Managing Credit in Challenging Times

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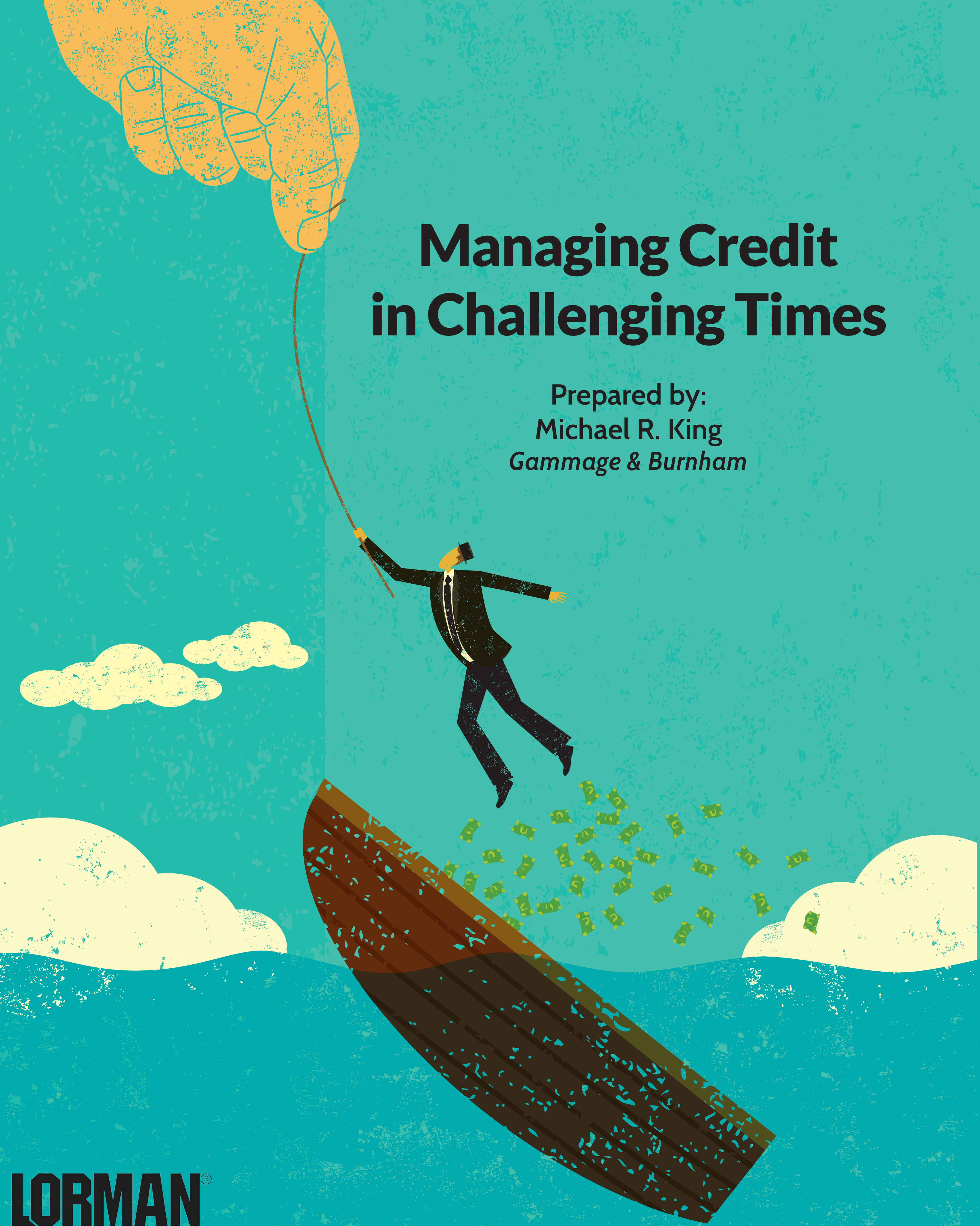

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MANAGING CREDIT IN CHALLENGING TIMES

In the last few years, your business has needed to learn how to do business strategically with insolvent or nearly insolvent customers. If you "cut off" every customer who failed to meet your credit policy underwriting standards of 2005, you made your Credit Department the "No Sales Department!" No doubt, that endeared you to the Sales Department and Upper Management!

The reality is that many of your customers have business challenges of their own. Learning to work with them and to help them with their business challenges is key to both the success of your company and your customers. Many (but not all) of your customers with current problems will survive and thrive. You want to identify and help the survivors, because they will be good customers in the future. At the same time, you must minimize the risk of those customers who will not make it.

BACK TO BASICS!

So, when is the last time you reviewed your credit policies to make sure they matched current economic necessities and business strategy? If you have not consulted your Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, and Sales Manager to align your credit policies with company strategy, you need to do so immediately! After bringing your credit policies current, you need to address your credit procedures. Do all of your credit and sales personnel know what to do to comply with the company's sales strategy and credit policies? If not, you need to dust off your credit policies and credit procedures to make sure they fit with your current business, your current customers, and proper credit-risk management!

KNOW YOUR CUSTOMERS!

Do your policies and procedures ensure that the sales and delivery people are telling the credit staff what they know from direct contacts with customers? Are you making sure that the Credit Department is informed when the delivery person knows that the customer is suddenly severely understaffed? Is the Credit Department advised when the sales people notice maintenance or service problems with the customers' premises?

Have you checked the public record to see how your customers are doing? Are their business entities still in good standing with the Corporation Commission? Are their licenses current? Are there any new liens on the public record, especially tax liens? When is the last time you reviewed the credit profile?

Moreover, have you checked to make sure that your own company's files and records are current? When is the last time you updated the credit applications and other key contracts with your customers? You know, the law has changed dramatically since 2000!

REVIEW YOUR CONTRACT DOCUMENTS!

When was the last time you and legal counsel carefully reviewed your contract documents?

Is your credit application current? Does it comply with all applicable federal regulations as they now exist?

If you haven't done so already, now is a great time to review all of your legal documents, including:

1. the Credit Application;
2. your basic form of contract or agreement with your customer (if different than the Credit Application);
3. prime vendor agreements;
4. delivery tickets or receipts;
5. invoices;
6. billing statements;
7. guarantees (both corporate and personal);
8. security agreements;
9. UCC financing statements (UCC-1 forms) with particular attention to descriptions of collateral;
10. bonds or letters of credit; and
11. your other credit documents.

WHAT DO WE DO TO PROTECT THE COMPANY FROM POSSIBLY INSOLVENT CLIENTS PRIOR TO THE FILING OF ANY BANKRUPTCIES?

If you have updated your credit policies and procedures and your credit documents, you should be in a position to predict or prevent customer defaults. Keep in mind that one of the best ways to shape the behavior of your customer is to decline to deliver more products or make additional sales.

If your customers need your products, they will work with you to help make sales on a basis that is mutually beneficial and secure. If the customers fail to measure up to your credit standards as set forth in your credit policies, then declining to sell protects the company from needless risk.

Even after a sale has been made, the Uniform Commercial Code allows a seller to refuse to deliver products when it "deems itself insecure" or believes it may not be paid for products delivered. Moreover, if you are concerned about payment by the customer, you can stop shipment of goods while in route. The Uniform Commercial Code also provides you with the right to reclaim goods after delivery if you follow the proper procedures.

If you have decided to continue doing business with the customer for strategic reasons, you should consider having the customer provide security for the credit advanced. A purchase money security interest in the goods that are sold with the lien to attach to the proceeds of those goods is a wonderful thing! You can go as far as making sure that payments from your customers' customers go into control deposit accounts with your company's bank. You and your customer direct the bank to pay a certain amount of the receivables to your company. Essentially, think of this as a lock-box arrangement to make sure that your company is paid for the materials it supplies.

Other things can secure an account and make it credit-worthy, such as:

1. deeds of trust or mortgages on lands and buildings;

2. liens on vehicles (perfected by notations of liens on motor vehicle certificates with the Department of Motor Vehicles);
3. liens on equipment;
4. liens on inventory (consider purchase money security liens against inventory); and
5. liens against other assets.

BUT WHAT ABOUT CUSTOMERS THAT FILE BANKRUPTCY?

Both the Uniform Commercial Code and the Bankruptcy Code allow your company to reclaim goods that have been sold to an insolvent buyer on credit in certain situations. If you determine that your customer is insolvent, after delivering products, you should send a written demand to reclaim the goods. While you may not get the products back, you will have preserved an administrative priority claim in the bankruptcy proceedings.

After bankruptcy, you can stop delivering product. Your company cannot be compelled to extend new credit. If the bankrupt customer needs your products, there are ways to protect those post-petition sales. In fact, there may be ways to recover pre-petition unsecured claims.

While Critical Vendor status may be sought, other remedies may be more effective in the long-run. Critical Vendor status is not recognized by the Bankruptcy Code and is subject to being challenged later through the bankruptcy appellate process.

Consider, administrative priority claims for sales that are made post-petition. In fact, sales made to the debtor during the 20 days prior to the bankruptcy petition are now entitled to administrative priority. You may wish to aggressively pursue this relief and establish a payment schedule for the deliveries made within 20 days before the filing of the bankruptcy.

If your company continues selling after the filing of the bankruptcy, you should consider requesting a super-priority or priority loan approved by the bankruptcy court under Section 364 of the Bankruptcy Code. You could seek a priority claim for post-petition advances of credit and also seek a priority lien for those post-petition advances.

In the right case, you could even seek a super-priority lien that would give your company lien rights ahead of existing liens. To obtain a super-priority lien position, the debtor needs to show that it tried to obtain the credit elsewhere, but was unable to do so on better terms. In addition, the debtor needs to show that the credit is needed to continue the business.

"EXECUTORY CONTRACTS" ARE A BETTER STRATEGY TO COLLECT PRE- AND POST-PETITION CLAIMS THAN SEEKING CRITICAL VENDOR STATUS!

If you have an ongoing contract with the Debtor to provide products on credit terms, you may have an "executory contract" that continues after the bankruptcy filing. An "executory contract" is an agreement that still requires performance by both sides. Thus, if you have an ongoing contract that requires your company to provide goods and requires your customer to pay for those goods, you may have an executory contract. A lease is a classic example of an executory contract, because the landlord has an ongoing duty to provide the premises and the tenant has an ongoing responsibility to make the rent payments.

If your contract can be deemed an "executory contract" under Section 365 of the Bankruptcy Code, you may be able to recover both your pre-petition unsecured claim and your post-petition claims!

Under Section 365 of the Bankruptcy Code, the Debtor must make a choice. The Debtor can "reject" an executory contract and, therefore, breach the contract. If the Debtor rejects the contract, then an unsecured claim amount is set by the Bankruptcy Code.

If, on the other hand, the Debtor needs to continue doing business with your company, the Debtor can "assume" the executory contract. The Debtor would "assume" your contract if it needs your products to continue its business. If the Debtor needs to "assume" your contract in order to maintain the supply of products to continue its business, then you are in the driver's seat!

In order to "assume" an executory contract, the Debtor must:

1. cure prior defaults; and
2. provide adequate assurance of future performance.

Assuming the contract requires that the Debtor pay your company for the pre-petition unsecured claims. In other words, you now have taken a completely unsecured pre-petition claim and elevated that claim to an administrative priority claim that needs to be paid before or upon confirmation of any plan of reorganization!

In addition, in order to "assume" an executory contract, the Debtor must provide adequate assurance of future performance. That means the Debtor must show how it will pay you for any future products delivered. Adequate assurance can include such things as liens against receivables and liens against the Debtors' bank accounts. Adequate assurance may also include bonds or specific accounts set aside for the benefit of your company.

USE YOUR CREDIT SKILLS AND THE TOOLS WE HAVE DISCUSSED TO APPROVE MORE SALES AND INCREASE CASH FLOW!

Many strategic choices can be made with regard to managing credit in challenging times. With thoughtful analysis, a credit manager can help the company do business strategically with insolvent or nearly insolvent customers. Once again, the Credit Department can save the day!