Common-Sense Ways for Businesses to Increase Collection of Accounts Receivable

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The United States may be facing its worst financial crisis since the Great Depression. Customers are increasingly unable or unwilling to pay for the products they have purchased. Therefore, businesses should think beyond customary protections to ensure payment for the products they sell. Below is a brief description of protective measures that businesses may want to consider:

- Audit current practices and documentation;
- Implement a cash prior to delivery system;
- Receive a payment guaranty;
- Become a beneficiary of a letter of credit; and
- Obtain a security interest on shipped goods.

1. Audit. Initially, businesses should carefully review their current form customer contracts and determine whether they need to be updated or otherwise modified to reflect the current economic climate. The terms of condition of sale, invoices, purchase order acknowledgements and other customer contracts may already include certain protections. These should be "state of the art" and reflect industry practice. However, form contracts should be periodically updated and can often be substantially improved with minimal work.

2. Cash On or Prior to Delivery. Requiring customers to pay cash on delivery or to pre-pay before goods are shipped assures payment absolutely. In this situation, the transaction occurs essentially simultaneously, and there is no need for additional assurance of payment. This method may be effective in many situations.

3. Payment Guaranty. A payment guaranty may be obtained from a person or entity related to the customer, who has a solid net worth or sufficient assets to assure payment of the customer's accounts receivable. In a payment guaranty, the guarantor (such as the general contractor) promises to pay the invoice if the customer (or subcontractor) is unable to do so. A well-constructed payment guaranty requires payment from the guarantor without having to institute a lawsuit or first exercising any of the other legal remedies against the customer.

4. Letter of Credit. With a letter of credit, the customer contracts with a financial institution (typically a bank), which provides a "letter of credit" to the vendor promising to pay in case the customer is unable or unwilling to do so, subject to certain terms. While most banks have standard letters of credit forms, it may be important to negotiate the terms specifically to ensure that the conditions precedent to payment fit the transaction.

5. Security Interest. A security interest will typically provide that if a creditor is not paid, then, subject to certain procedures, it can seize and sell all or a portion of a debtor's assets (depending on what the security interest covers) to discharge the amounts owed by the debtor (referred to herein as the "debtor obligations"). State laws vary as to how to properly obtain and perfect a security interest, but it typically involves: (i) the debtor granting the creditor a security interest (this can be placed in the purchase order or another contract with the debtor) and (ii) filing a Uniform Commercial Code financing statement that properly describes the "collateral" securing payment of the debtor obligations with the Secretary of State in the state where the debtor is incorporated or otherwise organized. If the debtor has a loan outstanding, documenting this interest may be more complex. Depending on the collateral covered by the security interest, additional steps may be required to properly perfect a creditor's security interest (*e.g.*, possession of stock certificates and a control agreement with respect to accounts).

In addition to the foregoing, businesses should include other traditional measures to increase the likelihood that the customer does not default. Such traditional measures include: (i) communicating with customers frequently about payment due dates and penalties for late payment; (ii) checking the credentials of a new customer with a standard credit check, (iii) obtaining trade references or even bank references; and (iv) incentivizing customers to promptly pay via a discount.

Given this economic crisis, businesses should consider thinking beyond traditional protective measures to increase the collection of their accounts receivable. The first step should be to have legal counsel review existing customer contracts and determine where deficiencies lie. The next step should be to update such contracts and possibly implement one or more of the foregoing nontraditional protective measures to increase the probability of payment from customers.

This Alert is one in a series that discusses proactive steps smart businesses may wish to explore given the current economic conditions.

For Further Information

If you have any questions or would like more information regarding this topic, please contact David J. Kaufman, Nicholas O. Isaacson, Jennifer C. Escalante, any member of the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.