

EFFECTIVE CREDIT APPLICATIONS

By

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Functions of Credit Application

The credit application performs the following six primary functions:

- Identify customer
- Obtain information to establish or continue credit
- Obtain information for collection activities
- Obtain information for the sale itself
- Establish credit terms and terms of sale
- Establish possible basis for fraud claim

These functions should be kept in mind both when constructing a credit application and when the customer completes the application.

Limits of Credit Application

Credit applications are limited in two primary respects. First, the credit application can only provide the credit manager with the financial condition of its customer as of the date of the application.¹ Second, because the obtaining of the credit application is so intimately tied in with the efforts of the sales department trying to “land” the new customer, there is reluctance in most instances to try and overburden the customer by asking for what might be considered to be an inordinate amount of information or information that the customer deems private.

Viewed in this light, the credit application perhaps should not be looked upon as the primary vehicle for obtaining information about a customer, but simply the initial round of information from which initial credit decisions will be made. At the beginning of the relationship, a vendor might decide to limit the amount of information it seeks in the credit application in order to bring the customer into the company and to try to deal with immediate purchasing needs. This willingness to sell on limited financial information may also warrant a restriction of credit granted pending the receipt of more detailed information. In the longer term, it is good practice for the vendor to obtain updated financial information on a regular basis as a condition to its willingness to consider providing credit to its customer.

¹ The financial information has only limited use a year later and that use diminishes as time passes.

Components of Credit Application

Ideally, a credit manager would want to obtain all of the available information about a customer before extending credit. Because the new customer may be unwilling to provide the information or because there may not be time to obtain it, it may be impractical for the credit manager to obtain all of the information that he or she would want before making that initial decision to extend credit. Perhaps as important, the credit manager may not have the time or the resources to review all of the information that might be obtained from the customer.²

Decisions, therefore, need to be made as to what is to be included in the credit application. A balance must be struck that takes into consideration on the one hand the vendor's position in the industry, its competition and the tolerance of its customers to provide the information requested and, on the other hand, the risks that not obtaining that information will result in imprudent credit decisions and a lack of critical information when it comes time to collect. The credit manager should also take into account whether the information will, in fact, be reviewed or whether he or she is collecting information just for the sake of having it.

The following chart sets forth most of the provisions that one might consider putting into a credit application and a brief comment about each. Each vendor will find different provisions to be important to it in deciding what to put in the credit application. In reviewing the chart, remember that you likely will be limited to perhaps half of the 70 items that follow. No matter which ones you choose, it is strongly recommended that items in bold be included in every credit application.

<i>INFORMATION</i>	<i>COMMENT</i>
Application Date	Establishes reference point for information and allows quick determination of whether application needs to be updated. Can be at beginning of application or at signature line.
Legal Business Name	Essential information for credit check, lien search and collection.
d/b/a	Helps identify customer and provides additional information for credit check and for identifying assets in connection with collection activities.
Ship to address	Important in connection with the sale itself and in identifying the location of assets.

² Obtaining but not reviewing information could have an unintended negative result, such as where the customer says one thing but the financial statement proves that statement to be incorrect. In a subsequent fraud action, a court might dismiss the complaint on the ground that had the credit manager reviewed the financial statement he or she would have discovered the fraud and, as a result, reliance on the customer's representation was not justified.

<i>INFORMATION</i>	<i>COMMENT</i>
Billing address	Essential in knowing where to send invoices. It usually is also the place where the books and records are kept. In most instances, it will be the same as the principal place of business.
Address of principal place of business	If not the same as the billing address, normally provides location where decision-making functions are made and provides additional location where assets might be found. Certain intangible assets may be deemed to be located at the company's principal place of business. The physical place of business is particularly important if the billing address is a post office box.
Years at this address	Much less important than years in business, but may give sense of stability of business and raise questions if the business has not been at the address for long.
Other locations	Provides important information about location of other assets, whether business has substance and whether it is spread too thin.
Credit contact name	Important for contacting customer. Also, may raise a question if person is different than signatory on application.
Phone	Important for contacting customer.
Fax	Of moderate importance for contacting customer. Can always be obtained later.
Cell phone	Generally of low importance. Customers should be able to be contacted at main number.
Pager	Generally of low importance. Customers should be able to be contacted at main number.
Email	Of moderate importance for contacting customer. Can always be obtained later.
Marital status	Prohibited by the Equal Credit Opportunity Act unless the applicant resides in a community property state or vendor is relying on property of the applicant located in a community property state.
Sex	Illegal provision. Prohibited by Equal Credit Opportunity Act.
Race	Illegal provision. Prohibited by Equal Credit Opportunity Act.
Nature of Business	Helpful in understanding financials and assessing credit risk.

<i>INFORMATION</i>	<i>COMMENT</i>
Date business established/Years in business	Helpful in establishing stability of business.
Federal ID #/Social Security Number	Helpful in obtaining other information.
License Information	Relevant for some businesses.
Legal form of business	Essential information. General partners of partnerships and sole proprietors are personally liable for the debts of the business. Owners of corporations are not liable for business debts. Form of business also bears on where UCC filings need to be made.
State of business organization	Essential information for performing UCC search and for UCC filings where debt will be secured. Also important in determining where the business can be sued.
Trade references (name, address, contact, phone, fax, account number)	Very important information, but only if they are checked out. Application should also include authorization to contact trade references.
Credit limits with trade references	Helpful in determining creditworthiness of customer. This information, however, may be able to be obtained when the trade references are contacted.
Bank references (name, address, contact, phone, fax, account number)	Very important information, but only if they are checked out. Application should also include authorization to contact trade references.
Credit lines with bank references	Helpful in determining creditworthiness of customer.
Prior bankruptcies of business	Alerts to possible problems and paves the way for additional questions.
Prior bankruptcies of principal owners and/or officers	Possibly as important as prior bankruptcies of business, especially in closely-held business.
Pending lawsuits against business	Provides warning sign of possible problems.
Judgments against business	Provides warning sign of possible problems, especially if judgment remains unsatisfied.

<i>INFORMATION</i>	<i>COMMENT</i>
Capitalization of business (i.e., amount of equity and working capital loans)	Helpful in understanding financial strength of business. Could work against creditor wanting to make claim against principal on ground of inadequate capitalization if creditor extended credit knowing the business was not adequately capitalized.
Total assets/Total liabilities	Provides minimal information about business but generally not enough to base credit decision.
Total current assets/Total current liabilities	Much improved over total assets/total liabilities. Shows ability to pay debts as they become due in the short run, but sole reliance on this may overlook some intermediate and long-term problems.
Accounts receivable aging	Very helpful. Shows strength of receivables and expectations of sufficient cash flow.
Accounts payable aging	Very helpful. Shows whether customer is paying debts as they come due.
Inventory	Total inventory is of minimal help without additional balance sheet information.
Inventory detail	Inventory detail (e.g., inventory mix) will give a better idea of inventory worth by showing such things as inventory turn and obsolescence.
Amount of secured debt.	Important in understanding whether the credit extended will be collectible if customer does not pay.
Names of secured creditors.	Less important than amount of debt. Names of secured creditors can be obtained through UCC search.
Description of collateral securing debt.	Important in understanding whether there will be assets available from which to collect if customer does not pay. Collateral description should be matched up with debt.
Annual sales	Annual sales are helpful in understanding size of business, but do little to show profitability.
Net income	Important indicator of profitability. If possible, numbers for the past two years should be obtained for comparative purposes.
Loans to insiders.	Important to understanding integrity of business. Existence of loans is a red flag but in itself may not warrant denial of credit.
Insiders' salaries.	Together with insider loans, information can be obtained about how much cash is flowing out of business into pockets of principals.
Own or rent business location.	Helps in understanding assets of business. Also, where assets are owned, business is less susceptible to dump/buy-back scheme.
Name of mortgagee or landlord.	May help to identify any relationships that are other than arms length.

<i>INFORMATION</i>	<i>COMMENT</i>
Is mortgagee or landlord an insider or relative of an insider?	Where contracting party is an insider or relative of an insider, the transaction should be scrutinized. Also, these types of relationships make the business subject to dump/buy-back scheme.
If own, how much is mortgage? If rent, how much is rent?	Of marginal value, but could help in understanding cash flow issues.
What assets are leased or licensed?	Helps in understanding assets of business. Also, where assets are owned, business is less susceptible to dump/buy-back scheme.
Name of licensor.	May help to identify any relationships that are other than arms length.
Is licensor an insider or relative of an insider?	Where contracting party is an insider or relative of an insider, the transaction should be scrutinized. Also, these types of relationships make the business subject to dump/buy-back scheme.
Balance sheet.	Provides snapshot of company. Most helpful if balance sheet is obtained for two years.
Income statement	Shows whether the company is making money. Two years of statements are preferred for comparison purposes.
Tax return	Good check against income statement. Arguably a more reliable statement of income.
Names and titles of officers/owners.	Helpful in the event of litigation.
Names of directors.	Helpful in the event of litigation.
Names of major shareholders.	Helpful in the event of litigation.
Addresses of officers, directors and/or shareholders/owners.	Not as important as the names, but helpful if they can be obtained.
Phone numbers of officers, directors and/or shareholders/owners.	Not as important as the names and addresses.
Social security numbers of officers, directors and/or shareholders/owners.	Helpful in tracking information about officers, directors and shareholders, but not essential to have.

<i>INFORMATION</i>	<i>COMMENT</i>
Name of insurance company and policy limits	Product liability insurance may be helpful for certain types of sales. Property insurance may also be relevant in certain circumstances. Other types of insurance are generally not that relevant to extension of trade credit.
Tax exempt status	Important in determining whether to add sales tax to the transaction.
Is the company bonded? Has it ever been refused a bond?	In those industries where the customer normally would obtain a bond, this question is helpful in assessing past performance and creditworthiness.
Credit limit requested	Helpful in understanding customer's needs. Not essential to the decision as to whether to grant credit.
Customer's billing cycle	Helpful in understanding customer's cash flow.
Special billing instructions	Helpful in making sure bills get paid.
Terms of sale	Not essential to credit application, but convenient to include them.
Signature verifying accuracy of information	Essential. There should be a separate signature line certifying the truth of the information and the intent to have vendor rely on it.
Printed name of signatory	The name of the person signing should be inserted below the signature line in case you cannot read the signature.
Title of signatory	Inclusion of the title of the person signing is helpful in order to demonstrate his or her authority.
Signature acknowledging terms of sale.	Separate signature recommended for terms of sale, so there is no dispute as to what the customer agreed to.
Personal guaranty with separate signature line	Personal guaranty helpful to collect debt. Separate signature essential if guaranty included.

Parts of the Credit Application

Depending on the vendor, the credit application might be divided into as many as seven parts, including four signatures, as follows:

- Credit information
- Signature verifying accuracy of credit information and authorizing credit check
- Sales information (shipping instructions, contacts, etc.)
- Signature verifying sales information
- Terms of sale

-
- Signature acknowledging and agreeing to terms of sale
 - Personal guaranty
 - Signature of guarantor

It is recommended that credit information be separated from sales information and that signature lines appear after each section.

Form of Verification of Accuracy of Information and Authorizing Credit Check

A verification of the accuracy of the credit information might read as follows:

The undersigned hereby certifies that the foregoing information, including any financial statements, income tax returns and other documents submitted herewith are true and accurate in every respect. The foregoing information is being provided in order to induce [Name of Vendor] to grant credit to Customer and will be relied on by [Name of Vendor] in making its credit decisions. The undersigned further agrees to notify [Name of Vendor] forthwith upon my receipt of information that any of the foregoing is not completely accurate. The undersigned further authorizes [Name of Vendor] to gather and use, from time to time, without the undersigned's knowledge, any and all financial and/or credit information relating to the Applicant that can be obtained from any source whatsoever. In connection therewith, the undersigned hereby authorizes any and all of the Bank and Trade references listed above to release to [Name of Vendor] such information as [Name of Vendor] may request in connection with its investigation of the credit of the Applicant.

Terms of Sale

The following are some common provisions that might be included in the terms of sale:

Payment Terms

It is helpful to at least set forth the standard payment terms that will apply to the transactions between the parties. The following are examples:

Unless otherwise agreed by [Name of Vendor] in writing, all invoices are due and payable within thirty (30) days after the date of the invoice.

or

Unless otherwise agreed by [Name of Vendor] in writing, the terms of the sale shall be 2% 10 net 30.

No Variation of Terms

It is a good idea to include language protecting the vendor from an attempt by the customer to vary the standard terms of sale. The following will normally suffice:

All sales made by [Name of Vendor] are subject to the Terms of Sale contained herein, which shall prevail over any inconsistent terms of Customer's purchase order or other documents. No terms and conditions in any way altering or modifying these provisions shall be binding upon [Name of Vendor] unless they are specifically authorized in writing by [Name of Vendor]'s authorized representative. No modification or alteration of these provisions shall result by [Name of Vendor]'s shipment of goods following receipt of Customer's purchase order, or other documents containing provisions, terms, or conditions in addition to, in conflict with, or inconsistent with these provisions. There are no terms, conditions, understandings or agreements other than those stated herein, and all prior discussions, proposals and negotiations are merged herein.

Acceleration

It is recommended that language be included to allow the vendor to accelerate payment in the event of a default in payment or other terms. For example, if a customer is within terms on some shipments but outside of terms on others, the vendor may be prevented from suing on the recent shipments absent an acceleration clause. The following is an example:

In the event Customer is delinquent in any of its payments, [Name of Vendor] may, at its option, declare the entire balance immediately due and payable without prior notice to Customer.

No Waiver Clause

Vendors may want to include a clause stating that the vendor shall not be deemed to waive any right to collect based on its not strictly enforcing payment terms should be included. The following is an example:

The willingness of [Name of Vendor] to accept payment other than on the due date or its failure to take action on account of a delinquent payment shall not be deemed to constitute a waiver of its right to strictly enforce

the payment terms, which terms may be varied only by a statement in writing signed by an authorized representative of [Name of Vendor].

Interest

A provision for interest should be included. Whether or not the vendor actually collects the interest, the inclusion of an interest clause will make it easier to collect the principal amount of the debt, if collection activities are necessary.

Counsel Fees and Costs

It is highly recommended that a provision for counsel fees and costs be included. It is much easier to collect the full amount from a delinquent customer where the vendor's counsel fees will be tacked onto its claim against the customer. It is recommended that the amount of counsel fees be stated as a "reasonable" amount rather than a percent, especially in those situations where the amount in controversy may be small.

Governing Law and Jurisdiction

It is advisable to include a provision establishing which state's law will govern the transaction and providing the option for jurisdiction in a state convenient to the vendor. Inclusion of such a provision will not necessarily guarantee that you will obtain jurisdiction in that state, but it would give the creditor a leg up in any objection to jurisdiction. The following is an example:

This agreement and all sales hereunder shall be governed by the internal laws of the Commonwealth of Massachusetts (without reference to conflict of laws rules). Customer does hereby consent to jurisdiction in the Commonwealth of Massachusetts for any suit that [Name of Vendor] may bring to collect any amounts owed by Customer on account of any transactions hereunder.

Arbitration

For most vendors, an arbitration clause will likely not be helpful and may actually hinder collection efforts. Courts will usually act more quickly in collection matters than arbitration panels will, especially in those states that allow pre-judgment attachments and other pre-judgment remedies. Arbitration clauses may be helpful in those businesses where the dispute is likely to be more substantial.

Purchase Money Security Interest

Language granting the vendor a purchase money security interest in the goods being sold should be considered where appropriate. Language granting a purchase money security interest and establishing the rights of the parties can be quite extensive. The following is sample language granting the security interest:

Customer does hereby grant to [Name of Vendor] a security interest in all goods sold by [Name of Vendor] to Customer, together with the proceeds and products therefrom, to secure payment of any obligations of Customer to [Name of Vendor]. Customer agrees to execute any documents reasonably appropriate to effectuate the security interest granted hereby, including the execution of a UCC-1 financing statement. Customer further certifies that the Credit Application contains a complete and accurate list of all creditors claiming a security interest in assets of Customer.

Guaranty

A guaranty should be included whenever possible. The guaranty could be of an individual or a corporate affiliate. If a guaranty is signed, the vendor may also want to obtain a financial statement from the guarantor. Whether or not the vendor is able to collect from the guarantor, the existence of a guaranty usually results in the vendor receiving better treatment than creditors that do not have guaranties. While general language of guaranty may suffice, the better approach is (1) to make it clear that the guaranty is of timely payment and not of ultimate collection; (2) to provide for the guarantor to provide advance notice of termination of the guaranty; and (3) to provide for counsel fees and costs separate and apart from any counsel fees and costs that are provided for under the terms of sale. The following is sample language.

In consideration of [Name of Vendor] extending credit to [Name of Customer], the undersigned does hereby guaranty the prompt and timely payment of all obligations of Customer to [Name of Vendor] as and when they become due. This Guaranty shall remain in full force and effect until ten (10) days after the undersigned provides to [Name of Vendor] written notice of its desire to terminate the guaranty. In such event, the undersigned shall remain liable for any amounts owed by Customer as of the effective date of such termination. In any suit to enforce the Guaranty, the undersigned shall be liable for reasonable counsel fees and costs of collection.