

## When Bad Things Happen to Good Customers

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### Introduction

There are countless articles and other sources of information about the early warning signs of a customer's financial distress. But often, credit managers find themselves in the difficult position of finding out, too late and after the fact, that a valued customer is experiencing financial problems. Such problems present a classic dilemma in credit management, which threatens both the collectibility of the existing account, as well as future sales and profits from that customer. Credit managers have long been charged with balancing pressure from their company's sales and marketing organizations with their basic mission of controlling the extension of credit and administering accounts receivable. This article provides a turnaround and crisis manager's perspective on how a credit manager in such situations can be both efficient ("doing things right") and effective ("doing the right things").

### First Steps, Early Considerations

When an account "hits the radar screen" of the credit manager, a crucial immediate step should be to review not only the accounts receivable ledger, but also the

order, production and fulfillment cycles to determine what the total outstanding risks are. Just looking at a list of unpaid invoices will likely not be sufficient, as the following "noncredit" risks illustrate:

- There may be substantial work-in-process for that customer, or the customer may purchase customized products that are not easily saleable elsewhere.
- Shipments may be in process, which will become additional credit exposure, since the invoicing cycle may create a delay before such items show up on the accounts receivable ledger.
- The purchasing department might be in the process of ordering more raw materials for that customer's order, which may not be useable for other customers' orders.
- There may even be plans for expansion, whether new facilities, extra production shifts, additional equipment, or just extra manpower, all based upon an assumption of continuing or increasing sales to a customer whose credit worthiness may now be in question.

To manage these risks, companies should create designated cross-functional working groups comprised of credit managers and—as appropriate—representatives from the purchasing, shipping, production, legal, and sales and marketing areas. Credit managers should use these information channels to keep everyone apprised as to the troubled customer's status, and steps should be taken early to interdict the exacerbation of the company's exposure to the above noncredit risks. Like a good credit policy, a predetermined procedure that details how at-risk customers are handled internally will help promote manageability and reduce risk by ensuring that everyone stays informed and updated. In some cases it may be necessary to get senior management involved to resolve policy issues concerning whether the company will stretch its credit and noncredit exposure versus risking an adverse effect on sales and profits.

When such a potential credit risk is initially identified, the credit manager should contact the customer's account representative to find out what may really be happening with the customer. This early *contact* can lead to an early *conflict*,

however. The salesperson likely has a relationship with his or her customer, and wants to preserve future sales and revenues. Indeed, the salesperson's own income may be based on booked, not collected, sales or profits; and so the salesperson will not want to risk alienating, or potentially losing, the customer as the result of a credit decision.

Of course, extending further credit to a troubled customer, without taking appropriate measures as described below, could be a dangerous move for the company, which is the credit manager's responsibility to manage and possibly prevent. Credit managers can deal with this understandable and inherent conflict in management organizations by joining with the salesperson to view the troubled customer as an opportunity for future revenues, while creating the shared understanding that in the big picture, a sale becomes a "good sale" only after the invoice has been paid. If necessary, the credit manager may have to enlist the help of the salesperson's manager in order to support this policy.

The credit manager should take advantage of the salesperson's knowledge of and experience with the customer in diagnosing the customer's condition since the salesperson is likely to have insight into the customer's operations that extend far beyond the black-and-white financial statements and payment history. Customers whose businesses are highly seasonal, for example, may legitimately need to extend their payment cycles during their ramp-up period (when they typically purchase materials, but have little in the way of revenues to pay for those materials at the time of purchase). During these seasonal periods, a supplier to these customers can expect to see the customer's account aging creep upwards. While this is certainly cause for attention, it may not be cause for alarm. By employing the salesperson's knowledge of his customer's business and practices, the credit manager can get a better overall picture of the troubled account, and optimally plan for and closely manage credit needs such as temporarily dating or stretching credit terms or limits.

Steps should also be taken to shorten the interval required between shipping and invoicing, and if necessary between invoicing and posting. The credit manager

should see to it that he or she has up-to-the-minute information on orders received but not shipped, WIP, raw materials purchasing, etc. The credit manager should be included in the decision-making process whether to even continue accepting orders from a troubled customer, since notwithstanding the customer's financial situation and poor payment record, failure of the supplier to ship could give rise to legal exposure. For example, the troubled customer might be able to show that it was promised or actually granted additional credit terms, or that the acceptance of its purchase order in the face of previous payment problems was a tacit agreement to extend terms.

In addition to reviewing the matter with the sales rep, credit managers should of course avail themselves of the resources at their disposal through industry credit groups and associations such as NACM. Knowing how a customer is viewed through the eyes of a supplier's peers gives the credit manager additional information with which to make potentially difficult decisions concerning credit and terms. Obtaining information directly or indirectly from other suppliers may also provide a picture of how important the credit manager's company is to the customer. Of course, such information must be carefully obtained and utilized, as there are strict legal requirements for the sharing and utilization of customer credit information among suppliers.

Given this information, credit managers should consider the following questions:

- Is my company a sole-source supplier, or is my company's product or service easily replaceable by the troubled customer?
- Is my firm unique in its credit position, or has this account been exceeding its credit terms elsewhere in the industry?

Credit managers should consider the regulatory impacts, if any, of a decision to stop extending credit. Some industries are governed by regulatory guidelines affecting their credit policies. For example, a regulated utility may not be permitted to withhold "shipments" of its "product" without first going through a detailed process of warnings and

notifications. Another legal consideration is whether changing the credit facilities to a customer might severely damage the customer, which if occurring in the wake of assurances to the customer that credit would be extended might give rise to litigation.

As a practical matter, while reducing or cutting off credit to a difficult customer may appear to be the right short-term decision, if the effect of that decision is that the customer's failure is likely, a large receivable balance may be jeopardized. In the case of credit provided by utilities and construction industry suppliers, for example, a sudden reduction in credit could push even the healthiest company into failure: halting operations, stopping building projects, or idling machinery. Therefore, credit managers should in such cases consider the relative risks and advantages of their alternatives, and consider treating the customer as a "credit-holic" that needs to be weaned off of excessive credit with care, rather than "cold turkey". So, rather than precipitate the failure of a customer through an abrupt change in credit availability, a creative approach could help both to protect the overall debt due from the customer, as well as preserve the viability of the customer as a future source of sales and profits.

Also, as discussed previously, if as a practical matter the abrupt cessation of shipments will cause the credit provider losses beyond the customer's receivable, e.g., through unsaleable inventory, production overcapacity, etc., it may be the expedient choice to continue shipments while inventories are depleted and production capacity is reduced, while simultaneously tightening up on internal shipping and billing cycles, and considering the credit management enhancement procedures described below. At the very least, other departments must be placed on notice not to automatically continue building inventories or capacity under the assumption that shipments can continue unabated.

If a viable alternative is to continue to extend credit, credit managers should reexamine the existing credit terms and, working with the troubled customer, consider amending these terms to allow shipments to continue, while properly protecting the supplier's interests and avoiding deepening the supplier's expo-

sure. Whether the customer is temporarily strapped for cash but is still viable, e.g., in a seasonal business, or where the customer's difficulties are likely to continue or worsen, the credit manager should consider one or more of the following actions:

- Require personal guarantees from the customer's principals.
- Reduce credit line amounts until the account is brought current (to minimize future risk but keep necessary products flowing to the customer until its cash flow returns to a healthy state).
- Reduce or restructure payment terms (down-payments, staging smaller payments over a longer period of time, starting earlier in the aging of invoices).
- Fit a payment schedule to the customer's cash flow.
- Require the granting of a security interest on some (or all) of the customer's assets, even if this requires being subordinate to the customer's secured lender and obtaining the lender's consent.

Regardless of whether these options are attainable, a heightened and more ongoing degree of due diligence on the part of the credit manager is vital. Especially where the credit manager's company is a key supplier to the troubled customer, or if the troubled company is a key customer to a supplier, the credit manager should monitor the customer's cash flow, such as by requiring regularly updated cash flow forecasts. These will create a common understanding of facts, help to rebuild trust between supplier and customer, and create the basis for structuring payment terms that are best for both parties.

#### Call In The Cavalry

If the customer is not itself able to provide cash flow forecasts, updated financial statements or other information necessary for sound credit decision-making on the part of the supplier, the credit manager should consider bringing in a turnaround professional to develop information quickly concerning the troubled customer's viability and how to help it manage through the distressed period. Lenders routinely require borrowers to engage such turnaround advisors, or—in extreme cases—a crisis manager, so there is no reason why a key supplier should not avail itself of the same assistance. A turn-

around advisor assists a management team and Board of Directors that remain in place, providing critical observations, analysis and advice on navigating through the "transition". A crisis manager is a hands-on agent of the customer, perhaps an interim senior officer such as chief restructuring officer.

Note, however, that engagement of a turnaround professional must be properly structured in order to avoid the risks of "lender liability" and "equitable subordination" for the supplier, to which they may be subjected if they go about this in the wrong way. Optimally, the turnaround advisor or manager should be engaged by the customer and report to its Board, but be permitted to share its findings and recommendations with the supplier, preferably in the presence of the customer. If the customer is recalcitrant and the turnaround consultant is engaged by the supplier to advise it of the customer's situation, then the consultant may only collect and analyze information, but must be careful not to appear, as the agent of the supplier, to be telling the customer how to run its business.

If the supplier becomes a secured creditor of the customer and is realistically looking to its secured collateral as a potential source of repayment, the credit manager should then consider the customer's overall financial picture. Before considering this approach as an effective way to deal with the situation, the credit manager should obtain updated financial statements from the customer, even if these have not yet been audited. The supplier should have an analysis performed of the customer's debt, especially of other secured debt, including a lien search.

Having this information ready at the outset will allow the credit manager to judge effectively the risks inherent in providing credit under these circumstances. Again, obtaining the assistance of a turnaround professional may be the most expeditious way to get on top of a distressed customer situation.

#### When Failure Is Imminent

There will be occasions when a credit manager determines that a customer is truly distressed, that there is little hope

for the customer's survival and that the supplier should cut its losses and move on. At this stage, the credit manager should also consider how those losses might be more effectively reduced or forecasted. Savvy credit managers should consider the nature of their troubled customer's business. A middle-market brick-and-mortar shop, for example, may not present as much risk to the supplier as an online superstore, swimming in cash flow, since even in the most dire of circumstances, the medium-sized traditional brick-and-mortar operation may have more in the way of saleable assets and inventory than the virtual online powerhouse whose suppliers drop-ship everything to its end-users or customers.

Where there is any substantial risk of bankruptcy, the credit manager should evaluate how her company would fare in a proceeding or liquidation. A "rolling preference analysis" should be performed, so that the supplier knows not only its current credit exposure, but also its further exposure through having to disgorge past, present and future payments received that may be avoidable preferences. Keeping an eye on the 90-day "preference clock" is an unfortunate but necessary aspect of credit management where distressed customers are involved.

It is important for the credit manager to involve the company's legal counsel for analysis of whether preferences do or will exist, and how these might be avoided. If the supplier has stopped granting credit altogether, it should be assumed that unless the payment is on a COD basis for a contemporaneous shipment of equal or greater value, there is a substantial chance that some or all of such payments may have to be repaid as a preference. The above notwithstanding, it's always better to have a payment in hand rather than no payment, and if necessary, to fight about preferences later. From an accounting perspective, it may be appropriate to set up a reserve for the possible return of payments that may be considered avoidable preferences.

Especially when the customer has been insolvent for some time, including when it received recent shipments, the credit

manager should also consider exercising reclamation rights under the UCC. This requires “fast footwork” since there is a narrow window of opportunity within which such rights can be exercised effectively, and competent legal advice should be sought in such situations.

There will be some situations where the distressed customer is of strategic importance to a supplier beyond the credit risk involved. In such situations, the credit manager should advise senior management of the aggregate of credit and noncredit risks, and seek guidance concerning how a potentially strategic threat to the supplier's business should be handled, so that the credit “tail” does not wag the strategic “dog”.

While these are matters that require urgent attention, there are also opportunities present in such situations. Many companies, when faced with the distress of a strategic customer, have stepped in to assist in the repair of their troubled trading partner. Supply-chain powerhouses such as the Big Three automakers continually evaluate the health and viability of their critical suppliers, and dispatch assistance when things get tough. A troubled customer may represent an acquisition opportunity, or an opportunity to gain market share if credit issues can be resolved proactively.

A strategic customer's troubles are a prime opportunity for bringing in outside expertise experienced in assessing distressed companies. As discussed above, qualified turnaround management professionals can quickly assess the troubled company's situation and prognosis, and will determine if the requirements for a successful turnaround are present:

- a viable core business (or businesses);
- adequate human and organizational resources; and
- adequate financial means to get through the turnaround process

Such an assessment usually takes only a short period of time, and will provide detailed insight into the troubled company's outlook, the steps that must occur for the company to right itself, and in cases where there the customer presents substantial risk to the suppli-

er, will give the supplier a better picture of its own overall risk.

The involvement of the supplier/creditor will vary depending upon the manner in which the turnaround specialists have been retained. If the supplier is taking an active role in the evaluation and turnaround of the troubled account, the turnaround professionals will know that and will keep the credit manager informed. If a troubled customer has a number of similarly situated creditors, these companies might consider forming an informal creditors committee to obtain consistent information about how the turnaround process is progressing.

There are frequently cases—perhaps more than are initially recognized by credit managers—where a troubled customer has retained a turnaround management professional on its own initiative, or at the behest of its lender or another supplier. While it can be a source of alarm initially to discover such a development, it should be good news to the supplier, since the involvement of a turnaround professional increases the likelihood of repayment to the supplier and survival of the customer.

At the very least, there is the potential for more accurate and up-to-date information about the customer's situation that is generated by the turnaround professional, provided that the supplier becomes involved in the process and makes sure the information is made available.

Although the turnaround professional is bound by its obligations to its client, a reputable turnaround professional is not an advocate in the sense lawyers are, but rather an objective observer, analyst, and realistic reporter of the situation, as well as a key agent for change. One of the benefits that a credit manager should realize after a troubled customer has retained a turnaround professional is an increase in the credibility of information about the customer's situation and progress. Turnaround professionals recognize that the credit managers of the suppliers to their clients will make decisions based on the credibility of the information that they receive, and therefore the turnaround professional will seek to regain the trust of the credit manager that the customer once enjoyed. Many credit managers remark that, after a distressed customer

retained a turnaround professional, they received more credible information from the customer, on a more regular basis and with better results. A credit manager should expect bad news early, good news conservatively, and absolute credibility. The agreement between the turnaround professional and the credit manager, spoken or unspoken, is “no surprises”.

Whether the supplier or the customer has retained the turnaround specialist, credit managers should be aware that turnaround professionals who are members of the Turnaround Management Association are bound by a strict Code of Ethics which requires, among other things: a commitment to increasing one's skills through continuing education; a commitment to maintain the integrity of their client by keeping client information confidential; and a commitment to serve their clients independently. In particular, those turnaround professionals who have earned the respected Certified Turnaround Professional (CTP) designation have passed a rigorous three-part exam covering finance, law and the principles of turnaround management, have a verified track record with a required number of years as a turnaround practitioner; and have undergone rigorous reference checks, client confirmations and an extensive peer review process. CTPs also have stringent continuing education requirements, and represent individuals for whom turnaround management is a professional career.

Credit managers see bad things happen to good customers every day. But utilizing the pointers described in this article, credit managers may not only reduce and manage better their company's risk, but can also be prepared to be proactive in troubled customer situations, to the benefit of both their own company and their customers' future.

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