

Vetting Vendors and Customers in Tough Times

With bank bailouts and tightening of credit, many businesses are concerned about availability of business loans. What most businesses may not realize is that they're becoming de facto lenders for vendors and customers. Extensions of payment terms, willingly or unwillingly, to customers and payment up front to vendors are just two ways businesses find themselves in the lending role. Businesses can protect themselves in 9 key ways in "lending" to vendors and customers.

- 1. Recognize when your business is extending credit.** While the CFO may recognize that a large customer is receiving credit by riding on the company's back in stringing out payments to 45, 60 or even 90 days, the employees in charge of collecting invoices may not be aware of how that is impacting cash flow nor how the customer is getting an interest free loan.

Is there a company policy on extending payments or an authorization chain for that? What may be obvious to management may not be to those on the front line. Similarly, do the employees in charge of purchasing know what prepayments, retainers or other advances may or may not be given to suppliers for goods or services necessary for your company's products or services?

- 2. Credit Reports—what's helpful and what's left out.** The better known credit reports are Dunn & Bradstreet, Experian business, Equifax Business, and Business Credit USA (basic reports start around \$50). When one business issues another credit, that trade credit information may be reported to the business credit bureaus. However, the information reported to the business credit bureaus is done voluntarily—information about your customer or vendor may not be available (in some cases the reports may have no information). If no information exists, you may have to get a personal credit report of the owner or CEO of the company.

Other sources of information for the credit bureaus include incorporation documents, lien filings, bankruptcy filings and judgments. The accuracy and completeness of these credit reports is less than those for consumer credit reports according to some experts. Some argue it is more important to have solid financial statements, trade references and a bank that will vouch for the company as opposed to a D& B or other credit report. Larger companies may rely only on credit reports. Extra due diligence may be required if the amounts are large, the customer or vendor comprises a significant part of your business, and/or your gut instinct or industry scuttlebutt tells you a workout or bankruptcy is on the horizon.

- 3. Regular Credit Reviews.** Most companies do credit checks when they open the account and then let direct payment history be the only guide for continued credit terms. Sometimes companies thus end up extending credit far beyond original expectations. If the customer is having credit problems with other vendors they increase spending with others and this can represent real risk. Institute several credit policies in this regard:
 - Set credit limits and require updated credit checks to extend additional credit beyond this limit,
 - Annually review purchase history and lower credit limits if purchase history is running significantly below credit limit (the idea is to trap unusual changes in purchase trends and require human evaluation and decision to move forward)
 - Annually and at contract renewals run updated credit checks
 - Set credit limits to 0 for companies that haven't purchased products for 3-6 months
- 4. Researching Vendors and Customers.** Whether your customer or vendor is new or existing, you will need to research their credit worthiness and stability. While you may not use a statistical based predictive model to assess credit risk, there are other things

your company can do to determine if this customer or vendor is credit worthy to start doing business with or to continue doing business with. It's easier on the front end to weed out problem businesses than it is to engage in back office collection efforts on overdue accounts.

- **References**—easily overlooked, they can give you direct, immediate information on a customer's payment history and a vendor's timely shipment of goods. Get references from companies similar to your size and market power—IBM is likely to get better service than a small Colorado based company. Ask for a comprehensive list of suppliers (otherwise you will get cherry picked list of companies providing only good references).
- **Referrals**—companies within your industry may be able to give you referrals for vendors and collection advice on customers. Unless they are a competitor, small to mid size companies may share information you could get nowhere else. Trade association scuttlebutt is important--who's not paying, who's failing to deliver.
- **Look beyond Google**—look on the actual web sites of local newspapers and local business journals. Lawyers and detectives will tell you that you have to go local and dig deep. Rather than just skim the first page of the Google search, look also on the web site of the local newspaper and the local business papers. Key words to include in searches in addition to the company name are "bankruptcy", "layoffs", "lawsuits", "closing", "loss", "reorganization", "restructuring ". Do not forget to go on the company web site—company press releases may also indicate if trouble is brewing.
- **Questions to ask**—Has your customer or vendor made timely payments and/or deliveries? Any problems, including slow pay, no pay or litigation? Ask bankers how long the customer has banked with them, whether they have a loan with the bank, and have they met their obligations on a timely basis. Ask vendors not on the reference list.

5. **Terms to Consider for Getting Good Vendors and Customers.** Look at contract terms as a way to ensure faster payments, upfront payments and better relationships with customers and vendors. Terms that you should consider:

- **Discounts**—"2% discount if paid within 5 days, net 30 days". Some larger companies have a mandate to take discounts wherever possible and penalize their payables department if they don't take the discount.
- **Retainer**—a retainer each month up front based on expected billing hours. Variations on this include a retainer for sixty days of anticipated billings.
- **Emergency service fee**—for after hours or expedited services, a charge for rush jobs.
- **Dispute escalation procedures**—the last thing you want is to be trapped in a dispute with another company while your invoices remain unpaid. This type of clause allows you to escalate the dispute from the front line to the management level who have authority to resolve and most importantly. This often overlooked clause is critical in disputes with large companies.

7. Making the Call. There are 2 types of calls to make:

Preemptive Call--when a customer has a large amount coming due or there has been a recent extension of additional credit, call a/p in advance of the due date to verify that the a/p has everything it needs to issue payment and to get the scheduled payment date-- not a collection call but a call to make sure everything is on track and identify potential problems early.

Pay Up/Deliver Up Calls--If the customer has not paid, the vendor has not delivered—you need to swing into action and calls need to be made. Outline the punitive steps you will take (including rights you have under the contract), make frequent calls, and have someone make a personal visit. If these non legal steps do not work, make a realistic assessment of the debtor's ability to pay or the vendor's ability to deliver before you incur significant legal fees. If you can

get a reduced immediate payment or a workout arrangement, this may be preferable to an uncollectable judgment. If you are going to terminate the contract, do it in writing. If you intend to pursue this debt, get a lawyer to write the collection letter. If you decide to file suit, whether you give up a portion of your claim to a collection agency or contingent fee counsel depends on debtor's financial status.

8. When to Renegotiate. If the customer or vendor's financials, i.e. credit and payment history and current financials, warrant renegotiation and the product or service warrants contract continuation, renegotiation may be an option. Take a very hard look at the profit margin on the contracts, whether the company on the other side is high maintenance, and the extent of risk or down side in terminating a contract. If renegotiating seems viable, remember that this negotiation will be different because of your prior relationship—there is less mutual benefit in renegotiating contracts—allocating risks and losses is much harder. Read your contract—there may be termination provisions, benchmarking requirements on pricing, scope provisions that allow you to curtail or limit work and governance provisions that can get the other side's executives involved. Talk directly to the other side about your intentions regarding curtailment or termination—you may get them to alter terms to reflect market trends before you need to send a termination notice.

9. What to do if it hits the fan—when Litigation and Bankruptcy are Looming. If you have received notice of either a lawsuit or a bankruptcy filing, make sure you contact litigation or bankruptcy counsel before taking any steps to extract payment or renegotiate. Be aware that bankruptcy debtors through the bankruptcy trustee often seek to set aside payments made within 90 days of the bankruptcy filing, i.e. it is a "preferential transfer" that they contend must be repaid. However, this is a common ploy of bankruptcy trustees—they send out mass mailings of "preference demand letters."

The key under bankruptcy law is whether you received payments within the "ordinary course of business." Send a letter to the claimant asking them to furnish you with any information they have supporting the preference claim. Once you get that information, you need to analyze your defenses. If a large claim is involved, get bankruptcy counsel. Send a detailed letter setting forth your defenses to the claimed amounts.

If you desire to make a settlement, do a cost-benefit analysis. Do not forego your negotiating power, you have the money. In many cases, the claimant will take less than the preference amount just to settle the claim. The settlement amount depends on the facts of the case and the size of the claim. Don't put forward your best offer first. Also, take care in signing a release—you may have additional claims against the debtor that you forego by signing a full release. Use the practical strategies in this article and confer with bankruptcy counsel. You may be able to reduce or eliminate the amount you pay to such "preference" demands.

If you use the strategies in this article you may avoid becoming a lender to your customers and vendors and reduce your exposure to nonpayment and disrupted business relationships.

Copyright 2009. Joyce Colson and Rob Quinn are partners in the Boulder law firm Colson-Quinn. Colson-Quinn represents established and emerging entrepreneurial Colorado companies in corporate and intellectual property matters. They can be reached at 303.415.2557 or by e-mail at Joyce@colsonquinn.com or rob@colsonquinn.com.