Ways to Reduce Risk in Case of a Default

Credit managers need to be careful when relying on security in the event of a default. A fundamental rule for securing a transaction is to determine the quick-sale value of collateral; and then limit your company's exposure accordingly.

Upon doing so, look to classify the various types of security by grouping the collateral according to the type of agreement, says Charles Gahala, CCE, CICP, author of *Credit Management Principles and Practices*. For instance, assets can be grouped as real property or personal property. Guarantees can be grouped as personal or corporate. But note that "each classification of security requires specific concerns for the credit analyst to consider," Gahala notes

Five of the common types of protection for creditors and tips for creatively reducing their risk are as follows:

1. **Real property.** If a creditor accepts real property (e.g., a building) as security, he or she should consider obtaining an appraisal to estimate that collateral's value, Gahala advises. If credit managers are in doubt about the status of personal property, they should obtain a landlord or mortgage waiver to protect against claims by a landlord or mortgage lender.

2. **Personal property.** Personal property refers to movable assets that are not classified as real property. It can be further divided into two categories of goods: those creditors keep in their possession and those debtors keep their possession.

   In the former situation, the debtor makes a *pledge* to the creditor for, say, an amount of stocks and bonds. Regardless, the creditor should obtain a separate pledge agreement that authorizes the creditor to sell items pledged in case of nonpayment, Gahala says. In some cases, a debtor may pledge the same collateral to various creditors, meaning this collateral would not support the overall debt. Also note, creditors relying on cash value of an insurance policy should notify an insurance company or bank "… to block any potential withdrawal of funds by the debtor until the credit commitment is fulfilled."

   On the other hand, creditors should perfect a security interest held by the debtor, such as accounts receivable, inventory or machinery, by following the requirements of Article 9 of the Uniform Commercial Code (UCC).

3. **Guarantees.** Typically, any business transaction should not rely solely on obtaining a guarantee, but it can strengthen the creditor's position, Gahala says. Guarantees can be arranged as a guarantee of payment, which allows the creditor "… to present an obligation to the guarantor immediately following default, or a guarantee of collection, which requires the creditor first try to collect and, if unsuccessful, seek payment from the guarantor.

A personal guarantee needs to be signed by the obligor acting as an individual, not as an officer of a company. This can serve to gain "… a psychological advantage from a guarantor…" Have the guarantor provide a signed, personal financial statement. Also, be wary of the potential of personal assets being inflated in a financial statement. Be sure to save the mailed envelope containing a personal financial statement because, if the statement is fake, the potential for mail fraud exists.

Corporate guarantees can be difficult to enforce, so try to obtain a board of directors' resolution that authorizes the corporation to guarantee the obligation.

4. **Mechanic's liens.** These liens are typically used in the construction sector to ensure compensation for labor or material furnished on construction jobs, Gahala says. Pay attention to the relevant state's laws governing the filing and enforcement of such liens.

5. **Trade acceptances.** This a form of time draft that occurs most often when a creditor ships goods to a customer. The creditor draws a draft on the customer's bank ordering the customer to pay for the goods at a specific time. The creditor can endorse and then discount the draft or collect when the draft matures; no liens are filed. The customer accepts responsibility to pay, and the draft is not subject to a customer stop payment or a customer claim of nonperformance. "Trade acceptances usually are not secured by any assets," Gahala said. But "they provide an alternative way in which to set up a payment arrangement."