

Insolvency and Corporate Restructuring

September 2009

Credit Agreements: Best Practices

Companies often supply services or products to their customers without appreciating that they are, in effect, extending credit to their customers for an extended period of time and often without a minimal level of due diligence.

After providing services or products, these companies will render invoices in the hope that they will be paid within the next 30 to 90 days. Often they will provide further services or products even though previous invoices remain unpaid. When extending credit in this manner, it is necessary to take proper precautions and determine whether the risk of extending credit is appropriate. These precautions include obtaining a credit application in order to assess the customer's creditworthiness and a signed credit agreement which sets out the terms under which credit is granted.

1. THE CREDIT APPLICATION

The credit application provides the company with key information such as the legal identity of the customer receiving credit and who is legally obligated to make payment. A credit application will also disclose other suppliers' experience with the customer and the customer's banking history and provide consent from the customer to conduct searches which are necessary in assessing creditworthiness.

Identifying the Customer

The first step in identifying the customer is to determine the customer's legal form of business: is the customer an individual, a partnership, or a corporation? This identifies the entity that is liable to pay invoices.

If the customer is a corporation, it is necessary to obtain the full corporate name, any trade names, the address, and the name of the individual in charge of accounts payable. If the agreement is with a corporation, then the corporation is liable and not the officers, directors or shareholders. However, it is important to know who the directors and officers are and if there are any related companies. Information about officers, directors and related companies permits an assessment of whether guarantees are required

from these entities. If the intention is for the officers, directors, or any other individuals or corporations to be liable, then these parties need to sign separate guarantees.

In the case of a partnership, each of the individual partners needs to be identified together with their contact information. It is also necessary to obtain any trade names, and the name of the individual in charge of accounts payable. Generally, operating as a partnership does not provide the same liability protection that corporations enjoy. Each of the individual partners is liable for the partnership's debts and accordingly, it is not necessary to obtain personal guarantees from them.

If the customer is an individual or operates as a sole proprietorship, the individual is liable. It is necessary to obtain contact information, any trade names, and the name of the person in charge of accounts payable.

Information About the Customer

After properly identifying the customer, it is necessary to obtain information about the customer which will form the basis of the assessment as to whether to advance credit.

The nature of the customer's relationship with its landlord is relevant. It is important to determine whether the premises where the customer operates are owned by the customer or are leased. If the premises are leased, obtaining the payment history can help in assessing creditworthiness. It is also important to understand the relationship between the landlord and the customer – are the customer and landlord related (in which case a guarantee may make sense) or are they unrelated, arms-length companies? In addition to ownership of the business premises, it is important to know how long the customer has operated at the location, which will give some idea of the customer's stability.

The customer's relationship with other suppliers also

provides useful information about creditworthiness. It is helpful to know whether the customer has paid other suppliers on a timely basis. The customer should be asked to provide contact information for at least three other suppliers. The customer should also be asked if any of the suppliers are related corporations or if the customer is required to pay cash on delivery. Each of these suppliers should be contacted in order to obtain information regarding the timeliness of payments, whether the suppliers have experienced any difficulties when contacting the customer and to generally discuss the supplier's history with the customer.

The customer should provide consent to a credit check with a credit reporting company such as Equifax or TransUnion. The credit report provides valuable information such as the number and amount of debts, payment history, returned cheques, lawsuits, and judgments. These reports are not always accurate or up to date, but they do give an idea of the customer's financial situation.

Other searches which can be useful in assessing a customer's creditworthiness include *Personal Property Security Act* ("PPSA") searches, searches for court actions and writ searches.

A PPSA search will determine if the customer's assets are subject to prior security and who holds that security. Depending on the nature and dollar value of the products being supplied, you may wish to consider whether it would be appropriate or possible to obtain and register a security interest in products delivered to the customer. Suppliers may obtain a security interest in identifiable products even if there are prior security agreements in place, but there are specific steps which must be followed. If a PPSA search reveals that the customer has provided security to a related company or individual, it is advisable to have that security interest subordinated to the amounts owed to you on outstanding invoices.

Even if there is no intention to obtain a security interest in the products being supplied, a PPSA search will provide insight into what might happen if it became necessary to enforce a judgment against the customer or if the customer was to make an assignment in bankruptcy. Generally, a judgment obtained by an unsecured supplier cannot be

enforced against assets which are subject to a security interest. Secured parties have the right to seize the secured assets first and sell them to satisfy any debt. In the case of a bankruptcy, the same principle applies – a party with a security interest in any assets has the right to those assets. The effect of this is that unsecured suppliers usually receive nothing.

A search for court actions will disclose whether the customer is involved in litigation with other suppliers. When asked to provide supplier references, customers will likely only provide contact information for those suppliers with whom they have a good working relationship. With the search for court actions in hand, it is possible to contact suppliers where the relationship has gone sour in order to assess where the responsibility for the breakdown lies.

Writ searches will reveal whether any other parties are attempting to collect judgments against the customer. If there are outstanding writs against the customer, this will obviously be a financial strain on the customer which may affect future ability to pay.

2. THE CREDIT AGREEMENT

Once the necessary information is obtained from the credit application and the decision has been made to advance credit, a credit agreement should be prepared and executed by both parties. A credit agreement is a contract which sets out the terms under which credit will be granted to the customer. This will include the amount of credit which will be advanced, the repayment terms, the interest to be charged, and other terms which will govern the relationship.

The Credit Limit

The amount of credit to be advanced should be considered when assessing creditworthiness. It is important to keep track of the credit limit and the amount of credit extended to the customer. As the relationship progresses, it is not unusual to increase the amount of credit granted to the customer, but this decision should be based on an assessment of the customer's creditworthiness, not made by accident because more products or services are provided to the customer than the credit agreement allows.

Payment Terms

The credit agreement should specify when invoices must be paid. The amount of time a customer will be given to pay invoices should be assessed at the beginning of the relationship. The more time a customer is given to pay an invoice, the greater the chance is that the invoice will not be paid. You should also remember that when extending credit you are likely paying interest on your own credit facilities and essentially financing the customer's business.

If invoices are not paid within the time specified, the agreement should require that interest be charged on the outstanding amount. Charging interest on outstanding amounts allows for additional flexibility to forego that interest if it is necessary to negotiate a settlement with the customer to obtain payment of an account.

The amount of interest should be specified in the credit agreement (and not just on invoices). The interest rate must be expressed on a yearly basis (as opposed to a monthly or other basis). If interest is not expressed on a yearly basis, the rate defaults to 5% pursuant to the *Interest Act*.

A prior agreement as to interest terms is important if it becomes necessary to litigate. If there is no agreement as to interest, a default interest rate for payment of interest on any judgment obtained is contained in the *Courts of Justice Act* ("CJA"). Generally, the CJA provides for simple interest, not compound interest, and the interest rate is very low. In order to avoid the default provisions of the CJA the credit agreement should specify the amount of interest and the manner in which it is calculated (compound as opposed to simple).

Costs

The credit agreement should explicitly state that the customer agrees to pay all collection costs including legal fees. The usual rule when litigating is that a successful party is entitled to approximately 60% of its costs. A clause which indicates that the customer will pay all of the collection costs allows the court to award 80% to 90% of the costs. Although the court always has the final say when it comes to deciding whether to award costs and what amount to award, a court will take such a clause into

consideration and, unless there are extenuating circumstances, will usually award a higher amount of costs.

Providing for payment of costs also allows for additional flexibility if it is necessary to negotiate a settlement. If the agreement indicates that the customer is to pay all collection costs, then it is possible to arrive at a compromise where the customer pays the full outstanding amount, but does not pay the costs.

Defects

It is surprisingly common for customers to accept all of the products delivered during the course of the relationship, and then complain about defects when payment becomes an issue. One method to avoid this problem is to insert a clause in the credit agreement which requires a customer to advise within a specific time if there is a defect. If that time passes, the agreement should indicate that the delivered products are deemed to be satisfactory. In order to avoid disputes as to whether notice was given, the agreement should make it clear that this notice must be provided in writing.

Entire Agreement Clause

It is not unusual for a customer's purchase order to indicate different terms, particularly payment terms, from what is intended by the credit agreement. If there is a discrepancy between the credit agreement and the purchase orders, it is not always clear which terms should govern. This problem can be avoided by explicitly stating in the agreement that no terms or conditions of any purchase order or other correspondence are binding unless agreed to in writing by the company advancing credit. This makes it clear that any different terms in a purchase order or in a subsequent letter do not override the explicit terms in the credit agreement.

Discretion to Terminate Credit

If there is an ongoing relationship between the company advancing credit and the customer, then it may not be possible to unilaterally terminate this relationship without giving reasonable notice. This notice period may force the company advancing credit to lend money at a time when it is clear that there is a risk that the money will not be repaid. This problem can be avoided by inserting a clause in the

credit agreement which states that the company extending credit will have the sole discretion whether to advance, continue or terminate credit and to impose further or different terms in the future.

Other Clauses

In addition to clauses dealing with the credit limit, payment terms, interest rates, and security interests, the credit agreement can deal with the following situations to avoid disputes:

- The credit agreement should make it explicit that if the company advancing credit owes money to the customer, this amount can be set off against any amount owed by the customer.
- The credit agreement should specify the jurisdiction in which any disputes are to be litigated.
- The credit agreement should specify who pays for shipping, who selects the shipping company, who is responsible for loading and unloading products, and who assumes liability for damage to the products while they are being shipped.

- The credit agreement should specify what warranties, if any, are provided.
- The credit agreement should include a *force majeure* clause limiting liability for damages caused by circumstances beyond the companies' control.
- When supplying large quantities of products it may be impractical to deliver the exact quantity requested by the customer. The credit agreement should specify that the company has the right to ship and charge for products within a 5 percent tolerance of the quantity ordered.

The key to providing product or services with the expectation of successfully recovering payment at a future date is to realize that it is no different than lending money to the customer. Before advancing credit or loaning money to any customer, it is necessary to obtain the right information in order to make a proper assessment as to whether the risk of extending credit is appropriate. Once that decision is made then the terms of the loan, including repayment and interest, must be made explicit.

Wojtek Jaskiewicz focuses his commercial litigation practice in the area of bankruptcy and insolvency.



Pallett Valo LLP Insolvency & Corporate Restructuring Practice

Businesses transform. Partnerships change. At every step, Pallett Valo LLP has proven itself adept at providing critical advice, strong representation and timely resolution when it matters most. We offer legal advice to debtors, secured and unsecured creditors, trustees and receivers in the context of proceedings under the *Bankruptcy & Insolvency Act (BIA)* and the *Companies Creditors Arrangement Act (CCAA)*. We have guided lenders, suppliers and landlords through many significant CCAA proceedings to their ultimate benefit.

Wojtek Jaskiewicz wjaskiewicz@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 285

John Russo jrusso@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 282

Bobby Sachdeva bsachdeva@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 295

Liana Turrin lturrin@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 249

This article provides information of a general nature only and should not be relied upon as professional advice in any particular context. For more information about Credit Agreements, contact a member of our **Insolvency & Corporate Restructuring Practice** at **905.273.3300**.

If you would like additional copies of the bulletin, or know of anyone who would be interested in joining our mailing list, please contact our Marketing Coordinator at marketing@pallettvalo.com.