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"Certain clues can reveal a customer's financial health. If a customer begins to make partial, delayed or irregular payments it may be a sign of financial distress."

Vendor Protections When Doing Business with Troubled Customers

By Andrew P. Lederman

Often a client will tell me about one of its customers that went out of business without paying its bills. By the time I hear of it, it's generally too late to collect the debt. However, if a business owner is vigilant about his or her outstanding accounts receivable and his customers' financial status, many losses can be averted. Certain clues can reveal a customer's financial health. For example, if a customer begins to make partial, delayed or irregular payments it may be a sign of financial distress. Postdated checks, held checks or checks returned for insufficient funds are other indicators of financial distress. Often, the withdrawal of trade credit by other vendors is a telltale sign of financial problems. These are just a few of the many signs a company can use to determine the risk it is taking by providing credit to its customers.

Even if a customer is experiencing financial difficulties, there are various ways to protect oneself from nonpayment. Certainly payment upon delivery (COD) or prior to delivery (CBD) is ideal, but in many cases just not practical. Short of payment upon delivery, a supplier can retain a purchase money security interest in the goods until the customer makes payment. Obtaining a standby letter of credit from the customer's bank is another way to ensure payment is made. An evergreen retainer or cash deposit to be used to pay for shipments on order, which the customer replenishes before the next order is shipped is another mechanism used to provide security for payment. The use of liens may allow for payment security in some cases; mechanics liens, possessory liens and toolmaker liens are all protections for getting paid. However, liens are generally state law creations and their applicability and enforcement vary from state to state.

There even may be various options available to a supplier once a customer fails to pay. Contracts may be terminable thereby relieving a supplier of future deliveries. Setoff rights may be available to reduce the outstanding debt owed. The Uniform Commercial Code may be applicable, which allows a supplier to request security from a customer to ensure that it will be able to perform its obligations under the contract. If a bankruptcy filing appears to be imminent, delaying delivery to at least twenty days prior to the filing—which is, for obvious reasons, very difficult to determine—or after the filing can be advantageous and provide the supplier with a priority of payment under the Bankruptcy Code. These are just a few of the many options available to protect payment of an outstanding debt due from a customer.

A diligent business may be able to minimize its risk and bad debt by paying attention to a customer's payment habits, its standing in the trade and potentially anticipating a customer filing for protection under the Bankruptcy Code. Using various techniques to monitor its customers' payment practices, its standing in the credit community and other financial indicators can significantly reduce a business' bad debt and contribute to a healthier balance sheet.

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