal documents that create a contract and to administrate or modify that contract. For these reasons, it is important to have your own contract forms available that will best preserve your position.

First and foremost, it is important to recognize that if you extend credit to a customer, you are a lender. You must think like a bank, carefully evaluating the creditworthiness of your customer and preserving your legal rights. You must remain flexible to adapt to an infinite variety of credit situations. Rigid, unthinking policies will result in lost business that could have been safely served and increased losses from defaults that could have been avoided. Evaluating and monitoring an account requires a holistic approach involving management, salespeople, the credit department and field performance personnel. Good credit policies increase sales and profits. A competent credit department can increase sales by constructing a safe credit management package for accounts that would otherwise be turned away. Sales and field people have an extremely important role in credit management by keeping their eyes and ears open to collect information about customers and projects.

MORE MONEY IN LESS TIME

We should all make more money in less time. You should consider taking more vacation without lowering your income. If you really like working long hours, you can still do so while raising your income. We will make more money in less time by *managing* credit.

Anyone who has taken a time management course will tell you that time management techniques work. We all tend to use our time *reactively*. Other people decide how we spend our time. We react to the telephone and the problems that the caller wants to explain. We react to the problems of our superiors and subordinates at work. If we are not careful, every minute of the day will be spent responding to what other people want. There are at least two problems with this scenario of "crisis management." First, you have no control over how you spend your time. This is frustrating and very tiring. You can never link more than five minutes together without an interruption. Your work is unfocused, fragmented and inefficient. You are not able to complete *any* problem efficiently and correctly. In short, you are not getting the job done right.

Second, you are probably *not* spending your time on more important projects. If you could prioritize all of your important tasks, you would have an opportunity for long-range planning and problem prevention. If your entire day is spent responding to others, you will never get to the larger, long-term tasks that may be more important. You are not getting the right job done.

These problems are unavoidable to some extent. You must be available at some times for phone calls and meetings with clients, subordinates and superiors. Time management experts will tell you, however, that we must first prioritize all of our long- and short-term projects. This will help determine which tasks are truly the most important to increase profits, prevent problems and develop long-range plans. Second, we must block out certain periods of the day in which we will be unavailable. These are the times we will accomplish our most important tasks. Finally, we must learn to eliminate self-inflicted and external inefficiencies by learning how to avoid procrastination and interruptions. This proactive approach to managing time will allow you to accomplish more in less time.

Unfortunately, most businesses also have a *reactive* approach to credit. When a customer goes 90 days past due, alarms go off and the credit team jumps into action. There are at least two familiar problems with this approach. First, you now have a problem that might have been avoided. An ounce of prevention is worth a pound of cure in the credit

business. You will never have time to focus on prevention, however, as long as you are always busy responding to all of your credit problems.

Other people are also deciding how you spend your resources. You may have lost control of your credit staff. Other people, namely your worst customers, have decided for you that your staff will spend all their time chasing bad debt. This is time better spent on prevention, planning and non-credit tasks. Your worst customers get free materials and services from your company. Then you spend more resources trying to collect. This is how to make less money in more time.

Unfortunately, it is your best paying customers that pay the cost of these defaults. Your best customers should be getting better prices and better terms, not your worst customers. It is worthwhile to spend time and money avoiding defaults and collecting accounts. The most effective credit management techniques, however, do not involve more time or more money. Let us just focus on working smarter. Time and credit management consultants can help you be more productive in less time. You can be more productive, more profitable and still have more spare time for yourself. It is a “win-win” situation. Don’t let credit “happen” to you. Take a proactive approach. Manage your credit. You will make more money in less time.

THE HIGH COST OF DEFAULT

The credit game is much like climbing a long ladder. It is uphill the whole way and each step can take great effort. One slip, however, and you can tumble a long way very fast.

Let us suppose your typical transaction has a 10% profit margin and takes three hours of staff time to sell the job and fill the order. As soon as a customer fails to pay within terms, your administrative time increases as your staff tracks the receivable and calls the customer, other creditors and project owners. Your administrative overhead can easily double, along with the costs of financing for this customer. You have just increased your cost and decreased your profits.

As soon as an account goes legal, the situation gets much worse. A lawyer is doing very well if an account can be collected for 10% of the claim through demand letters, mechanic’s liens or other limited legal action. Your administrative time, however, will again increase. Someone must coordinate with the lawyer, develop a statement of account, collect credit applications and invoices and plan case strategy. Your administrative overhead has now tripled, and your profit has gone to your lawyer instead of your bank account. You are now “in the hole” on this transaction and will need to put together a couple of successful transactions to break even. You are working harder to take home less money.

If your customer is insolvent, the situation gets worse still. Your attorney may have to take the case to trial, enforce a mechanic’s lien, or file garnishments. If serious legal action is required, attorney’s fees can easily reach 30% of your claim. This is a deal in which you had a 10% profit margin to start with. You will have to put together more than three new transactions just to break even. Your administrative overhead costs have also increased, with employees spending time as witnesses in depositions and at trial. You have just lost one week’s vacation because of bad credit management and this rosy scenario exists only if you eventually collect your money.

If you fail to collect, you have still spent 30% in attorney’s fees and now you have lost all of your costs for labor and materials. If your original profit margin was only 10% of the transaction, you will now need to put together 12 or 13 successful transactions to pay for the one default.

This is working a lot harder to make a lot less money. Defaults can be very costly and cause you to lose money faster than you earned it. We will avoid slipping down this ladder by using good credit management. Most importantly, we will prevent defaults altogether. In the event of a default, good credit management will help you collect your accounts faster, with lower administrative and legal costs.

THINK LIKE A BANK

You may think you are in the business of supplying products or providing services. Sometimes you are. However, you are also in the banking business. Every time you send labor or materials to a customer on credit, you are lending them money.

You may complete many transactions a day, sending thousands of dollars out the door. It is astounding how lightly many business people do this, considering how quickly defaults can destroy profits. You probably cannot follow

all the same practices as a bank. You may not be able to hand your customer lengthy applications and then tell the customer that your "committee" will meet in a couple of weeks. You may not be able to refuse the sale if security is not provided.

However, you can still learn much from your bank's example. Think about what happened the last time you borrowed $10,000 to buy a car. First, the bank made you fill out several lengthy applications. Then the bank ran credit reports and did an analysis of your creditworthiness. Finally, the bank required ample security for the loan. There is no logical reason why you should act differently. The bank is an expert in lending money. You can learn something from its example and follow the same basic steps.

1. Collect information on the creditworthiness of the customer and available security
2. Analyze your risk in view of the information collected
3. Preserve legal rights through proper documentation
4. Obtain and preserve the best possible security
5. Monitor the customer and account carefully
6. Move quickly to preserve rights and collect in the event of trouble

THE IMPORTANCE OF SECURITY

Why are one-year adjustable mortgage rates 6%, while some credit cards charge 18% interest per annum? Each dollar costs the bank the same amount. How can it be cheaper to lend one dollar than the other? Security is the most important difference. Security increases the bank's chances of *preventing* default and collecting its money within terms. In the event of default, the bank increases its chances of collecting faster and at lower cost.

What if the government required all lending to be at the rate of 10%, whether or not the bank had security? Which banks would make money and which would lose? What would determine profitability? The obvious answer again is security. The banks that could consistently get security for their 10% loans would get a windfall and become even more profitable. The banks that could not get security would lose money.

What if the market rate for all lending was 0%? What would determine which lenders were profitable? Guess what! The answer is still security. *The market rate for lending in your business* is 0%. You offer this 0% rate to anyone that pays within 30 days. Even if you have a credit application that discusses 18% or 24% per annum, you will probably provide this 0% rate to anyone that pays within 60 to 90 days. If you are a 0% lender, security is critical to your profitability.

When you or your business owner compute the price you need to be profitable, risk factor is one of the components considered. In addition to the cost of materials, labor and overhead, the business owner must consider the risks of default and non-collection. If these risks are lowered or eliminated, your business can sell the same product for less without reducing profitability. Consequently, you are better able to compete. Your good, paying customers will no longer have to pay for the damage caused by your non-paying customers. This is exactly how your credit management policies can be sold to your customers. If they are willing to provide security, you can sell them your products cheaper. Your customer can be more competitive.

If you can decrease your risks of default and non-collection without lowering your prices, you have simply increased your profits. This is making more money in less time.

Why does security decrease the risk of non-collection? When you purchased your last home or automobile, the bank required you to sign at least two pieces of paper. One was your promissory note. This was your "contract" with the bank in which you agreed to make certain monthly payments. This is your "personal promise to pay." This allows the bank to sue you personally in the event of default.

The other paper you signed was a mortgage, deed of trust or other "security agreement." Your security agreement provides the bank rights against the "security property." In the event of default, the bank can foreclose upon the security property, whether it's a house, automobile or other property.

The secured creditor has a "bigger hammer" than the unsecured creditor. The secured creditor can cause more immediate problems for the debtor by taking away the house, equipment, accounts receivables or other security property. The debtor will work harder to stay current. The risk of *default* is lower to the secured creditor.

If the debtor is solvent, security is not as important. The lender will be able to go against the debtor on the "contract." The lender will be able to obtain a personal judgment against the debtor and will then be able to attach all assets owned by the debtor.

If the debtor is insolvent or disappears, security becomes critical. The contract or promise to pay will be worthless if the debtor cannot be found or has no assets. If the lender has security, however, the lender will be able to sell the security property to obtain repayment on some or all of the loan. If there is default, the risk of *noncollection* is lower.

Insolvency or bankruptcy is the same as a debtor disappearing. If a debtor stops doing business or does not have assets, the contract or promise to pay will be worthless. The lender will not collect unless the lender has security. The lender will have to put together many successful transactions to pay for the one complete default. A supplier selling labor or materials to a corporate debtor must understand that the supplier will collect this debt only as long as the corporate debtor is in business and only so long as cash flow continues. If you are not satisfied with this arrangement, you must require personal guaranties or other security. You must also collect information to understand and monitor the corporate customer's business. You must then evaluate the risk that your customer's business may fail.

In the event of bankruptcy, the "secured creditor's" rights in the "security property" are not affected by the bankruptcy. The debtor has, in effect, disappeared and the lender's contract rights against the debtor are now worthless. However, the secured creditor, while perhaps delayed from foreclosing against the property, will eventually collect as long as there is sufficient equity in the property.

"General *un*secured creditors," however, will share only in assets that are not already encumbered as security property for a secured lender. Typically, there are not many unencumbered assets. If there were, there would probably not have been a bankruptcy. The bottom line in bankruptcy is that secured creditors get some or all of their money while unsecured creditors get very little or nothing.

One of the most important components of bankruptcy is the "automatic stay." This automatic stay ends the "race to the courthouse." Creditors are no longer allowed to sue the debtor, obtain preferential payments from the debtor, or obtain new security property from the debtor. Accordingly, advanced planning is very important. You are not allowed to obtain security property after bankruptcy or even 90 days before a bankruptcy. In addition, the debtor will have very few available assets shortly before a bankruptcy. As a lender, you must think ahead to make sure you have adequate security as the account is opened and as the relationship grows.

Labor and material suppliers must understand security as a *proactive* credit management *planning* tool. It is true that a construction materials supplier must understand mechanic's lien and bond rights so that they can *react* to a defaulting customer by providing timely mechanic's lien notices. It is more important, however, to understand your security from the beginning of each transaction, so that you can properly assess your risk with each customer and each project.

Construction subcontractors and suppliers are fortunate to have special forms of judicial security. The most important are mechanic's lien and payment bond rights. The security rights in each jurisdiction warrant special attention and are discussed in greater detail in other chapters. For example, Virginia law provides a relatively powerful mechanic's lien that will not be lost in bankruptcy. Maryland has a lower priority mechanic's lien that will be lost in bankruptcy. If a project is bonded, you will have good security that will not be as expensive to enforce. You must understand these differences to assess the security and risks you have in each transaction.

Security can be either *consensual* or *judicial*. Consensual security is provided with the consent of the debtor and is available to all types of lenders. Customers can agree to provide blanket consensual security applicable to all projects, such as personal guaranties, letters of credit or security interests in accounts receivable and equipment. These devices would be helpful to suppliers in any business, including construction materials, food service, or equipment dealers.

Security is not as important if your customer is solvent. It is not necessary to expend resources preserving or creating security rights if you are confident that your debtor will continue in business and have assets.

COLLECTING INFORMATION

The first step in good credit management is collecting information on your customer *and* on the project. Collecting information about the customer and the project serves two purposes. First, it helps the credit team analyze the risk in deciding whether to lend money to start with. Second, collecting important information early will help you collect in the event of default.

The mechanic's lien and payment bond security rights available are probably the most important information to collect on a construction project. Home office personnel with special training, usually in the credit department, are normally necessary to collect information about security.

Get Everyone Involved

Your business must also collect information about the customer and their creditworthiness. Collecting information about the customer and the project requires a holistic approach involving almost everyone in the business. The credit management team, sitting in the home office, is not in the best position to collect this type of information. Their greatest role is in analyzing information, such as security rights, and making sure that proper documentation is in place before performance begins.

Salespeople are actually in the best position to collect information about a customer and the project when the relationship is established *and* as the relationship continues over time. The credit department can mail a credit application, but the salespeople will visit the customer's place of business and be in constant contact. Unfortunately, the relationship between credit and sales staff is often uncommunicative and sometimes downright confrontational. The credit department is "killing" business deals. The sales staff is "promising the world," regardless of risk.

This discord can and must be eliminated. Business owners should consider making sales income tied to gross receipts or profits, rather than sales. If salespeople are salaried, bonus systems should be linked to collection rates and profitability. Salespeople should be involved or in charge of collecting their own accounts. Salespeople will then feel the "pain" of a default, by spending many hours collecting bad accounts that prevent them from using that time to make new sales. If salespeople's income is tied to sales only, they naturally will worry only about making sales. They will not be concerned about whether the sale is profitable or whether the account is ever collected.

In most standard economic models, the risk of a problem should be placed with the people best able to avoid the risk. Salespeople are in the best position to recognize and avoid problems. They will have the most contact with customers and have the best opportunity to collect information. Since they are in the best position to notice trouble, they should have an incentive to notice and help avoid credit management problems.

Credit staff, on the other hand, might have bonuses linked to total successful sales volume or new customer accounts successfully placed. It is bad for business if the credit staff has a subconscious incentive to kill all transactions in order to avoid defaults.

Delivery personnel and construction superintendents, as well as salespeople, are all in an excellent position to continually monitor for trouble. Would the credit department want to know if all other suppliers are shipping on a COD basis? What about rumors that a customer missed payroll or that equipment is being repossessed?

Management must make it clear to all personnel that they have an important role as the eyes and ears of the business. If nothing else, managers should emphasize this in personnel meetings. It is amazing what people can accomplish when they understand what is expected of them. They won't understand if they are not told. When possible, economic incentives should also be in place to encourage participation in the credit management process.

Don't Be Afraid to Ask Questions

Tactfully done, asking questions can show your competence and interest in the project. If you seem truly interested, most people will run their mouths at great length about their past success. Pay attention: THE CUSTOMER IS FILLING OUT AN APPLICATION. Mentally note common acquaintances or other details. Write these details down at the earliest opportunity. You will not be able to remember these details months later if you are trying to collect a bad account. You may want to keep credit application forms handy to remind you of the information you may need and to organize your notes.

Evasive answers, secretive tendencies and unfavorable answers are hints that you should be more careful. Your best customers will be straight shooters who are not offended by the questions.

Common Sense

Use your common sense. Much information concerning customers and their projects can be obtained using this useful and free tool.

1. Are the plans and specifications coherent and workable in the field? You are an expert in your type of business. You may know more than your customer. Does your customer's project make any sense, or is the customer likely to have big problems?
2. Is the project ugly? Is there a market for your customer's product?
3. Does the customer seem well managed and organized? Is there constant turnover in management and personnel?
4. Does the customer drive a Ford Pinto or an old pick-up truck? Does he seem to talk on and on without saying anything? Do some parts of the story not quite add up?

Salespeople can engage in sincere conversations with a customer to become acquainted, to understand the customer's needs and to provide free expert assistance to the customer on some aspects of the project. Straight shooters may welcome the help. Most people like to talk about their projects in any event. Salespeople need to understand that these are important opportunities for more than one reason. It is wise to establish relationships with a customer to boost sales. However, it is also an important opportunity to obtain critical credit information and to make management aware of potential problems.

It is very important to develop antennae to recognize signs of potential problem customers and projects. This does *not* mean you want to refuse their business. It does mean that you must increase your credit management care a few notches.

CREDITWORTHINESS

Credit Applications

In deciding whether to lend money, the business wants to know whether a customer is "creditworthy." Does the customer have sufficient assets? Is the customer likely to pay bills when they become due?

Don't be afraid to ask for credit applications. It is only logical that you need information on a new customer. This displays the competence, care and professionalism of your business. A good customer knows that an organized supplier is probably more reliable. Over and over again, it seems that the customer objecting to your credit policies is the customer you are likely to have trouble with. It is all the more important to stick to your guns at this sign of trouble.

The Credit Application shown in the Appendices provides examples of information you want to collect. The "terms and conditions" or "contract" language on the application will be discussed later in Chapter 2.

You don't necessarily have to ask the customer to fill out an application. That may be offensive. Discuss their previous projects with them and your mutual friends. This will show your interest in them and their project. Most people will open up more than they should if they think they have an ear interested in everything they have to say. You can similarly use a simple "Customer Information Form." Sales staff can fill this out with the customer, without "terms and conditions" or a customer signature. You can legitimately request this Customer Information Form so that you can "better serve" the customer, but it could still be very helpful to have this information recorded to analyze credit risk or to collect later in the event of default.

Credit Checks

The single most powerful tool in collecting information about the customer is the credit check. Straight shooters will not be offended by your desire to run credit checks. They are proud of their credit, and they know it will make you want the job more.

Corporate Credit Checks

Corporate credit checks, such as Dun and Bradstreet, are the most commonly used. Although much of the information in corporate credit reports is self-reported and sometimes unreliable, these reports can be very helpful, especially to identify judgments entered, lawsuits filed and Uniform Commercial Code (UCC) Financing Statements creating liens on the customer's equipment, receivables and other assets. Also, corporate credit reports often contain information provided by other companies on credit history.

The fact that a customer has been able to get credit at other companies is a good sign. Blanket UCC Financing Statements on assets, however, mean that there are fewer assets available to you for security or to collect a judgment.

New and Small, Closely-Held Corporations

Corporate credit checks are worthwhile but of limited use for new and small, closely held corporations. Little information will be available, and the information available is often outdated, self-reported and with little verification. This makes a credit check on the principals in the corporation much more valuable.

The creditworthiness of small closely-held corporations will follow the creditworthiness of their principals very closely. A check on the principal officers in a small corporation will tell you what payment history can be expected from their corporation. You want to know whether the company president is habitually late paying his personal credit cards or has had judgments entered against him. This information is available on a personal credit check.

You are certainly allowed to run a personal credit report with permission. One of the terms and conditions on the Credit Application shown in the Appendices is the right to run credit reports on all of the individual officers, directors and shareholders listed.

Personal Credit Checks

You are always allowed to run a personal credit report with permission under the Fair Credit Reporting Act (FCRA). You are also allowed to run personal credit checks resulting from a credit application from an individual or to review or collect an account. This would include individuals applying for credit as owners of a sole proprietorship and, probably, a partnership. You are also probably allowed credit checks on account guarantors, although getting personal credit applications with this agreement is a better practice. The Personal Guaranty shown in the Appendices also contains express permission to run credit reports.

Under the FCRA, you may or may not be able to run personal credit checks on individual officers, directors, shareholders or guarantors of a corporation, even without permission. You should consult your credit bureau and attorney on this questionable legal interpretation issue.[1]

Fair Credit Reporting Act and Equal Credit Opportunity Act

The Fair Credit Reporting Act (FCRA) was passed by the U.S. Congress in late 1997 to regulate the use of individual credit reports and credit information.[2] The Equal Credit Opportunity Act (ECOA) was passed a few years earlier to prohibit discrimination against credit borrowers based on race, religion, color, national origin, sex, age or marital status.[3] Both acts impact credit applications between sellers and customers. There is uncertainty about the meaning of some portions of the acts.

The bottom line of both acts, considered together, is that all creditors must respond to applications for credit within 30 days after receipt of a completed application. Creditors must always provide notice of borrower's rights under both acts. Sellers normally take the role of "creditor/lender" and the customer normally takes the role of "borrower." The Credit Response shown in the Appendices will help most creditors comply with both acts.

Fair Credit Reporting Act

In commercial transactions, the FCRA only concerns the use of personal consumer credit reports used to evaluate credit in a business transaction. The FCRA does *not* apply to the use of business or commercial credit reports. The permissible purposes for using a consumer credit report include:

1. By permission

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[1] *See e.g., Korotki v. Attorney Servs. Corp*., 931 F. Supp. 1269, 1275 (D. Md. 1996), *ftn*. 21 [It may be possible to take the contrary position that the report is not governed by the FCRA because it was utilized for commercial purposes. Representative Sullivan, a sponsor of the FCRA, stated that the FCRA "does not apply to reports utilized for business, commercial, or professional purposes." 116 Cong. Rec. 36,572 (1972). Likewise, the Federal Trade Commission (FTC) has concluded that "[t]he FCRA does not cover reports furnished for transactions that consumers enter into primarily in connection with businesses they operate (e.g., a consumer's rental of equipment for use in his retail store)." 16 C.F.R. Part 600 App., at 387 (1995). That position however appears to conflict with the way some courts have defined a consumer report. *Comeaux v. Brown & Williamson Tobacco Co*., 915 F.2d 1264, 1273-75 (9th Cir.1990) ("If a consumer reporting agency provides a report based on a reasonable expectation that the report will be put to a use permissible under the FCRA, then that report is a 'consumer report' under the FCRA" regardless of whether report is actually used for a business purpose) (emphasis in original); *Ippolito v. WNS, Inc*., 864 F.2d 440, 453 (7th Cir. 1988) ("even if a report is used or expected to be used for a non-consumer purpose, it may still fall within the definition of a consumer report if it contains information that was originally collected by a consumer reporting agency with the expectation that it would be used for a consumer purpose"); *Heath*, 618 F.2d at 696].

[2] 15 USC § 1681 *et seq.*

[3] 15 USC § 1691 *et seq.*

2. For the extension of credit pursuant to an application from the consumer
3. Review or collection of a consumer's account
4. A legitimate business need in connection with a transaction initiated by the consumer.[4]

It always is the best policy to get written permission to run a consumer credit report. This permission should be in the terms of all credit applications and should also be included in all personal guaranty forms.

If a lender takes any type of "adverse" action, based in whole or in part on a consumer credit report, the lender must send the applicant a notice informing the borrower:

1. That the adverse action was taken in whole or in part based on information contained in a consumer credit report.
2. The name, address and phone number of the consumer reporting agency that provided the report.
3. An explanation of the borrower's rights to obtain a copy of the credit report to dispute any erroneous information in the report.

The sample Credit Response shown in the Appendices contains the required statements. "Adverse action" includes a denial of credit, a modification of the requested terms or a change in terms on an existing account.

The purpose of the FCRA is to promote the accuracy, fairness and privacy of information in credit reports. Borrowers must have an opportunity to dispute inaccurate information in their credit reports. Borrowers have an opportunity to do this only if they are told that adverse action by a creditor is based on the credit report and told where to get a copy.

The triggering factor requiring notice under the FCRA is the use of a personal consumer credit report. A creditor should send the notice if they pulled a personal consumer credit report and then refused to extend credit on the terms requested. It does not matter whether the credit is for a commercial account or a personal account. If a personal credit report is pulled in connection with a commercial transaction, the described notice of adverse action must be sent. On the other hand, no notice is required in commercial transactions based on unfavorable trade references, unfavorable public record information or unfavorable business credit reports.

Credit Reporting Agencies (CRAs) are probably more impacted by the FCRA than individual creditors. Reporting agencies now require their creditor clients to certify the permissible purposes for which credit reports are obtained and to certify that the reports will not be used for any other purpose. The biggest change for creditors is probably the requirement that the credit applicant be notified if you take an "adverse action" based in any part on information obtained in a credit report. You would have to provide this notification if you deny credit, change credit terms or reject an employment application.

Equal Credit Opportunity Act

The ECOA, on the other hand, requires a written response within 30 days of a completed application in all transactions, whether for business or personal use. The notice must inform the borrower of their right to request a written statement of the specific reasons for the denial within 60 days after a notice of credit denial. If a written request is made, the creditor must send a written statement of the reasons for denial within 30 days. The statement of reasons does not need to be very specific and examples include "adverse credit history," "lack of sufficient business experience," "lack of sufficient working capital," "too much secured credit" or "value or type of collateral insufficient."

A creditor must send notice if: (1) credit on the requested terms is denied; (2) if credit is approved on less favorable terms than those requested in the application; or (3) if credit is approved on less favorable terms than the creditor's normal terms. Creditors should keep records of all credit applications and responses made for at least 12 months. The creditor must also send notice if an application is incomplete. The Credit Response shown in the Appendices

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[4] *Mone v. Dranow*, 945 F.2d 306, 307-308 (9th Cir. Cal. 1991) [A consumer whose credit report is obtained for reasons other than those listed in the statute may recover actual and punitive damages and attorney's fees and costs from the user of such information. Determining whether an adverse party in litigation will be able to satisfy a judgment is plainly a purpose unrelated to an individual's eligibility for credit, insurance or employment].

complies with these requirements in a typical commercial transaction. More detailed Sample Notification Forms are also in an appendix to the Code of Federal Regulations known as "Regulation B."[5]

The ECOA also prohibits credit discrimination based on sex and marital status. In more than one case, a creditor was not allowed to enforce a personal guaranty against a borrower's wife, because the creditor had a blanket policy of requiring all borrowers' spouses to sign,[6] although courts do vary in this result.[7] The problem was in the blanket policy of discriminating against married persons by requiring their spouses to co-sign guaranties. A lender is always free to evaluate the individual assets of a borrower or guarantor, decide that the individual assets are insufficient, and decline credit unless additional guarantors are supplied. Creditors can also have a blanket policy requiring multiple personal guarantors, requiring all officers or all stockholders to sign, etc. The critical policy is to make sure that discrimination is not based on race, religion, color, national origin, sex, marital status or age.

The ECOA has created problems for companies that wish to open credit accounts quickly and obtain deliveries. Before spousal signatures can be required, the borrower must submit individual financial statements; the creditor then must review those financial statements and determine that the individual assets are insufficient. This can take precious time, and many customers do not like supplying individual financial statements. In most cases, individual assets will be insufficient, because married couples own most assets jointly. It is difficult to find a practical solution to this problem.

The safest course for suppliers is to require and evaluate individual financial statements and then either decline credit or require additional guarantors if individual assets are insufficient. If this is not practical, sellers should provide their customers a choice *either* of submitting complete financial statements of individual assets to apply for individual credit *or* providing the signature of multiple guarantors such as other officers, shareholders, spouses or other family members. Although it has not been tested in the courts, this option to borrowers would seem to comply with the spirit and the letter of the ECOA, while reducing paper work and the time necessary to open an account. Personal Guaranty forms should also waive rights under the ECOA and acknowledge that individual guarantors have decided not to apply for individual credit. An example of such a form is the Personal Guaranty shown in the Appendices.

The owners of most small closely held corporations will probably decide to provide guaranties of owners and spouses, but it is the borrower who has to decide to submit a joint application. Spousal signatures can be volunteered by the borrower but cannot be required by the creditor. The borrower is always free to make an application for individual credit, supported by financial statements.

Responses to credit applications under the ECOA can be verbal. The required notice of rights under the ECOA can be included on the credit application itself in order to comply with the acts. This will cut down on the total paperwork. We think it is a better policy, however, to make all responses in writing, by using a form similar to the sample Credit Response Form. This allows creditors to keep a complete written record of notices sent. Under the ECOA, creditors are required to keep records of credit applications and responses for 12 months.

References

References are an important tool in determining creditworthiness and should be included on any credit application. It is important to note, however, that the references listed on a credit application are probably *not* the most important references with whom to speak. A debtor is likely to list the people who will report positive information. You need to speak with neutral references that are willing to tell you the worst about the customer. Credit networking groups and salespeople are very important for this purpose.

Salespeople have an opportunity to chat with customers about common acquaintances. Be sure to follow up on references provided on application forms or in casual conversations. Telephone some of the people mentioned and discuss the customer. Salespeople and credit staff are in a position to informally network with other creditors and become aware of financial problems with certain customers. They have acquaintances selling related products to the same customers. Even competitors should be willing to discuss customers' credit history. They have a common

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[5] *See* 12 CFR §1002.1, *et seq.*[Regulation B], Appendix C to Part 1002—Sample Notification Forms at http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=3912c817eaff5bdad63405394a73b24b&n=pt12.8.1002&r=PART&ty=HTML#ap12.8.1002_116.c.

[6] *RL BB Acquisition, LLC v. Bridgemill Commons Dev. Group, LLC*, 754 F.3d 380 (6th Cir. Tenn. 2014); *Eure v. Jefferson Nat'l Bank*, 248 Va. 245, 448 S.E.2d 417 (1994).

[7] *Hawkins v. Cmty. Bank of Raymore*, 761 F.3d 937 (8th Cir. Mo. 2014).

interest in keeping the bad apples out of the barrel. Real friends will discuss things "off the record" with you, if you assure them that word will not be passed on. Networking for this purpose is extremely important.

There are formal networking groups such as the National Association of Credit Management (NACM), which are very valuable. They hold monthly meetings for credit managers in different industry groups who provide each other with early information on tardy payments and defaults. Your competitors and your customers have a common interest in promoting your good credit management. No one benefits from bad debt. Your customers end up paying the cost of bad debt, and it increases their competition from weak businesses. All creditors have a common interest in avoiding bad businesses.

Discussions with competitors always raise antitrust concerns. Formal networking through groups such as NACM is beneficial for this reason. Generally, it is proper to discuss past empirical facts about a customer. *Never* discuss what you are *going to do* in the future, however. It is proper to say, "That customer is now 90 days past due" or "I have already cut that customer off." It is not proper to say, "I intend to cut that customer off if they do not pay me this week" or "I intend to hold all of my customers to 30-day terms."

Prior Businesses and Projects

Has this customer had successful projects and businesses in the past? It is amazing how consistently the same individuals have failed businesses and failed projects. It is even more amazing how these individuals keep finding someone else to lend them money. These people were not born yesterday. Where have they been the last decade? Who did they work for or with? Did they succeed or fail?

You can ask these types of questions on a credit application. Like credit references, however, people are unlikely to list prior businesses that reflect poorly. Once again, this is where salespeople and credit networks can be very helpful. Prior employers and projects are logical things for a salesperson to discuss with a prospective account. It is a warning sign if a customer does not want to discuss these subjects. Any prior businesses mentioned should be researched for credit history.

COLLECTABILITY

We have discussed creditworthiness because it is important to know whether a customer will *want* to keep a good credit history. It is also important to consider whether a customer will be *able to pay*, whether they want to or not. You need information on both the customer and on each new project for this purpose.

Qualifying the Customer

Is your customer well capitalized with many hard assets and without large amounts of debt? The stronger and more trustworthy the customer, the less important the project and security rights. It would be very helpful to know a customer's net worth and financial strength. Consider the possibility of simply requesting complete financial statements. This is an unusual step, but should be considered as a possibility for marginal customers, if you will be lending large amounts of money regularly, or if you are in a strong bargaining position as a sole source supplier.

Whether or not you can get financial statements, salespeople and networks again become very important. There may be talk on the street about financial backing or weaknesses that should be passed on to the credit department. It is important to know whether a customer has been or can be bonded and whether this particular project has a payment bond. Bonding companies can make poor credit decisions, but their willingness to bond a customer and/or project is an important sign of some financial strength.

Qualifying the Lender

For construction projects and new businesses you may need to talk to lenders. Customers obviously will not like this and it will not be possible in all instances. However, sometimes it is very wise to let this determine whether or not you take a job. Tell the customer you must verify the amount of available funding for the project. Hopefully, this will allow you have a general discussion with the lender about the project and the customer.

Does the owner have a construction loan in place for this project? This may be the most important question you fail to ask. There have been large projects that have been started based on the owner's "confidence" that lending would soon be finalized. Owners can be overly optimistic about funding, and this can be devastating for them and all contractors on the project.

The standard AIA Document A201-1997 (General Conditions of the Contract for Construction), as developed by The American Institute of Architects, contains a provision allowing the general contractor to request evidence of funding for the project before they begin work and at later stages of the project. It is important to be aware of this and to *use* it. As a subcontractor or supplier, you may want to require that the general contractor utilize this provision to confirm funding. You may have more experience than both the owner and the general contractor. You may save a lot of trouble for everyone by asserting yourself and requesting or requiring evidence of funding before you agree to perform.

You may be able to get a contract term allowing you to directly verify available funding with the lender and to obtain verification of additional funds to be supplied by the customer. You can add this to your contract or credit agreement. If nothing else, it is helpful to get a copy of the loan commitment or a letter from the lender confirming the availability of funds.

Qualifying the Project

For new accounts *and* long-term accounts, it is important to be familiar with your customer's large projects. A bad project can be the financial death of a good customer. Will the project succeed? Who are the owner and general contractor? Are they creditworthy? Was the project properly bid? Is it funded? Are the plans and specifications workable in the field?

How large is the project to your customer? Some projects are so big and so bad that they can pull an entire company into insolvency. This can make a good customer unable to pay you, no matter how hard they try. On the other hand, a successful project probably means you will get paid, as long as you have good communication with upstream contractors and/or the owner. You've learned a lot about this business in your years of experience. Evaluate the project yourself and make your own determination whether it is likely to succeed.

Consider the following:

1. Is the project being built in a glutted market?
2. Is the project pre-leased or pre-sold? Is it likely to sell or lease easily?
3. Is the budget realistic? Are there likely to be large cost overruns?
4. Is the project attractive and functional?
5. Are the plans and specifications change order heaven or bankruptcy hell?

Evaluate whether there are sufficient allowances for contingencies in the budget in light of your evaluation of the probability of large change orders. You can again help yourself and your customer by sharing your experience and expertise in the business. If a customer absolutely refuses to discuss these items with you and absolutely refuses to let you have any contact with the lender, perhaps you should be concerned.

Problems in the project hurt everybody. Tell the customer that you have the same interest in seeing that this project succeeds. You are an expert with a lot of helpful experience. All of your discussions are in the strictest of confidence. You are just trying to help the customer or the owner produce a realistic budget and succeed with the project.

Qualifying Security

Information is collected on the project *early* in a proactive credit management strategy. You want to know what security rights you have *before* you agree to supply labor and materials. If you determine a project is bonded, then your risk factor is lower and you do not need as much documentation from your customer. If there is no bond and mechanic's lien rights are weak or expensive, you must think more about requiring personal guaranties or COD shipments.

Security can be either consensual (requiring the customer's consent) or legal/judicial (provided to you by law whether the customer agrees or not). When you borrow money from a bank to buy a car or house, the bank requires that you grant a security interest in that car or house. This is a consensual lien. If you sell materials to a customer to be used in the construction of a house, the law grants you mechanic's lien rights. This is legal security. This gives you the right to foreclose, very much like a consensual lien.

Detailed outlines on mechanic's lien and payment bond rights appear as separate chapters in this book. In short, however, almost all sellers participating in the construction process either have mechanic's lien or bond rights. In most private projects you will have mechanic's lien rights. The quality of these rights varies from state to state and

also varies depending upon the type of project and type of product. It is very important for you to understand the extent to which you have mechanic's lien rights in any given project. If you know you have good mechanic's lien rights, with good priority, and which will be relatively inexpensive to enforce, you can be slightly less concerned with other types of security and slightly less concerned with a shaky customer.

You also want to collect information early in a project to be able to quickly and accurately enforce security rights later, if necessary. It is always easier to collect such information while you are still friends with your customer. Debtors, general contractors and owners are not as likely to cooperate once you have already supplied labor and materials and problems occur. When a customer is more than 60 days past due, they are not likely to return phone calls or provide copies of payment bonds.

Once you have a problem, you will be very short on time. Information is important for the traditional *reactive* approach of enforcing security rights after a problem has arisen. Collecting information on the project early will ensure mechanic's lien and bond claim accuracy, allowing you to move quickly and to hold your cost down.

The Project Information Sheet shown in the Appendices will help prompt you on the information needed. Get a site plan for the project and keep it within easy reach. This is the best single source of information to hand to your attorney in order to identify the project and begin a title search to develop a good legal description. It also can be very important to solve allocation problems in multiple parcel or unit projects and to determine the value of labor and materials supplied to each unit or parcel involved.

Material suppliers and remote subcontractors should be sure they know the names, addresses and telephone numbers of the owner, general contractor, architect and bonding company. You will want to be able to contact both the owner and any general contractor in the event of a problem in order to "freeze payments" and arrange joint checks or direct payment. In order to prepare a bond claim, you will need the general contractor and bonding company information. For a mechanic's lien, you will need the owner and general contractor information, along with a description of each lot or parcel of land involved in the project, and the description of labor and materials supplied to each lot or parcel of land involved in the project.

It is also important to know whether you are a true general contractor. Under most mechanic's lien laws, a general contractor is defined as any contractor with a direct contractual relationship with the owner. This status can be very important since it can determine whether notice is necessary or if a "defense of payment" exists.

Some projects use numerous corporate entities to create "artificial" tiers of general contractors and subcontractors. You may have a contract with the ABC Corporation, but if ABC Office Project, Inc., owns the land, then you are a subcontractor and not a general. Being aware of this difference can be important since a subcontractor must act quickly to file liens in order to avoid a defense of payment. If the contract between the owner and the related general contractor corporation calls for the general contractor to be prepaid for all construction work, then the subcontractors, who thought they were general contractors, may never be able to lien the job under any circumstances. While this result is frightening and perhaps fraudulent, this scheme may work.

Many private construction projects also will have payment bonds. For most public projects, either construction or other types of procurement, you will have payment bond rights. It is very important to be aware of the bond rights that may exist. Payment bond rights are very effective and inexpensive compared with enforcing mechanic's lien rights. The existence of a payment bond will make you much more comfortable about your prospects of getting paid, enabling you to bid the project more aggressively and to forego other types of security.

Because mechanic's lien and bond rights vary significantly from state to state and project to project, it is a credit management issue to be aware of these differences when you do business in different states. In Virginia, a mechanic's lien has priority over all other claims to real estate, except the purchase money lender. This means that the mechanic's lien holder will get its money before the construction lender. The priority of the mechanic's lien is significantly less favorable in Maryland, Pennsylvania and the District of Columbia, so other forms of security and guaranties are more important there. In all states, however, it is important to push the right buttons to preserve your mechanic's lien and payment bond rights.

Any business involved in construction or public procurement must have one representative (the underwriter) reasonably well-versed in security rights. You are taking an important step in reading this book or coming to this seminar. Other chapters in this book provide much more detailed information on security rights. Please call for more information or if you need more training on mechanic's lien and bond rights.

ANALYZING YOUR RISK AND MAKING A CREDIT PLAN

Once you have collected information, it must be analyzed. Someone in your organization must have enough training or experience to be capable of truly assessing your risks, creating and implementing a credit plan. This is the underwriter's job in a bank or insurance company.

Your people in the trenches, the salespeople, must understand credit management and collect the right information. The underwriter must be able to count on them to collect the correct information and recognize signs of problems. The underwriter must then determine what level of contractual agreements or security is required.

The credit manager must be able to analyze the information and prepare a credit strategy for each particular customer on each particular project. If you have reason to think that a customer or a project is marginal, you must use more stringent credit management techniques. You are in a better bargaining position with such customers and self-protection becomes more important.

Most businesses become bureaucratic and institutional, especially concerning subjects with which they are not comfortable. Consider how businesses create credit "policies" that require a certain credit application form and may require a certain number of references. Once the salesperson or credit manager has followed the approved credit policies, a decision is made to either sell to the customer or not. There are no other choices.

This inflexible approach can hurt in at least two ways. First, business can be lost because the customer didn't fit within rigid policies. Second, the business can lose a lot of money on a customer that met company policy, but the business either failed to recognize the risk or failed to preserve its rights.

To make more money in less time you must think smart and remain flexible. If your customer has a terrific net worth and/or a great track record, security rights are less important. If your customer has money, any dispute is likely to be settled with a payment to you. Even if litigation is necessary, your customer will pay (or can be forced to pay) any judgment that you obtain. If your customer has no money, however, whether or not you ever get paid may depend on whether you have security.

You must, at least, make sure you have a good credit agreement and that you have collected and carefully analyzed all available information. If you are just a little nervous or have a new customer, at least make sure you know your UCC and contract rights, mechanic's lien rights or bond rights. If you don't have security, you must be more careful. With small, closely held corporations, you should consider personal guaranties.

You will probably not get a personal guaranty for large, regional or national corporations. You may not even be able to get corporate credit agreements. These things are not as important if you have a long and successful track record with customers or they have excellent credit reports and references. On the other hand, remember that straight shooters with good credit histories normally do not object to providing information and credit agreements. Do not forget to ask for these things.

When faced with a more marginal customer, you may not want to send them out the door, but you must use a higher level of credit management than what is offered to your best customers. Tell the customer that you must have personal guaranties and explain how this allows you to reduce your price. Require a joint check agreement or a direct payment from the customer's buyer, the project owner or lender. You may convince a customer that they too would prefer such an arrangement because they are also eliminating credit risk. The buyer should be indifferent if its total costs are unchanged. Construction owners or lenders may prefer to avoid the risk of mechanic's lien or bond claims.

Dealing with a truly marginal customer is the credit department's opportunity to greatly assist the sales staff and make the business more profitable. If you can make a marginal account secure, your company will succeed where others fail, for these accounts are often very profitable. Consequently, your company can be in a position to demand the highest prices. Consider requiring a payment bond or security in the business owner's home and equipment.

All of these mechanisms are described in detail in other chapters of this book. The ability to consider and use all of your options is the reason why it is important to study all of these subjects. You will then be able to truly evaluate the strength of your position and then be able to improve it. The credit department should always strive to make a deal work. On the other hand, neither the credit department nor the sales department should push it too far.

There are deals you don't want! Unfortunately, some businesses must still be told this. You must be ready to let a job go if it is not right. However, you do not need to tell a customer you don't want their business. Let your credit management requirements be determinative. In the extreme case, simply tell the customer you must be paid in advance. Let the customer say "no thank you." You can still be in the politically correct position of telling the customer you would love to do his work and you are ready, willing and able to do so. Tell the customer you are able

to provide this special rock bottom price only if the credit risk is eliminated. You may be surprised how many sales you can make in this manner. This is business you would have otherwise turned down.

Collecting information on the project and analyzing risk do not stop once the file is opened and performance begins. Salespeople, construction superintendents and other field representatives are especially important in this context, for they are in the trenches. They hear rumors about problems with certain subcontractors, with governmental authorities or with design professionals. Salespeople or the credit department may wish to discuss the project regularly with governmental authorities, design professionals or the general contractor. This is discussed in greater detail in the section on Contract Administration in Chapter 2.