Covering Credit Bulletin

March 2008

This Month's Topics:

- **Bankruptcy Myths**
- **Collection Tips and Tricks**
- **Lockbox Usage**
- **Questions and Answers**
- **How to Manage Settlement Offers**
- **How to Refuse Credit**

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Collection Tips and Tricks

- **If your company's pricing strategy makes your company a low price supplier, it is important to explain that fact as part of your collection efforts.**
- **Discourage payment delinquencies by charging late payment penalties and by enforcing them. Also, encourage prompt payment by making certain that unearned cash discounts are charged back and the customer is required to repay them.**
- **Set up a system to determine which accounts to handle in house; which account to turn over to a collection agency, and which accounts to send to an attorney.**
- **When a customer provides an excuse for delaying payment or for breaking a payment commitment, be polite, because you are still speaking to a customer, but be firm because any sympathy you may have for the debtor's problem[s] does not change their responsibility to pay the balance due.**
- **Your strategy for debt collection should not be tentative; it must be direct, firm and assertive.**
- **Develop an effective way of knowing when accounts come due, and track customers that do not pay on time.**
- **Insist on a specific payment commitment once you have addressed the stalling tactics and the maze of excuses offered by the debtor.**
- **If a collector treats payment as an abstract instead of a concrete goal, their results will be less than expected. Collectors need to understand that their goal is not an abstract? Their goal involves collecting money owed to your company.**
- **There are some excellent software packages available, but at a minimum collectors need software that allows them to record notes on line as well as a follow up reminder feature.**
- **Use your computer software to its best advantage by keeping collection notes on-line, and on line reminders to follow up on payment commitments**

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Lockbox Usage

Many companies use lockboxes or lockbox networks to accelerate deposit of payments from customers by reducing mail float, as well as processing float. A lockbox network is a mechanism that allows a financial entity such as a bank to collect and deposit payments on behalf of its customer, the creditor. The primary goal of lockbox systems is to accelerate the availability of funds to the creditor. A lockbox study can help a creditor company to decide how many lockbox locations it needs to have and where those lockboxes should be located. As a general rule, a company should have a lockbox study performed if or when:

- **It currently does not use any lockbox system.**
- **The company sells nationally but has only one lockbox location.**
- **The creditor company is using a multiple bank network rather than a network operated by a single bank.**
- **The current lockbox network locations were selected without the benefit of a formal lockbox study.**
- **It has been at least two years since the last formal study was completed.**
- **The creditor's customer base has changed significantly over the last two years.**
- **The creditor opens a large number of new accounts each year, or has recently completed a merger, an acquisition or a divestiture.**
- **The company has recently expanded into new geographic markets**
- **The lockbox bank has been acquired and/or has closed one or more of the lockbox locations used by the creditor company.**

Clearly, in some cases the number and location of lockboxes in the existing network is adequate. In this scenario, a lockbox study is likely to recommend changes involving which customers are asked to remit to which lockbox. A study might recommend a more comprehensive change in which lockboxes are added or deleted from the network, and customers are reassigned based on the location from which customers currently send payments. In certain cases, a complete overhaul is required. It is conceivable that all of the lockboxes the current network will be closed, and an entirely new configuration will be established. In this scenario, every customer would be asked to remit to a new lockbox address.

Tip: Sometimes, the most difficult task for the credit department involves convincing customers to remit payment to the company's lockbox. Why? A charitable explanation would be that the customer's accounts payable department is too busy to change the remittance address. A more likely explanation is that customers are sometimes reluctant to remit payments to lockboxes because they realize that making this change will reduce payment float.

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<u>Questions and Answers</u>

Question: What is a check guarantee service?

Answer: It is a third party service provider that guarantees a check if it is returned by the bank. This service has a relatively low cost, and when a creditor sends the service a bounced guaranteed check, the service will reimburse the creditor for the face value of the check, usually within 30 days. The service will then handle collection of the unpaid balance from the debtor company. Occasionally, the creditor will be unable to secure a guarantee on the check do for any number of reasons.

Q. Can we purchase credit insurance for only high risk accounts?

A. I cannot say for certain. I would encourage you to contact your insurance agent or a broker for information. It depends on how bad the high risk customers are that you interested in insuring appear to the underwriter.

Q. Can a stop payment be placed on a Cashier's Check?

A. It is my understanding that under certain circumstances a stop payment can be placed. An example would be if the check is lost or stolen… or if the customer decides that it does not want to purchase the products or services for which the check was issued.

Q. A customer is not paying, and our credit application contains a personal guarantee. How do we enforce the personal guarantee?

A. If you send a demand and the guarantor will not pay voluntarily, you have to sue the guarantor in order to get paid. If the guarantor also owns or is a major stockholder of the company, it is possible that the guarantor will file a personal bankruptcy when the corporation files for Chapter 7 or Chapter 11 business bankruptcy. In that scenario, the guarantee may be valueless.

Q. A customer demands to know their credit limit. Must we reveal this information?

A. Must you? No. Should you? I don't know. Obviously, you have concerns about doing so and I would want to understand these concerns before I could make any intelligent comments about this issue.

Q. How much emphasis do you put on the fact that a customer has tax liens listed on their credit report?

A. There is not enough information to answer this question, so I will make two general comments. The more tax liens are listed, the more concerned I would be. If any of the tax liens remains open rather than closed/resolved, I would be much more concerned than if tax liens were listed as paid/closed.

Q. Can you sue a customer or place them for collection over unpaid finance charges and unearned cash discounts… no invoices, just back-charges.

A. Sure. However, it might be difficult to convince anyone to accept the claim on a contingency basis given the fact that the entire balance due is in effect in dispute. Good luck with this one.

Q. There is a disputed balance. The customer says their PO states we have thirty (30) days following payment to dispute payment. If we have not issued a written objection to their deduction, the deduction is considered legitimate and the balance deducted is considered a legitimate deduction. We never agreed to any of these terms. However, I have reviewed their purchase order terms and conditions, and the terms listed above are included. What do you think?

A. I suggest that you discuss this with your attorney. Absent a written contract signed by the customer that invalidates unilateral changes found on a purchase order or other document, my guess is that the customer is in the stronger position.

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Bankruptcy Myths

There are a number of myths and misconceptions about bankruptcies, including these:

- **Myth: Bad debt losses resulting from customer bankruptcy mean that someone in the creditor company made a mistake. Reality: Some losses are unavoidable, some are the result of mistakes or oversights, some are the result of business decisions, and some result from a combination of factors.**
- **Myth: Placing an account for collection after it in bankruptcy is a good decision. Reality: The automatic stay protects companies that file for bankruptcy.**
- **Myth: Creditors are not at risk if they sell to customers in bankruptcy. Reality: There is no guarantee that creditors will be paid on post petition sales**
- **Myth: Once a customer files for bankruptcy protection, the creditor can do nothing to protect the company. Reality: The creditor can place the account on credit hold; stop shipments in transit and arrange for its return; File a reclamation claim for goods received within a specific number of days prior to the bankruptcy filing date; Pursue payment under a personal guaranty; Demand payment under and inter corporate guaranty; Refuse to extend credit to the debtor on open account terms on post petition sales; Determine their company's preference claim risk**

A note of caution: Less than half of the companies that go into bankruptcy successfully emerge from it. This should be kept in mind when considering whether or not to extend credit to a bankrupt company.

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How to Manage Settlement Offers Proposed by Customers

From time to time, credit professionals must decide whether or not to accept a settlement offer from a customer. A settlement usually involves either partial debt forgiveness, or an extended repayment period. When faced with this challenge, some of the factors to consider include these:

- **Is the settlement proposal reasonable in relation to the size of outstanding balance due**
- **Is this a recurring problem, or a first time request from the debtor**
- **Do you have a personal guarantee from someone working for the debtor - assuming the debtor is a corporation. [Hint: If not, this would be an excellent time to request one be signed]**
- **Are you a secured creditor with a perfected security interest. If so, is "foreclosing" on the pledged collateral a better choice than accepting the proposed settlement offer**
- **Is the customer telling you everything you need to know to make an informed decision? For example, a customer that asks for this type of concession but is unwilling to provide current financial statements may be hiding something**
- **Is the business a going concern, or one that is slipping away to insolvency or bankruptcy.**
- **Can the debtor provide projections showing when the company will resolve its current financial problems?**
- **Are other trade creditors being asked to accept the same settlement offer, and are other creditors currently being offered better terms**

- **Will the customer offer security in exchange for an agreement by the vendor to accept their settlement offer**

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How to Refuse Credit

There is no good way to deliver bad news. Rejecting applicants for credit is an unpleasant put necessary part of the credit function. Here are some suggestions to make the process slightly less difficult:

- **Make sure your facts are correct before rejecting any applicant.**
- **Make certain the people making the decisions have been thoroughly trained, and understand your company's tolerance for uncertainly and credit risk.**
- **If the decision cannot be made because of a lack of sufficient information, that information can and should be shared with the applicant. This way, the applicant has the option and the opportunity to supplement the information they provided on or with their completed credit application.**
- **Never base a negative credit decision of factors such as age, race, sex, sexual orientation, religion, or national origin.**
- **Try to soften the refusal to extend credit. For example:**
    - **At an absolute minimum, thank the applicant for their interest in doing business with your company**
    - **Explain that your credit acceptance standards are stringent**
    - **Encourage the rejected applicant to re-apply after six months**
- **Know your rights. Commercial credit grantors are not required to provide copies of credit reports, or specific information about what other creditors contacted said about the applicant, or to explain their credit decision-making policies, procedures and processes in any detail.**
- **Document the reason or reasons for your decision and safeguard that documentation for at least one year.**
- **Consider generating a form letter of explanation pertaining to rejected applicants and sending it as soon as possible --- and certainly no later than 30 days after the decision is made.**

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