

Chapter 1

Getting to Know Credit and Collections

In This Chapter

- ▶ Implementing written credit policies
 - ▶ Keeping good records and documentation
 - ▶ Chasing down slow payers
 - ▶ Hiring an outside collections agency
 - ▶ Considering litigation
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When you're in business, you may feel that a competitor always lurks on the horizon, plotting and scheming to take away your customers, cut into your market share, and take your profits. And you're right. Competition is a fact of life, and with it comes the pressure to extend credit to all the customers who come your way, whether they deserve it or not. After all, if you don't give customers credit, they can probably find a competing business that will.

If you're relatively new to the credit and collections process, you may be asking yourself several questions:

- ✔ Should I always be willing to open a line of credit for a customer?
- ✔ How do I balance the risks of extending credit against the risk of losing the business of customers I turn down?
- ✔ What happens if a client doesn't pay an invoice?
- ✔ How can I deal with issues such as bad checks or disputed claims with a customer I've done business with?
- ✔ What do I do if a customer suddenly moves, leaving no address or phone number to make contact?

- ✔ Can I file a lawsuit, and how do I sue?
- ✔ When do I need a collections professional to help me, and how do I find one?

This chapter addresses those questions, and the remaining chapters of this book explore credit and collections issues in great detail.

Establishing Good Habits for Credit and Collections

Setting high goals for sales is a worthy ambition, and achieving those goals is admirable. What's even better is your customers paying their bills on time and in cash. Alas, many of your clients will prefer to do business on credit, and most will likely insist that you extend credit terms. Worse, even under the best of circumstances, it's unlikely that they'll all pay on time.

By establishing, implementing, and enforcing smart credit policies, your company can stay competitive while maintaining a sufficient cash flow to support your business operations. To improve cash flow and control risk:

- ✔ Establish clear, workable credit policies, in writing.
- ✔ Follow the five Cs of extending credit: character, collateral, capacity, capital, and conditions (we explain them in detail in Chapter 2).
- ✔ Know whether your customer is a sole proprietorship, partnership, limited liability company, corporation, or other legal entity. Such knowledge helps you collect a delinquent balance.
- ✔ Beware of con artists and other ways you may “accidentally” extend credit because of the shenanigans of a customer who's supposed to pay in full upon delivery.
- ✔ If you perceive the extension of credit to be too risky, consider taking a lien or personal guaranty, as we describe in Chapter 3, to help ensure that you'll ultimately be paid.



You may find that some customers are too risky and you may choose to do business with them only on a cash or COD basis.



Carefully evaluate all customers to determine their creditworthiness. Remain mindful of runaway credit extensions, especially with new and marginal customers. You could be left with uncollectible debt and loss.

Staying in Control through Good Documentation

A principal goal of a good credit and collections manager is to avoid collection problems before they occur. Although not every account receivable problem can be headed off at the pass, many can.

Using documents in the extension of credit

You can help keep the odds in your favor by insisting on good documentation throughout the credit and collection process. Good documentation begins with a credit application, which is required before your first sale on credit to any customer.

Beyond requiring credit applications, you should periodically review credit information for all your customers. Depending on your industry and your history with the customer, you might review credit information every six months or once a year, but even with established customers, you don't want to go beyond a two-year review schedule. In between reviews, update your customer's credit data whenever you come across new relevant information. Have your customers complete a new credit application or make appropriate additions and deletions to the old one.



You can avoid a lot of difficulties with defaults if you monitor your clients for changes in their business and financial health. For example, if you find out that a customer's business has new ownership, or that the owners have formed a new but similar company (John's Bike Shop is now John and Mary's Bike Shop), it may be time to thoroughly recheck that customer. Sometimes your clients really don't want you to find out about changes, and that's a reason in and of itself to recheck them.



If a customer won't take the time to fill out a credit application, and you choose to extend credit to the customer anyway, you can protect yourself. Make sure you interview that customer to obtain the information you need to determine creditworthiness and to use as a resource if the customer's paying habits deteriorate. If you interview the customer by phone, keep a recording of the call (but be sure you can legally record the call under the laws of your state), or write the answers down on your standard credit application and add the completed document to the client's credit file. Basic information includes:

- ✓ Full, legal name, physical address, and phone numbers.
- ✓ E-mail addresses, Web sites, and other online references.
- ✓ Contact persons.
- ✓ The customer's legal entity (corporation, limited liability company, partnership, and so on) in case of eventual litigation.
- ✓ Agreements concerning payment of interest and costs of collection, together with other written agreements you and the customer enter.
- ✓ Bank account information, which is extremely useful if and when you're looking for assets to attach postjudgment.

Even with a formal credit application in hand, you may require other key documents before extending credit, including

- ✓ Financial statements, which establish a picture of the applicant's assets and liabilities as of a certain date.
- ✓ Operating statements, which show the applicant's sales and profits over a certain span of time.
- ✓ Personal guaranties, giving your company additional protection should the customer's business falter.
- ✓ Liens that, in the event of default, allow you to take action against the customer's assets.

We discuss these documents in detail in Chapter 3.



The information your customer provides is valuable when making credit determinations, but that information can be one-sided, as your customer may choose not to share unflattering information about himself. Perhaps he conveniently forgot to mention tax liens against his assets, or maybe he doesn't remember that he previously filed for bankruptcy protection. Oops. To balance out the possibility that some information may be false or exaggerated, obtain documentation from other sources for the purpose of verification, such as a credit report (see Chapter 3 for more on credit reports).

One problem we've yet to encounter is having too much information about an applicant for credit. Problems often arise when you act without enough information to accurately assess creditworthiness. If you enforce your credit policies and get the documents you need now, you avoid problems later.



Even if a customer isn't creditworthy, tools exist that may allow you to sell on credit while shifting the risk to a third party. For example, a *letter of credit* established through a bank allows for virtually risk-free sales to customers. The bank guarantees payment of the funds due to you while protecting your

customer by assuring that the product you sell is delivered as ordered. Chapter 3 provides information on the use of letters of credit and liens to protect yourself when you extend credit.

Using documents in the billing process

Don't underestimate the importance of proper billing practices. Documents used in billing include

- ✓ Invoices that describe the goods or services you provide and request payment.
- ✓ Debit memos, to correct or highlight an amount due from a customer.
- ✓ Credit memos, to document credits given to a customer.
- ✓ Statements of account, summarizing the transactions on the account.
- ✓ Purchase orders, to prove that an order was placed.
- ✓ Change orders, to verify that customer changes were authorized.
- ✓ Delivery receipts, to prove that goods were delivered.

Good billing practices ensure that your customer always has detailed, accurate documentation, minimizing the chance that your client may inadvertently overlook payment. Chapter 4 details how to create and maintain good billing documents.

Using documents in the collection of past due accounts

It's part and parcel of a well-organized credit and collections department to have a good set of documents for following up on past due accounts, such as a series of demand letters ready to go out at a moment's notice to slow payers. If you reach an agreement with a debtor involving repayment over time, you may need a written payment plan, even if it's just an e-mail from the debtor covering the basic elements of the agreement, such as the amount to be paid and the payment schedule. Keep a copy of any written agreement or confirmation in the customer's credit file.



In your communications with the debtor, try to get her to admit (preferably in writing) that she owes you money. Admissions in writing are worth their weight in gold should the matter end up in court.



We discuss demand letters in Chapter 7, and we offer sample letters in that chapter and on the CD accompanying this book, as Forms 7-1, 7-4, and 7-5. We describe repayment contracts in Chapter 10, and we provide a template on the CD as Forms 5-1 (promissory note) and 16-8 (settlement agreement).

Handling Delinquent Payments

Despite your constant flow of reminders, such as invoices and monthly statements, some customers inevitably fall behind. As trouble brews, your patience and determination may be tested to their limits.



Warning signs you shouldn't overlook include

- ✓ **Changes in ownership of your customer's business**, which you may discover by accident if you call and the business is using a different name, or if you're referred to an unfamiliar person.
- ✓ **Deterioration of paying habits**, which you may not notice unless you've implemented a policy to track monthly paying habits.
- ✓ **Broken promises**, from the cliché “the check is in the mail” to a missed payment on a negotiated plan to pay off an overdue balance; when the debtor doesn't keep a promise, serious trouble often lies ahead.
- ✓ **Communication issues and difficulty in actually making contact with your customer**, with calls directed to voice mail or left unreturned.
- ✓ **Changes in customer orders**, especially sudden decreases in orders that may signal a decline in your customer's business.

Chapter 5 provides tips on spotting trouble early while maintaining customer relationships and getting good clients back on track. Chapter 6 covers legal issues that credit and collection professionals must understand in order to function aggressively without violating collections laws and regulations.

When an account is overdue, you must implement firm, timely measures to bring the account current. Remind the customer of the importance of prompt payment, as we describe in Chapter 7, and progress through follow-up letters and collection phone calls, which we discuss in detail in Chapter 8.



You can aggressively collect your accounts receivable and improve your cash flow and still comply with all legal requirements. You must word collection letters and phone calls in a professional and legal manner.

If a customer writes a bad check or attempts to trick you into settling for less than you're owed (such as by writing "in full settlement" on a check), you need to know how to avoid compromising your rights. Chapter 14 covers bad checks and related issues in detail.

Knowing When to Hire Professionals

Collection agencies and collection law firms abound, ready and willing to help you with billing, tracking down debtors who've gone missing, finding assets, and your other credit and collection needs. Whether you have a problem with a small number of accounts (perhaps only one) or most or all your accounts receivable, you can find professionals capable of serving your needs. But what kind of collections professionals do you hire? Where do you find them? What should you expect from them? You find a detailed discussion of these issues in Chapter 13.

Before you hire a professional, you must determine what services you need. Professionals come in all sizes and shapes, and they offer a laundry list of services to assist your credit and collection operations, including

- ✔ **Billing services and early-in collection services:** These are services that help you right at the beginning of the credit process, from the time you provide your goods or services, long before any delinquencies occur. Why hire a professional so early in the game? You may prefer to use an outside service instead of hiring and managing your own credit personnel, or you may prefer to maintain a small, in-house staff while the outside company provides the backup you need as your workload ebbs and flows. For professions that involve complicated forms or billings to insurance companies (such as a medical practice), professional document preparation and form-filing services can really shine.
- ✔ **Skip tracing:** It's becoming easier for people and even businesses to move around without leaving much evidence as to where they've gone. Phone numbers may remain the same, regardless of where a debtor is located. Crafty debtors hide behind *mail drops* — physical addresses that turn out to be post office boxes at private stores, such as a UPS Store. When your debtors disappear to parts unknown, professionals can often find them and their assets.
- ✔ **Credit reporting and interchange services:** Many professionals report bad payers to credit bureaus and participate in services that exchange credit information about businesses and industries. They can provide you with additional insight into your active and prospective customers.

What inspires debtors to pay you

Sometimes debtors have the money to pay, but they make it really difficult to collect. However, when they face some embarrassment, in public or perhaps just a loss of face to their friends, some debtors suddenly realize that, oh my goodness, the rules apply to them as well. One wealthy celebrity who had become notorious for her failure to pay her bills was inspired to write a giant stack of checks when, to the shock of her friends and hangers-on, a creditor showed up at her mansion with a large truck, several movers, and a writ of execution.

Business debtors may not want to pay you, but they can have a sudden change of heart if your collections threaten their business activity. If you garnish a payroll account right before payday, or if you show up at their offices with that large moving truck and an order permitting you to take their computers right off of their employees' desks (and perhaps also take the desks), you'll see how quickly the most recalcitrant debtor can find money to pay you.

For more on judgment collection tools, turn to Chapter 19.

Arriving at the Last Resort: Litigating to Recover Delinquent Balances

When all else fails, sue your debtor. But how do you do that, and must you hire an attorney? Not necessarily. In many cases you can

- ✓ **File a lawsuit:** Prepare, file, and serve a lawsuit on your debtor.
- ✓ **Litigate a case:** Take a default judgment if your debtor fails to answer, or handle contested litigation if the debtor does file an answer.
- ✓ **Testify as a witness:** Present your case in court.
- ✓ **Collect money postjudgment:** Search out assets and attach them using the powers of your judgment.

Before you even head to the courthouse, consider developing a litigation strategy to determine:

- ✓ Whether filing suit is practical and cost-effective.
- ✓ Whether alternative dispute resolution is a possible solution.
- ✓ Who to include in the suit.
- ✓ What legal theories to include in the suit.
- ✓ Where to bring the suit.
- ✓ Whether to do it yourself or hire an attorney.



Before you file a lawsuit, think about the best course of action for your specific collection problem, based on the facts of the situation. Not every slow payer is a deadbeat whom you need to sue. That said, take prompt action on every late account. Don't let problems languish or become stale. A head-in-the-sand approach to bill collection is the worst possible approach to take.

Chapters 15 through 17 describe in detail issues related to bringing litigation. Chapters 18 and 19 discuss how to handle pending litigation and how to collect a judgment after you've won.

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