

Preventing Debt Collection Problems Up Front

By:

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There are many steps a business can take up front to avoid having collection problems. Equally as important, business must realize that by the time a collection case has been referred to an attorney for suit, the client-creditor, through its actions, has either provided the attorney with a case that is a winner or one that is a loser. The following list of "Recommendations to Creditors" has been created based on 20+ years of performing debt collections for large and small businesses throughout much of the United States and elsewhere. These recommendations will assist businesses both to 1) minimize delinquent accounts and 2) increase the likelihood of collecting when it is necessary to employ a collection attorney.

RECOMMENDATIONS TO CREDITORS

1. **PRIORITIZE** – Make collections important from CEO down. Do not treat sales and marketing as more important than collecting the very monies that comes from sales and marketing. Make collections a vital part of the marketing, sales, and contracting planning. Take responsibility for the fact that collection problems do not just happen and that they are largely avoidable.

2. **RECOGNIZE THAT “CREDIT SALES” ARE “LOANS”** – Understand and emphasize to salespersons and other employees that each “net-30” sale means the company **is in the lending business**. Ask yourself: Would you lend money to this customer, and, if so, on what terms and with what security or personal guarantees?

To put this in perspective, imagine a bank that hired a number of young sales people with no experience in lending and offered them a ten percent (10%) commission each time they made a loan. Would it surprise you at all that the bank would soon have very serious debt collection problems?

3. **TRAINED, MOTIVATED STAFF** -- Have well-trained collection staff, good collections procedures, incentives for performance, and support from CEO down. Do not treat collections as unimportant or as something that is not worthy of your time or that of your better employees.

4. **ACCOUNTABILITY FOR SALES FORCE** -- Force accountability on sales personnel; do not pay commissions on a credit sale when the particular account receivable proves to be uncollectible. Sales people are the eyes and ears of the company; have them “on your team” in the battle against bad debt.

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5. **SALESPERSON VS. CREDIT DEPARTMENT** – Strive to achieve a proper balance between salespersons (who almost always want to make the credit sale) and the credit organization (that often wants only risk-free credit sales.)

6. **BANKRUPTCY LAW** – Develop considerable knowledge of bankruptcy law. Expect a significant number of customers to file bankruptcy--Chapter 7, Chapter 11 and Chapter 13, and plan to deal with that in terms of price, security, guarantees, and otherwise.

7. **KNOW YOUR CUSTOMER** – Experienced bankers say “banks lend to people, not to collateral.” It is the person, *not the collateral*, who is expected to repay the loan. Smart bankers know their customers. The Internet, Beacon scores, and many good information services and software programs make it much easier today to know more about the customer than ever before.

8. **MONITOR EXISTING CUSTOMERS, TOO** – Many, many companies suffer serious financial losses because they fail to have any mechanism in place to do follow up checks on customers who were in the past approved for credit and who may in fact have been credit risks for many years. The warning signs are often there; the customer has been slower and slower in paying, going from net 30, to net 45, to net 60, to net 75. The customer has been returning merchandise, making warranty claims, and not ordering as much. In some cases, a valued customer has switched suppliers and no longer needs you—and no longer feels the need to pay your bills. Sometimes, on the very eve of filing bankruptcy, the customer will pay one of his or her 3 or 4 outstanding invoices, place a large order, and then file bankruptcy shortly after you delivery the final order “net 30.” Had you had in place a mechanism to pick up on the red flags or routinely rechecked even your good customers, this large financial loss and months of dealing with a bankruptcy court might well have been avoided.

9. **AVOID “PROFESSIONAL DEADBEATS”** – Question: How much money does a deadbeat make when he buys goods net 30 for \$10,000 and sells them for \$12,000 cash? Answer: \$12,000 (when he never pays the \$10,000 and not just \$2,000). There are many people who simply do not feel any obligation to pay for goods or services—especially services—purchased on credit. These people are often easily identifiable because they have low Beacon score, prior repossessions, prior bankruptcies, prior evictions, and large credit card balances with very few payments. They may also have prior “NSF” checks, excessive warranty claims and returns, and other evidence of nonpayment of bills. Take care, too, that they may use aliases or set up shell corporations, limited liability companies, or simply operate under an assumed business name—“D/B/A” (“Doing Business As”).

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10. CORPORATIONS AND LIMITED LIABILITY COMPANIES (“LLCs”)

- Special care is required when dealing with small businesses that have incorporated or formed an LLC. Just as the IBM salesman who sell you a computer is not personally obligated to make it or stand behind it, the President of ABC Company, Inc. is not responsible for the goods or services ABC Company, Inc. agreed to purchase from you for \$1,000 on credit (net 30 sale). Unless you require the President to sign personally—not just on behalf of the corporation—or personally guarantee the debt of ABC Company, Inc., you will have a claim against *only the corporation* for the \$1,000. You should be guided accordingly in extending credit, having contracts signed, and in having credit applications signed.

11. **CREDIT CHECKS, ETC.** – Do up-front credit checks, become a member of the local Credit Bureau, subscribe to Dunn & Bradstreet, or a similar service, check Beacon scores, use Internet resources, and so forth. Place the burden on the would-be borrower; decline to make credit sales (net 30 sales) until and unless the potential buyer satisfies you that he or she is creditworthy or can provide security or the guarantee of a creditworthy person.

12. **CREDIT APPLICATIONS; REFERENCES** – Use detailed credit applications that are well-drafted, up-to-date, thorough, require references, and are signed under penalty of perjury. **CHECK THE REFERENCES!** Preferably, a customer’s signature should be witnessed by your employee or by a Notary Public. Credit Applications should provide for a) interest at one and one-half per cent (1½ %) per month for late payments, b) attorney fees upon default; and c) personal guarantees for small corporations and LLCs. In North Carolina, the proper use of the word “Seal” will give you ten (10) years rather than three (3) years to collect on a debt, and that can be a substantial sum when interest is accruing at 1½ % per month. Some well-drafted credit applications recite that sales are made on the seller’s terms and conditions, including limited warranties and limited remedies. For reasons that should be apparent, you should have an experienced collection attorney review or assist in developing your form, especially if you deal with consumers.

13. **PERSONAL GUARANTEES** – As discussed in connection with small corporations and LLC buyers on credit, you should require well-drafted personal guaranties. In some states you need to restate the right to attorney fees, even though it is contained in the contract being guaranteed. It is often best to insist that the spouse also sign because a) the home is often the most valuable asset a family may own and it is usually owned “by the entirety” and cannot be reached by a creditor of only one spouse, and b) assets have a way of “belonging to the other spouse” when a collection case is commenced or bankruptcy is filed.

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14. **SALES AGREEMENT; FORMS** – Use well-drafted sales contract forms, updated periodically with input from an experienced collection attorney. See above comments under CREDIT APPLICATIONS about provisions for a) interest at one and one-half percent (1½ %) per month for late payments, b) attorney fees upon default; c) personal guarantees for small corporations and LLCs; and d) in North Carolina, the proper use of the word “Seal” to give you ten (10) years rather than three (3) years to collect. Needless to say, the sales forms should address far more than collection matters. However, nothing is more important to the seller who sells product or services on credit than the critical issue of getting paid. Accordingly, expert advice and assistance should be obtained at the outset; do not wait until your company has at risk millions of dollars in contracts and Accounts Receivable before doing all that is reasonable to insure your company will get paid and paid in timely fashion.

15. **AVOIDING FRIVOLOUS COUNTERCLAIMS** -- On a very related matter, because collections actions can often be thwarted by frivolous counterclaims, it is important to anticipate counterclaims in contracting. It helps to provide limited warranties and limited remedies and require prompt written notice of warranty claims to avoid belated, frivolous “warranty” claims and counterclaims that occasionally show up only when suing to collect on old debts. See Uniform Commercial Code Section 2-607. That statute contains a provision designed to invalidate "late" defenses and counterclaims that surface for the first time when a creditor attempts to collect on a delinquent account. The applicable language, dealing with the effect of acceptance of a tender of goods, is as follows: "Where a tender has been accepted, the buyer must within a reasonable time after he discovers or should have discovered any breach notify the seller of breach or be barred from any remedy." Where the contract involves the sale of goods, this statute should be utilized to full advantage. Where the contract involves services or the UCC does not otherwise apply for some other reason, the Court should be asked to apply the statute "by analogy." In any event, a well-drafted contract should create or preserve this right for the seller.

Consider also that the seller of goods is permitted by the Uniform Commercial Code, Section 2-725(1), to **reduce the statute of limitations to one year** and thereby avoid stale counterclaims in that fashion. The question then is: Has the seller also limited the seller's right to bring a collection action to one year?

16. **CONTRACTING PROCEDURES** – All too often a company has very good forms but very little in the way of procedures for getting forms signed or retaining signed forms to deal with collection problems that arise years later. Use good contracting procedures, updated periodically, detailed, in writing, with adequate training of key personnel, and index and store contracts and guarantees properly.

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17. **SECURITY IN GOODS SOLD** – When selling goods having substantial value and worth retrieving should the customer fail to pay, add a provision in your sales form retaining a purchase money security interest whenever practical. Perfect by filing when practical and/or should the buyer default.

18. MISCELLANEOUS

- **Monitor accounts** for changes—slow pay, reduced orders, excessive returns, personnel changes, and so forth.
- **Develop and rely on a "tickler" system** to keep track of delinquent accounts.
- **Promptly follow up on delinquent accounts and keep steady pressure until paid.**
- **Go to the customer's physical site.** Perhaps the single most effective collection techniques is simple to show up unannounced and wait for your check. You may also learn a lot from the visit.
- **Use the telephone.** Telephoning is much more effective than letters, which are easily ignored. Telephoning also provides feedback and information.
- **Listen** to any claims or defenses raised by the debtor, without any way encouraging the debtor to raise any such claims.
- **Seek oral admissions** that the debtor owes the sum sought.
- **Obtain oral admissions** regarding the "non-quality" reasons why the debtor has not paid (business downturn, health problems, etc.)
- **Record excuses in a detailed log** stating dates, responses and reasons.
- **Send confirming letters** reiterating non-quality reasons for not paying.
- **Determine the disputed portion of a debt if such a claim is made.** Where a debtor acknowledges that the debtor does not dispute 90% of the debt, ask the debtor to pay the other 90% while you investigate the disputed portion.
- **Promptly sue and aggressively pursue collection** activities; use a good law firm experienced in debt collection.

COLLECTIBLE OR NOT—YOUR CHOICE—The contracts businesses make every day more or less dictate the outcome of future litigations. In that sense, the collection aspects of contracts are no different.

Scenario 1: A business brings the collection attorney a contract that is signed, guaranteed, and has the right to reasonable attorney fees and interest at 1½ % per month. The attorney collects the entire debt plus the attorney fee and a substantial amount of interest. Furthermore, the attorney is able to prevail at a summary proceeding without trial or indeed able to convince the debtor to pay the full amount owed without a long, costly trial. Why? Because the debtor does not want to have to pay the creditor's attorney fees and the 1½ % per month interest.

But, change the facts slightly:

Scenario 2: The same sale of goods is involved, but no written contract was used. There is no personal guarantee, no right to attorney fees, and no right to high interest. Indeed, there is no particular reason for the corporate buyer to settle as suit will take a year of more, interest is accruing only at the legal rate of 8% non-compounded, and the seller cannot recover attorney fees. Indeed, the owner of the corporate buyer can collapse his company and set up a new one in a week for only \$125. Result: after a six month legal battle and threats of bankruptcy, the seller-client settles for 20% of the debt, receives no interest, has to pay his own attorneys fee, and is lucky to get anything at all.

The choice is yours.



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