Principles of Business Credit, Eighth Edition
COMPREHENSION CHECK QUESTIONS

Chapter 1—Credit in the Business World

1. The idea of exchanging goods or services on credit developed after centuries of trade. Explain some of the reasons why credit evolved.

See pages 1-2 – 1-4 for potential answers for this open-ended question.

2. Explain why organizations like NACM evolved.

Organizations like NACM evolved initially to exchange credit information, but evolved as NACM has below.

NACM's purposes and objectives are:

- To promote honest and fair dealings in credit transactions.
- To ensure good laws for sound credit.
- To foster and facilitate the exchange of credit information.
- To encourage efficient service in the collection of accounts.
- To promote and expedite sound credit administration in international trade.
- To encourage training for credit work through colleges, universities, self-study courses and other means.
- To foster and encourage research in the field of credit.
- To disseminate useful and instructive articles and ideas with respect to credit management techniques.
- To promote economy and efficiency in the handling of estates of insolvent, embarrassed or bankrupt debtors.
- To provide facilities for investigation and prevention of fraud.
- To perform other such functions as the advancement and protection of business credit may require.

See pages 1-3 – 1-4

3. List and explain the reasons credit terms are offered.

The primary reason for a company to offer credit terms to customers is to accommodate the sale of goods and services in order to create revenue. More specifically, companies offer credit

- to **increase sales**. Extending credit to buyers often involves a trade-off between holding inventory or holding accounts receivable.
- in anticipation of a **competitive market**. Matching a competitor's credit terms may be a sales necessity.
- as a means of **promotion**. A business may offer special credit terms as part of a promotional program for a product.
- because some buyers may not have access to any other forms of credit, as they may not be **available.** In tight credit times, seller trade terms or financing may be necessary.

- as a **convenience**. Trade credit provides benefits not easily obtained from other payment arrangements, including the simple convenience of writing a single check to pay for hundreds of purchases.
- due to **demand**. Credit is extended in response to customer demand for a company's products or services. This implies that the sale may or may not take place without the extension of credit.
- as an aspect of **price.** The time that the buyer has before payment is due is one of the dimensions of the product (like quality, service, etc.), which determines its attractiveness. Like other aspects of price, the firm's terms of sale and credit-granting decisions affect its sales volume. (*page 1-4*)

4. Explain why a sale may not take place, in the business setting, if credit is not offered.

See page 1-4 for possible answers to this question.

5. What does the Latin term CREDERE mean? How does it describe the credit process?

The very derivation of the word "credit" from the original Latin *credere*, to believe or trust, graphically describes the entire process of credit as a matter of mutual trust and confidence. The buyer selects the supplier on the basis of its reputation as a source of quality goods at an acceptable price. The supplier accepts the order and extends the credit necessary to facilitate the sale if it believes the customer will honor the contract by paying the invoice according to the terms agreed. (*page 1-5*)

6. Explain why selling on credit is more costly than selling for cash.

Costs include the cost of the credit department, the investment of company funds in receivables, discounts for early payments, and the cost of converting receivables to cash and collecting bad debts. All of these factors comprise the cost of credit. No matter how great these costs, however, they are more than offset by distinct sales advantages. By offering credit terms, the seller can build a greater customer base, make more efficient use of production facilities, create greater goodwill, expand geographical markers, accept marginal risks, earn incremental profits and ultimately realize a greater return on investment. (*page 1-5*)

7. List and explain the important elements of credit.

- **Risk of Nonpayment.** The purchaser may default in making any or all of the payments due to the seller.
- **Timing.** When credit is offered, the seller must wait for payment, even if that payment is received on time. This increases the risk of losing the use of funds that are tied up in financing the credit transaction or, if a payment is late, in carrying or financing the past due customer.
- **Security.** As a means of gaining partial or full protection for the credit transaction, a seller may require the purchaser to pledge a form of collateral or provide a financial guaranty. This can be accomplished by pledging an asset, providing a personal, corporate or bank guarantee, or entering into a security agreement.
- **Extra Costs.** The seller incurs the expenses associated with granting credit, such as the cost associated with the credit department, the investment of company funds in receivables, discounts for early payments and the cost of converting receivables to cash.
- **Legal Aspects.** Federal and state laws have been enacted that affect both the credit grantor and debtor. Both businesses and consumers must be aware of applicable state and federal laws.
- **Economic Influences.** Changes in economic conditions, such as the rate of inflation, can have strong effects on credit sales. For example, in inflationary times, a seller will not want to wait too long before getting paid and will likely impose stricter credit policies. (*pages 1-5 – 1-6*)

8. List and explain the Five Cs of Credit.

The Five Cs of Credit represent important features of a credit applicant. The ability to analyze each of the Five Cs provides an important foundation in the credit process. The Five Cs of Credit are:

- **Character.** Those moral qualities and actions of a credit applicant that oblige the applicant to pay debts as they become due.
- **Capacity.** The ability to pay when a debt is due.
- **Capital.** The financial strength of a risk as measured by the equity or net worth of an applicant.

- **Collateral.** Those possessions or equities from which the customer or debtor might be expected to draw upon should character and capacity fail.
- **Conditions.** The current and expected general economic situation as they might affect the applicant.

(*pages 1-6 – 1-8*)

9. Define the term OPERATING CYCLE.

The period of time between the acquisition of material, labor and overhead inputs for production and the collection of sales receipts. During the operating cycle, the manufacturer is both a debtor and a creditor. (*page 1-10*)

10. Why will a manufacturer be both a debtor and creditor at any given time?

During the operating cycle, a manufacturer is both a debtor and a creditor. Consider a typical operating cycle for a manufacturer: the operating cycle begins when the manufacturer purchases raw material from a supplier. The purchase of raw material is usually a business credit transaction. The material is converted into goods during the production stage, and the manufacturer must pay its supplier for the material. The manufacturer then sells the finished goods to a customer, who ultimately pays for the goods that were purchased on credit during the collection stage. *(page 1-10)*

11. Define and give an example of PUBLIC CREDIT.

Public credit, also known as government credit, is credit extended to or used by governments or governmental divisions, agencies or instrumentalities. All levels of government—federal, state and local—borrow money to meet public needs, including financing the cost of schools, highways, health and social welfare and military preparedness. Governments buy a wealth of products and services such as tanks, planes, food, office supplies, books, computer equipment, labor, electricity and so forth. (*page 1-11*)

12. Define and list the major types of PRIVATE CREDIT.

Private credit is extended to or used by individuals or businesses to carry on the exchange of goods and services in the private sector. It can be divided into five broad categories: investment credit, consumer credit, agricultural credit, business credit and bank credit. (*page 1-11*)

13. What is the most common type of corporate bond? List the characteristics of this type of bond.

Debentures are the most common corporate bonds. They are backed only by the financial strength or standing of the organization issuing them, rather than by any specific assets. A debenture buyer relies on the issuer's faith and credit as the only assurance of being paid interest and principal. (*page 1-12*)

14. What is the difference between a secured bond and a debenture?

While debentures are backed only by the financial strength or standing of the organization issuing them, secured bonds have specific titles attached to them. Secured bonds include mortgage bonds, equipment and trust certificates and collateral trade bonds. (*page 1-12*)

15. How do mortgage and collateral bonds compare?

Mortgage bonds are secured or collateralized with specific corporate assets such as real estate (land and buildings). Mortgage bonds are backed by a pool of mortgage loans.

Collateral trust bonds are similar to mortgage bonds except they are backed by securities of any company through the pledge of stocks and bonds. *(page 1-12)*

16. Define the term CONSUMER CREDIT.

Credit that is extended to a natural person primarily for personal, family or household purposes. (*page 1-13*)

17. List and explain three ways consumer credit can be classified.

Consumer credit can be classified as open-end, closed-end or incidental.

- **Open-end consumer credit** refers to credit extended under a plan where a creditor may permit an applicant to make purchases or to obtain loans from time to time directly from the creditor—or indirectly using a credit card, check or other device. Examples include bank and retail gasoline credit cards, department store revolving charge accounts and cash-advance checking accounts.
- **Closed-end consumer credit** includes all consumer credit that does not fit the definition of open-end credit; it includes both credit sales and loans. Single payment loans and installment loans are examples.
- **Incidental credit** is extended by service providers, such as hospitals and doctors, that allow clients/customers to defer the payment of bills. (*page 1-13*)

18. Define and explain the important characteristics of business credit.

Business credit is the extension of credit primarily for business or commercial purposes. Characteristically,

- its selling terms are relatively short.
- transactions are usually on open account or unsecured, but may be partially secured or secured in full.
- cash discounts may be offered for payment before the net due date.
- the terms include transactions to manufacturers, wholesalers and retailers, but specifically exclude the consumer.
- the timeliness in reaching a decision whether or not to extend credit is often much more critical in the business setting. Delays in the manufacturing process can increase costs and reduce the quality of perishable goods. (*page 1-14*)

19. Explain what open account credit is.

In open account credit, the creditor reasonably expects the customer to make repeated transactions and generally makes more credit available to the buyer as the outstanding balance is paid. A typical business creditor who sells on open account terms is relying specifically on the full faith and credit of a purchaser. The seller establishes the terms of sale. Also known as ordinary terms or standard terms. (*page 1-14*)

20. What is the difference between unsecured and secured credit?

Unlike its unsecured credit counterpart, a secured credit arrangement is one in which collateral is provided to the creditor. By obtaining some form of security, the creditor can reduce repayment risk. Secured credit is defined in Article 9 of the Uniform Commercial Code (*page 1-14*)

21. Explain the structure of the Federal Reserve.

The Federal Reserve is structured to be independent within the federal government. The Federal Reserve System is made up of the **Board of Governors,** the **Federal Open Market Committee** and 12 **regional banks**. (*pages 1–15 – 1-17*)

22. Define the term DISCOUNT RATE.

The discount rate is the interest rate banks must pay when they borrow money from a regional Federal Reserve Bank. (*pages 1-17 – 1-18*)

23. Briefly explain the concept of RESERVE REQUIREMENT.

A reserve requirement establishes the amount of funds that commercial banks and other depository institutions must hold in reserve against deposits. (*pages 1-18 – 1-19)*

24. What would the effect be if the Fed raised the reserve requirement? What if the requirement was lowered?

An increase in the reserve requirement usually leads to less borrowing since fewer funds are available for lending purposes. Interest rates will likely rise under this scenario. A decrease in the reserve requirement usually leads to greater lending opportunities since more funds are available. (*pages 1-18 – 1-19*)

25. List the four major tools used by the Fed to expand or contract the money supply and to control interest rates.

The Federal Reserve is the primary conductor of U.S. monetary policy, using three major tools designed to expand or contract the money supply to control interest rates: reserve requirements, discount rate and open market operations. (*pages 1-17 – 1-19*)

26. Must all banks belong to the Federal Reserve System?

Not necessarily. Approximately half of all banks, and all of the largest banks, are members of the Federal Reserve System. All national banks must be members of the Fed. National banks must use the word “national” in their name or have N.A. (National Affiliation) following their name. State-chartered banks can join if they meet the Fed’s financial standards. All banks must maintain Federal Reserve accounts to be able to move or receive funds through the Federal Reserve System, membership not withstanding. (*page 1-19*)

27. What two publications does the Fed release to the public as part of their mandate to study the economy?

Summary of Commentary on Current Economic Conditions by Federal Reserve District commonly known as the **Beige Book**. This report is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its District through reports from Bank and Branch directors and interviews with key business contacts, economists, market experts and other sources. The Beige Book summarizes this information by District and sector. An overall summary of the twelve district reports is prepared by a designated Federal Reserve Bank on a rotating basis.

Fed Minutes are notes from discussions the Federal Open Market Committee has over economic policy. They are released eight times a year, after each meeting. They often detail discussions between members over what policy to follow. *(page 1-20)*

28. What is the MICR system?

Developed and implemented by the Federal Reserve in the 1950s, the magnetic ink character recognition (MICR) system encodes pertinent data on checks so that the information can be read electronically. This data is printed at the bottom of a check and is known as the MICR line. (*page 1-21*)

29. What information does the MICR line contain?

The MICR line identifies the bank’s transit routing number, the payer’s account number, check sequence number and encoded check amount. (*page 1-21*)

30. Define the term AVAILABILITY FLOAT.

The delay between the time a check is deposited at the bank and the time the depositor’s account is credited with collected funds by the bank. (*page 1-21*)

31. Define CHECK TRUNCATION.

The process of taking the physical paper check out of circulation, capturing the check information electronically and moving the electronic copy through the clearing system. The paper check is destroyed or put into storage. (*page 1-22*)

32. Define the term ELECTRONIC FUNDS TRANSFER.

An electronic funds transfer (EFT) is a series of transactions, beginning with the originator’s payment order, made for the purpose of making a payment to the beneficiary of the order. EFT is often viewed as a faster and more secure method of payment than either cash or check. (*page 1-22*)

33. List the types of services for electronically transferring funds.

Electronic funds transfer (EFT) is the electronic transfer of money from one bank account to another, either within a single financial institution or across multiple institutions, through computer-based systems and without the direct intervention of bank staff. There are several types of services for electronically transferring payments.

Automated Clearing House (ACH) is an electronic network for financial transactions in the United States. ACH processes large volumes of credit and debit transactions in batches. The Federal Reserve Banks (FedACH) and Electronic Payments Network (EPN) are the two national ACH operators.

Fedwire is a real-time method of transferring cash value from one bank to another, using Federal Reserve account balances.

SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a dedicated computer network to support funds transfer messages internationally between member banks worldwide.

CHIPS (Clearing House Interbank Payments System) is a worldwide bank-owned, private-sector U.S.-dollar funds-transfer system for cross-border and domestic payments.

TARGET2 is the real-time gross settlement (RTGS) system owned and operated by the Eurosystem. TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system. TARGET2 is the second generation of TARGET.

TIPANET (Transferts Interbancaires de Paiement Automatisés) is an international payment system set up by the European cooperative banks. *(page 1-22)*

34. What does the FDIC *not* insure?

The standard insurance amount is $250,000 per depositor, per insured bank, for each account ownership category. The FDIC insures deposits only. It does not insure securities, mutual funds or similar types of investments that banks and thrift institutions may offer. *(page 1-23)*

35. What are some of the advantages of online business banking?

Online business banking has simplified money management. Enrolling in online business banking makes it easier to monitor accounts, financials, account history and statements; transfer funds between accounts and banks; pay bills and more. Other advantages include: automatic payments and debits, transaction alerts, cost savings and direct deposit, among others. *(page 1-23)*

Supplementary Questions:

List two of the effects of Check 21.

Effects of Check 21, a federally based initiative that increases the efficiency of the check clearing system, include the likelihood that customers no longer receive cancelled checks with their monthly billing statements, the reduction of availability float and the faster clearing of checks. (*page 1-23*)

Chapter 2—Credit in the Company

1. Discuss what the term BUSINESS means.

The word "business first appeared in the 14th century and originally meant "purposeful activity." (*page 2-1*)

2. What is meant by the term ORDER-TO-CASH?

A description for the credit department's evolving responsibilities, "order to cash" refers to the chain of events leading to the sale of goods or services at a profit. A credit department not only evaluates a customer's ability to pay, but it also must make and support decisions that require both financial and strategic decision making to ensure that a proper balance of benefits is derived from sales against carrying the cost or, even, a potential loss. (*page 2-1*)

3. Define the term STRATEGY.

The art of devising or using plans to achieve a goal. (*page 2-1*)

4. What factors impact a company's strategic plan?

External factors include social, political, economic, legal, technological and competitive pressures. They must be weighed in light of such internal factors as production capacity, financial strength, human resources and marketing. All factors are assessed in term of risk and reward. (*page 2-1*)

5. Discuss a credit-related area that has both a financial and strategic implication.

Such areas include deduction resolution, collections and credit analysis. (*pages 2-1 – 2-2*)

6. Define the term NET WORKING CAPITAL.

The excess of a business' current assets over its current liabilities. (*page 2-3*)

7. Using balance sheet logic, explain where the credit department falls within an organization.

As a result of balance sheet logic, most credit departments report either to the treasury department or the finance department. (*pages 2-3 – 2-4*)

8. List eight finance-related functions that the credit department manages.

- Protecting and managing the investment in the accounts receivable portfolio
- Cash forecasting
- The timely conversion of receivables into cash
- Financial analysis
- Handling collateral that secures a customer's account
- Depositing funds and maintaining a relationship with banks
- Handling customer deductions
- Evaluating economic trends on sales, receivables and collections (*pages 2-3 – 2-4*)

9. What is the goal of cash management?

The efficient management and use of cash in a manner that is consistent with the strategic objectives of the business. (*page 2-4*)

10. List and describe the three broad areas of cash flow management.

Managing cash inflows—Represented by funds that are collected from customer or obtained from financial services. Sources of such funds include the sale of goods/services, interest and dividends.

Internal cash flow management—Includes managing the company's cash reserves and investing cash or transferring cash among the operating units of a business or various bank accounts.

Managing cash outflows—Disbursing funds from cash reserves in order to pay for items such as inventory, operating expenses (salaries, rent, insurance) and long-lived assets (buildings or land). (*page 2-4*)

11. Describe the operating cycle.

The operating cycle comprises the activities a company performs to produce and sell its product or service. A business must first purchase the resources it needs to make its product. It then sells that product and collects the funds from the sale. Cash flows into and out of the business during the operating cycle. Cash flows out of the business during the production stage, when it purchases the resources needed. Cash flows into the business when it sells the product to a customer. Rarely do these events occur at the same time; the challenge of business is to maintain sufficient levels of cash throughout the operating cycle to ensure smooth and ongoing operations.
(page 2-5)

12. List the core activities of the credit department.

- Customer and credit analysis
- Developing credit policy
- Managing the collection function
- Setting credit availability thresholds
- Management reporting (*page 2-6*)

13. Discuss some of the areas of knowledge or skill sets required for credit management.

- thorough understanding of the accounting, financial analysis and finance disciplines
- comprehensive understanding of business and credit law
- sound business communications skills (i.e., writing and presentation)
- general management skills including expert negotiation skills
- customer service skills
- analytical skills
- computer skills (*pages 2-6 – 2-7*)

14. List 6 goals and objectives of every credit department.

- Increase sales and profit through a better understanding and skillful handling of all credit functions
- Match risk and reward through customer and financial analysis
- Monitor, protect and manage the company's investment in accounts receivable
- Communicate the condition, cost and trend of the company's investment in receivables to management
- Convert accounts receivable to cash in a timely manner
- Increase cooperation between sales and credit
- Maintain and increase goodwill in customer relations
- Coordinate credit activities with all departments
- Train and supervise credit department personnel
- Educate other departments about credit and the credit function
- Control operating costs and expenses
- Reduce collections and bad debt (*pages 2-7 – 2-8*)

15. How can a less creditworthy company be used as a marketing strategy?

What may be called a marketing risk should be distinguished from a credit risk. For example, to achieve adequate geographic distribution in marketing a name-brand product, it may be necessary to sell to a company that may not be creditworthy. Marginal accounts or accounts with poor payment history, inadequate working capital or a deteriorating financial condition are taken on for strategic reasons and should be identified as such when accounts receivable is analyzed. *(page 2-8)*

16. What is an approval subject to confirmation?

A situation where a customer is asked to do something tangible before goods are released, such as pay an overdue balance, reduce an outstanding balance to an acceptable level or submit an interim/annual financial statement. (*page 2-9*)

17. Define the term ELECTRONIC DATA INTERCHANGE.

The movement of data electronically from one computer to another in a structured, processable format. (*page 2-9*)

18. How does the credit department interact with the other departments to meet the goals of the organizations? Choose one and be specific.

See pages 2-8 – 2-9 for specific answers to how the credit department interacts with other departments

19. What are the day-to-day steps in credit processing?

The primary day-to-day steps in credit processing include: the credit approval process, account establishment, order processing, accounts receivable administration and collections and adjustments. For more detail see *(pages 2-11 – 2-12)*

20. What is a LOCKBOX?

A check collection system operated by a bank. (*page 2-12*)

Chapter 3—Organizing the Credit Department

1. Describe how the credit function would operate if credit is controlled at a headquarters office but administered from decentralized locations.

In this scenario, a mid-management level credit manager reports functionally to an executive-level credit manager at headquarters and also reports to the division head (the principle is the same for subsidiary or branch operations). While the executive-level credit manager is the authority for credit and collections, in all other respects middle management establishes the procedures to which the credit professional must conform. (*page 3-3*)

2. List and discuss the benefits of a centralized credit operation.

Benefits of a centralized credit operation include

- Economies of scale — A centralized credit office may lead to receiving fewer checks per customer, reducing the number of lockboxes and speeding up the receipt of payments.
- Functional expertise and reduction in training—A centralized credit function permits a company to develop a staff with depth and expertise in credit management while minimizing budget dollars that might be spent on travel to remote sites for training purposes.
- Consistency and control—Standardization of policies and procedures is more manageable in a centralized environment. This has the advantage of providing consistent credit decisions across all business lines and usually prevents satellite departments from having undue influence. (*page 3-5*)

3. List and discuss the benefits of a decentralized credit operation.

Benefits of a decentralized credit operation include

- Customer service and improved customer relations—With offices located closer to customers, a decentralized credit operation may be able to develop a better rapport with clients, provide improved response times and build stronger relationships due to physical proximity.
- Cooperation of business functions and better interdepartmental relationships—Being on site with other business functions promotes better understanding of shared goals and fosters the exchange of information about market and customer needs. It also enhances communications among departments and reduces the number of interdepartmental conflicts.
- Involvement in setting strategic priorities—Credit can integrate its objectives with those of sales and marketing into divisional goals. Also, decisions made at a local level can be implemented immediately without going through additional levels of review.
- More authority and accountability—The combination of increased business knowledge, flexibility to act and accountability gives the credit function an opportunity to be more timely and efficient in responding to customer needs and market conditions. (*page 3-5*)

4. What are some of management's responsibilities?

The functions of management may be divided into five main areas:

1. Planning.
2. Organizing.
3. Staffing.
4. Leadership.
5. Control. *(pages 3-5 – 3-6 for more detail)*

5. Give examples of various credit procedures.

See pages 3-7 – 3-8

6. What are the components of a job description?

Job descriptions are an essential part of hiring and managing employees. These written summaries ensure applicants and employees understand their roles and what they need to do to be held accountable.
Job descriptions also:

- Help attract the right job candidates.
- Describe the areas of an employee's job or position.
- Serve as a basis for outlining performance expectations, job training, job evaluation and career advancement.
- Provide a reference point for compensation decisions and unfair hiring practices. *(page 3-8)*

7. What are the special characteristics and abilities to look for when selecting personnel?

An individual may not possess the full qualifications listed below; however, the higher the position level, the more likely the credit professional will be able to:

- Determine appropriate methods of observing, organizing, analyzing and reporting data.
- Meet new situations and changing conditions with initiative, adaptability and ingenuity.
- Identify needs, unsatisfactory conditions and the causes of such conditions; handle unpleasant situations with tact, diplomacy and emotional stability.
- Analyze complex problems constructively and follow up difficult situations with
- resourcefulness.
- Make informed decisions and be willing to take considered risks for profitable company growth and development of sales potential.
- Direct the work of employees effectively, exercising considerate interest and fairness in dealing with people and communicating effectively and convincingly through speaking and writing.
- Handle customer and internal relations diplomatically and decisively when required.
- Acquire and maintain the required job knowledge, conduct affairs with integrity and persevere in eliciting confidential information. *(pages 3-9 – 3-10)*

8. What is the goal of a well-designed training program?

The primary objective of any training program is to provide employees with the opportunity to progress to whatever level of responsibility they can achieve. This requires programs for developing one's ability to think and to analyze and formulate workable solutions to problems. (*page 3-10*)

9. Name and describe some popular on-the-job training methods.

Vertical rotation (i.e., job shadowing or understudy assignments) and horizontal rotation (i.e., job rotation) are two popular forms of on-the-job training programs. In a vertical rotation, new employees often learn their jobs by serving under an executive as an observer or assistant to become familiar with the functions and areas of responsibility. A horizontal rotation establishes lateral transfers that enable employees to work at different jobs. (*page 3-11*)

10. Describe why continuing credit education is vital.

Such programs offer employees educational opportunities not provided by their company and enable those outside of the field to train for credit-related work. (*page 3-12*)

Chapter 4 — The Credit and Sales Partnership

1. What are the three Cs in the credit-sales relationship?

Communication, collaboration and cooperation. (*pages 4-3 – 4-6*)

2. How can the sales department assist in the collection of past due accounts?

The sales department can play an integral in the collection of past due accounts. In fact, in some companies the sales staff is the initial point of contact when an account is overdue. With companies that view payment/collection as part of the sales cycle, the sales staff may be expected to personally collect past due payments.

The sales staff may also share information about issues that have hampered the sales and delivery cycle—and have affected the payment schedule. It is incredibly important that the lines of communication between the credit and sales staff always remain open as each serves as the other's most reliable source of information. (*page 4 -10*)

3. Discuss what the sales department can reasonably expect from the credit department.

The credit department can help the sales department by

- offering neutral, open-minded investigations of all prospective and current customers
- monitoring established customers for changes in financial stability
- recommending when potential credit problems can be prevented or avoided with cautious credit terms and conditions
- working together to develop a successful collections approach that reduces risk and enhances customer relations.

The credit department can also identify flexible credit approaches that promote sales and acceptable loss levels and understand the balance between increased sales and acceptable loss levels. (*pages 4-11 – 4-12*)

4. Discuss what the credit department can reasonably expect from the sales department.

Given the need for cooperation between the credit and sales department, it is imperative that the sales department provides complete and accurate information about a given customer. Three key pieces of information are especially important: legal name, complete address and names of the corporate owners officers and registered agents.

The sales department is also well situated to educate new and prospective customers about its company's terms of sale and other conditions. Additionally, sales staff can help the credit department by clearly estimating what profit margin could be expected from a given prospect. Generally, a more substantial profit margin allows the credit department to take on a greater risk. (*pages 4-11 – 4-12*)

Chapter 5 —The Legal Forms of Business

1. Why does a credit professional need to be concerned with what form of business a debtor is?

A debtor's legal form of business can significantly affect creditors. For example, a creditor will want to know how a business, such as a partnership, will respond to the departure or death of a principal. Likewise, establishing legal liability for the debts of a business is a key factor. Certain types of organizations (corporations) can raise funds more easily than others. (*page 5-2*)

2. What factors does a credit professional need to consider when dealing with a proprietorship?

Factors include management, continuity, capital and liability. (*pages 5-2 – 5-3)*

3. Define the term PARTNERSHIP.

An association of two or more persons to carry on as co-owners of a business in order to share profits and losses. (*page 5-3*)

4. Describe the differences between a GENERAL PARTNERSHIP and LIMITED PARTNERSHIP.

In a general partnership, all partners are entitled to take an active part in the affairs of management unless otherwise amended by the partnership agreement. In a limited partnership, one or more general partners are joined by one or more limited partners. Unlike general partners, limited partners only risk the amount of their investment. In exchange for their limited liability, they are not involved in the management of the firm. (*page 5-4*)

5. Describe some basic characteristics of a LLP.

While a limited liability partnership (LLP) is similar to a limited liability company (LLC), it has been designed for professionals who do business as partners in a partnership. An LLP allows a partnership to continue as a pass-through tax entity while limiting the personal liability of each partner. (*pages 5-5 – 5-6*)

6. Define the term CORPORATION.

The classic definition of a corporation, attributed to U.S. Supreme Court Chief Justice John Marshall, is "an artificial being, invisible, intangible and existing only in contemplation of the law." A corporation may also be defined as a voluntary association of persons, natural or legal (including other corporations); organized under state or federal law and recognized by the law as being a person, fictitious in character, having a corporate name, and being entirely separate and distinct from the people who own it; having continuous life; and set up for some specified purpose or purposes. (*page 5-6*)

7. What is COMMON STOCK and what is PREFERRED STOCK?

Common stock represents the basic, and sometimes only, form of ownership in a corporation. By virtue of their status as owners, common stockholders participate in the selection of directors (through voting), share in the profits of the business if and when declared by the directors (dividends), and share in the distribution of assets should the corporation be dissolved. Additionally, in some cases common stockholders are protected by the preemptive right, which prevents the dilution of their equity without their consent.

Claims on the assets of preferred stockholders generally have a higher priority than those of common stockholders. In the event of liquidation, preferred stockholders are entitled to receive payment before distributions are made to common stockholders. Preferred shares are also normally issued with a fixed cash dividend schedule, but preferred stockholders have no, or very limited, voting rights. (*pages 5-8 – 5-9*)

8. To what extent do stockholders have liability for the debts of a corporation?

Stockholders have limited liability for the debts of the corporation—that is, their liability is restricted to the amount each stockholder has invested. (*pages 5-8 – 5-9*)

9. List the requirements of an S Corporation.

An S Corporation must have no more than 75 shareholders; only one class of stock; and shareholders must be U.S. citizens or residents, and must be persons. Corporate shareholders and partnerships are excluded; however, certain tax-exempt corporations, notably 501(c)(3) corporations, are permitted to be shareholders. (*pages 5-9 – 5-10*)

10. List the six characteristics of a "pure corporation."

In 25 CFR 301.7701-2(a)(1), the federal government outlined the following six characteristics of "pure corporations":

- Associates
- An objective to carry on business and to divide the gains there from
- Continuity of life "of the entity"
- Centralized management
- Limited liability
- Free transferability of assets (*page 5-11*)

11. How does an LLC differ from an S Corporation?

Unlike S Corporations, LLCs are not limited to a specific number of shareholders; do not restrict the type of individual who can hold an interest in the association or the amount of interest the association can hold in another corporation; and are not held to strict IRS provisions about their composition/classification. (*pages 5-11 – 5-13*)

12. Define the term JOINT VENTURE.

Also known as a syndicate, a joint venture is a combination of two or more persons (including corporations) formed to undertake a specific, and usually large, contract or project. Significant constructions jobs, public offerings or securities and complicated real estate transactions are often undertaken by joint ventures. (*page 5-15*)

13. Briefly discuss the relationship between a parent corporation and its subsidiary.

A corporation that owns more than 50 percent of the stock of another corporation is said to be the parent of its subsidiary. (*page 5-18*)

14. What is an OPERATING DIVISION?

An operating division is an internal arrangement of a corporation made for the convenience of its management. Since operating divisions do not affect the legal status of the corporation, there is no separation of credit liability. (*page 5-18*)

Chapter 6 —The Legal Environment of Credit

1. What is the purpose of U.S. antitrust law?

Around the turn of the 20th century, the United States began to enact antitrust legislation in response to the presence and damaging effects of monopolies that were negatively affecting smaller businesses. These post-industrial revolution monopolies successfully rearranged economic conditions for their own benefit through price fixing, restraint of trade and other forms of unfair trading practices. (*page 6-2*)

2. What is the Sherman Act designed to prevent?

As the first antitrust act passed in the U.S., the Sherman Act was designed to prevent monopolies and unfair restraints of trade. It basically worked to preserve the right of freedom of trade. (*page 6-2*)

3. What does the Robinson-Patman Act specifically forbid?

As a supplement to the Sherman Act, the Robinson-Patman Act forbids price discrimination where the effect of such price discrimination is to substantially reduce competition or to create a monopoly. This Act is of particular importance to credit professionals. (*pages 6-4 – 6-5*)

4. What types of business practices does the term price discrimination include?

The following business practices fall under the purview of the Robinson-Patman Act:

- Different prices charged to different purchasers
- Differences in terms and conditions of sale
- Preferential credit terms (*page 6-5*)

5. What is the purpose of the Fair Credit Reporting Act?

The FCRA requires consumer reporting agencies to adopt reasonable procedures for meeting the needs of consumer credit, personnel (employment), insurance and other information that is fair and equitable to consumers. It guarantees consumers the right to know all credit information that is maintained by credit bureaus and consumer reporting agencies and to be given a specific reason or reasons why they as consumers were denied credit. The Act was intended to apply only to consumer credit transactions and not to commercial credit transactions. (*pages 6-6 – 6-7*)

6. What is the purpose of the Equal Credit Opportunity Act?

The ECOA promotes the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status or age (provided the applicant has the capacity to contract); to the fact that all or part of the applicant's income derives from a public assistance program; or to the fact that the applicant has, in good faith, exercised any right under the Consumer Credit Protection Act. The regulation also requires creditors to notify applicants of action taken on their applications and to retain records of credit applications. (*page 6-8*)

7. The ECOA defines the term adverse action. List the four types of action that qualify as adverse under the ECOA.

- Refusal to grant credit
- Refusal to increase credit on an existing account
- Reduction of credit availability on an existing account
- Termination of credit on an existing account (*page 6-11*)

8. What is the purpose of the Dodd-Frank Wall Street Reform Act?

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Consumer Financial Protection Bureau (CFPB). While the CFPB's primary mission is related to consumer lending, its oversight applies to commercial lenders and trade creditors in limited instances. For example, the Dodd-Frank Act transferred rulemaking authority under both the ECOA and the Home Mortgage Disclosure Act to the CFPB. This

authority gives the CFPB responsibility for preparing fair lending reports to Congress and forcing compliance with law that requires lenders to report accurate data to credit reporting agencies. *(page 6-13)*

9. How does the Fair Debt Collection Practices Act affect the collection of a debt by a debt collector?

Under the provisions of the FDCPA, debt collectors must avoid practices such as

- Misrepresenting the character or amount of a debt
- Threatening to take action that is not intended to be taken
- Making repeated calls for the purpose of harassment
- Reporting a disputed debt to a credit bureau without disclosing that the debt is disputed (*pages 6-14 – 6-15*)

10. What is the purpose of the Truth in Lending Act?

TILA works toward protecting and educating consumers by ensuring that sellers of credit disclose certain information when offering credit. (*pages 6-15 – 6-16*)

11. List two provisions of the E-Sign Act.

Relevant provisions of the E-Sign Act include

1. Parties to the contract decide on the form of digital signature technology to validate the contract.
2. Businesses may use e-signatures on checks.
3. Businesses must require parties to the contract to make at least two clicks of a computer to complete a deal.
4. The consumer decides whether to use an e-signature or handwritten signature.
5. Cancellation and foreclosure notices must be sent on paper.
6. E-signatures on adoptions, wills, and product safety recalls are not allowed.
7. Records of e-contracts may be stored electronically. (*page 6-18*)

12. What are some advantages of e-signatures?

E-signatures make business on a domestic and international level faster and more efficient. They benefit both businesses and consumers from a legal standpoint, as well as reduce administrative work associated with printing, signing and rescanning a document in order to send it electronically. *(page 6-17 – 6-18)*

13. Define UNCLAIMED PROPERTY.

Tangible or intangible property owed to a person or entity (i.e., “owner”), yet held by another (i.e., “holder”). (*page 6-19)*)

14. If a holder determines it has unclaimed property, what due diligence is required?

Due diligence represents one last effort by the holder to reunite property with the owner prior to reporting it to the state. In most cases, attempting to locate a missing owner generally requires that the holder mail a first-class letter to the owner’s last known address. (*pages 6-21 – 6-22*)

15. Why is it important to properly report and remit unclaimed property?

The majority of states will generally relieve from liability and indemnify a holder that has reported and remitted property in “good faith.” It is important that holders follow the jurisdictional priority rules for determining the appropriate state. A failure to report and remit property to the correct jurisdiction may result in imposition of noncompliance penalties and interest. (*pages 6-19 – 6-22*)

16. Why did Congress enact the Sarbanes-Oxley Act of 2002?

Primarily in reaction to the fraud-ridden bankruptcies that characterized the U.S. economy during the early 2000s. The Sarbanes-Oxley Act was drafted and enacted to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes. (*page 6-23 – 6-24*)

17. What is the Red Flags rule?

As of November 2007, the Fair and Accurate Credit Transactions Act (FACTA) requires financial institutions and credit managers to develop and implement identity theft programs. Red Flags are any potential risks that could arise in terms of identity theft.

- As a business, it is important to:
  - Do a risk assessment to identify relevant red flags
  - Detect red flags
  - Respond appropriately to red flags to mitigate risks of identity theft
  - Update the written program periodically to reflect changes in risks to consumers or to business from identity theft
  - Have oversight dedicated to a company's Red Flags program *(pages 6-25 – 6-27)*

Chapter 7 — The Uniform Commercial Code

1. Article 2 applies to which kind of transactions?

Broadly speaking, Article 2 of the Uniform Commercial Code applies to sales transactions in goods. (*page 7-2*)

2. Under Article 2, what rule applies to sales worth more than $500?

Under Article 2, a contract for the sale of goods for the price of $5,000 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties. (*pages 7-2 – 7-3*)

3. Why does Article 2 distinguish between a merchant and casual or inexperienced sellers?

By establishing this distinction between merchants and casual/inexperienced sellers, the UCC recognizes that more reliance can be expected of professional sellers—thereby holding them to a higher standard. (*page 7-3*)

4. Within UCC Article 2, every contract has an obligation of good faith or honesty in the transaction concerned. Why is this an important concept?

Under this concept, courts have a right to refuse to enforce an unconscionable clause or contract. (*page 7-3*)

5. What does TENDER DELIVERY mean?

The seller must make the goods available to the buyer. (*page 7-3*)

6. What options does a buyer have if goods delivered by the seller do not conform to the contract?

The buyer can (1) reject all of the goods, (2) accept all of them or (3) accept any commercial units and reject the rest. (*pages 7-3 – 7-4*)

7. If a buyer refuses to accept goods that conform to the contract, how can the seller determine the damages for which the buyer is liable because of the breach of contract?

The seller has two ways of determining the damages that the buyer is liable for because of the buyer's breach of contract: (1) the difference between the contract price and the market price at which the goods are currently selling, or (2) the profit the seller lost when the buyer did not go through with the contract. (*pages 7-3 – 7-4*)

8. What does the general title section of the UCC state?

This UCC section provides that title passes to the buyer when the seller has completely performed his/her duties concerning physical delivery of the goods. Therefore, if the contract only requires the seller to ship the goods, then title passes to the buyer when the seller delivers the goods to the carrier. If the contract requires delivery of the goods by the seller, then title passes to the buyer when the goods are delivered and tendered to the buyer. If delivery is made without moving the goods, the title passes at the time and place of contracting, if the goods have been identified in the contract. (*page 7-4*)

9. List three conditions that relate to risk of loss.

Under the UCC, risk of loss depends on the terms of the agreement, the moment the loss occurs and whether one of the parties was in breach of contract when the risk of loss occurred. (*pages 7-4 – 7-5*)

10. What is a SHIPMENT CONTRACT?

Four types of commonly used shipping terms—FOB, FAS, CIF and C&F—create shipment contracts, whereby the seller turns the goods over to a carrier for delivery to the buyer. Under a shipment contract, both title and risk of loss pass to the buyer when the goods are given to the carrier. (*pages 7-4 – 7-5*)

11. What is a DESTINATION CONTRACT?

Three types of commonly used shipping terms—FOB Destination, Ex-Ship and No Arrival, No Sale—create destination contracts, whereby the seller bears the risk and expense of delivery to a specific destination, as defined by the contract. (*page 7-4 – 7-5*)

12. What does reclamation mean under Article 2?

The seller has the right to require the buyer to return any goods the insolvent buyer obtained from the seller within the previous 10 days. Under the UCC, the seller must demand the return of merchandise from an insolvent buyer within 10 days of the receipt of the shipment. Insolvency under the UCC is defined to include the so-called equity rule (inability to pay debts as they mature) as well as the bankruptcy definition (liabilities exceeding assets). (*page 7-5*)

13. Define the term WARRANTY.

A warranty is a contractual promise by the seller regarding the quality, character or suitability of the goods sold. (*pages 7-6 – 7-7*)

14. What is an EXPRESS WARRANTY?

An express warranty is an oral or written statement, promise or other representation about the quality of a product. Examples include s statement of fact or promise made by the seller to the buyer that relates to the goods; a description of the goods that is made part of the basis of the agreement that the goods will conform to the description; and a sample or model of the goods. (*pages 7-6 – 7-7*)

15. What is an IMPLIED WARRANTY?

An implied warranty is imposed by the law rather than by statements, descriptions or samples given by the seller. Such warranties are designed to promote high standards in business and to discourage underhanded dealings. The four basic types are an implied warranty of merchantability; an implied warranty of fitness for a particular purpose; an implied warranty that is derived from a course of dealing or usage of trade; and an implied warranty of title (if item is owned). (*pages 7-6 – 7-7*)

16. When is a lease contract enforceable?

A lease contract is enforceable if the total payments to be made, excluding payment for options to renew or buy, are less than $1,000 or if there is a written agreement. A lease is also enforceable under three additional scenarios: if the goods are to be specifically manufactured or maintained for the lessee and are not suitable for lease or sale to others in the ordinary course of business; if a party admits that the lease was made; or if the goods have been received and accepted by the lessee. (*pages 7-7 – 7-8*)

17. What is the general concept behind Article 6?

Article 6: Bulk Sales was drafted to protect creditors from the practice of bulk transfers. Such transfers take place when an indebted merchant sells out its entire inventory for less than what it's worth. By doing so, a merchant limits a creditor's ability to "reach back" and sell those goods to cover unpaid debts. (*pages 7-8 – 7-9*)

18. Under UCC Article 6, four requirements must be followed whenever a bulk transfer is made. What are they?

1. The buyer/transferee must require the transferor/seller to furnish a list of any existing creditors with their addresses and amounts owing.
2. The parties must prepare a schedule of the property being transferred so that it can be identified.
3. The buyer/transferee must maintain or preserve the list and schedule for six months following the transfer and make it available for inspection.
4. The buyer/transferee must give notice of the transfer to all creditors from 10 to 45 days (depending on state law) before taking possession of the goods or paying for them, whichever happens first.

Under Revised Article 6, the seller must prepare a schedule of distribution of proceeds for all creditors, which provides the creditors and transferee with details about the disposition of the proceeds of the sale. (*pages 7-8 – 7-9*)

19. Under UCC Article 9, what is a SECURED TRANSACTION?

A transaction is known as a secured transaction whenever the payment of a debt is guaranteed, or secured, by personal property owned by the debtor or in which the debtor has a legal interest. (*page 7-9*)

20. What is a SECURITY INTEREST?

A security interest is the interest in the collateral (personal property, accounts, etc.) that secures payment or performance of an obligation [UCC 1-201(37)]. (*page 7-9*)

21. What transactions are excepted from Article 9?

If the transaction involves a security interest or lien on real estate, aircraft and certain vessels, wages, certain types of insurance claims that are not proceeds of UCC collateral or consumer tort claims, the UCC does not apply. Motor vehicles present a special problem since creation of a security interest may be subject to the UCC, but perfection is subject to other law. (*pages 7-10 – 7-11*)

22. List the six categories of collateral.

Accounts and general intangibles; deposit accounts; goods, such as inventory and equipment; instruments; investment property, such as securities and brokerage accounts; and chattel paper (any writing evidencing a debt secured by personal property). (*page 7-11*)

23. List the items covered under Article 9's definition of account.

Under Article 9, accounts include the right to payment arising from the sale, lease, license and other disposition of all types of tangible and intangible property. More specifically, accounts may be

- Fees and royalties payable under intellectual property licenses, such as patent, trademark and copyright licenses, the right to lottery winnings, the right to payment under an installment real estate sales contract and manufacturers rebates.
- Credit card receivables.
- Healthcare insurance receivables owing to healthcare providers. They are interests in claims under a policy of insurance evidencing a right to payment of money for providing healthcare goods and services. (*pages 7-11 – 7-12*)

24. Why is determining primary use or purpose critical?

Determining primary use or purpose is a critical factor when it comes to certain types of collateral. In some cases, goods may be classified in several subcategories depending upon their primary use by the debtor. Consequently, secured parties may face situations where a particular good is held by different individuals for different purposes or uses and, thus, falls into different classes of collateral. These differences affect the applicability and effectiveness of a security agreement. (*pages 7-12 – 7-13*)

25. What requirements must be satisfied for the creation of a security interest?

A creditor must satisfy all of the following requirements for the creation of a security agreement:

- the creditor provided value to the debtor;
- the debtor has rights in the collateral and the power to transfer such rights to the secured party; and
- there is a valid security agreement that describes the collateral in which the creditor is granted a security interest. (*pages 7-13 – 7-24*)

26. What is a SECURITY AGREEMENT?

A security agreement creates or provides for a security interest. In order to be valid, a security agreement must contain a sufficient description of the collateral and be authenticated by the debtor. (*pages 7-13 – 7-14*)

27. What does a security agreement establish?

A security agreement establishes a security interest in personal property granted by the debtor to secure repayment of a debt. (*pages 7-13 – 7-14*)

28. At a minimum, a security agreement should contain four essential elements. What are they?

- Identification of parties
- Granting clause

- Collateral description
- Debtor's warranties, covenants and agreements (*page 7-14*)

29. What is PERFECTION?

Perfection is the process of taking the legal steps necessary to ensure that a secured party's interest in collateral will withstand attack by competing secured creditors, judgment lien creditors and a bankruptcy trustee. (*pages 7-14 - 7-15*)

30. Explain what is meant by the term PERFECTION BY POSSESSION.

Under this form of perfection, the secured party takes physical possession of tangible collateral. The courts have held generally that if a secured party has exclusive control of, access to or the use of the collateral, then it has possession of it. (*pages 7-15 – 7-6*)

31. Explain what is meant by the term PERFECTION BY CONTROL.

Under this form of perfection, the secured party may not be in physical possession of the collateral but is still able to exercise a sufficient amount of power over the collateral to control it. (*page 7-16*)

32. Explain what is meant by the term PERFECTION BY FILING.

The most common method of perfecting a security interest under the UCC is through the filing of a **UCC financing statement.** A writing that meets all of the statutory requirements for a qualified financing statement must be filed with the proper authorities. The security interest must be continued to extend the validity of the perfection beyond the five-year period usually allowed. Article 9 contains the rules governing perfection by filing a UCC financing statement. These rules are designed to simplify procedures for UCC filings, reduce the cost of compliance by UCC filing and reduce the risk of inadvertent errors. *(page 7-16)*

33. List three elements that should be included in a UCC financing statement.

- Name of debtor
- Name of secured party or its representative
- Description of collateral (*page 7-17*)

34. As a general rule, how long is a filing valid?

Under Article 9, a UCC financing statement is effective for five years after that date of filing the original UCC. Unless a continuation is timely filed, the perfected security interest lapses the day after the fifth anniversary of the original filing. (*pages 7-17 and 7-20*)

35. How is PRIORITY established? Give two examples.

Article 9's long-standing rule is that the first secured party to file a UCC financing statement or otherwise perfect its security interest has priority over competing secured parties. However, there is an exception for certain categories of collateral: A later perfection by possession or control of the collateral has priority over an earlier perfection by UCC filing.

For example, a security interest in an instrument that is perfected by possession has priority over a competing security interest that was previously perfected by a UCC filing. A security interest in tangible chattel paper that is perfected by possession also has priority over a competing security interest perfected by an earlier UCC filing, unless the latter security interest is legended on the chattel paper. And a security interest in either electronic chattel paper or investment property, perfected by control, has priority over a competing security interest that is perfected by an earlier UCC filing. (*page 7-22*)

36. How is a PURCHASE MONEY SECURITY INTEREST established?

To obtain a purchase money security interest in collateral (not including livestock and inventory), such as a purchase money security interest in equipment, a secured party must have the debtor execute a security agreement containing the appropriate granting language in the collateral and file a UCC financing statement in the appropriate jurisdiction within 20 days after the debtor receives possession of the collateral. (*page 7-23*)

37. What is CONSIGNMENT?

Under Article 9 of the UCC, a consignment is defined as a delivery of goods having a value of at least $1,000 to a merchant provided that

- the transaction does not create a security interest;
- the goods are not consumer goods immediately before delivery; and
- the merchant deals in goods of that kind under a name other than that of the consignor, is not an auctioneer and is not generally known by its creditors to be engaged substantially in selling the goods of others. (*page 7-25)*

38. List at least five "events of default."

A secured party should define default in such a way as to address the most likely reasons to foreclose. Examples include:

1. The debtor's failure to make any payment when due
2. The debtor's failure to satisfactorily insure the collateral
3. The debtor's refusal to allow an inspection of the collateral within a reasonable time after a request for inspection by the secured party
4. The debtor's failure to pay taxes on the collateral when due
5. The debtor's removal of the collateral permanently from the agreed location without written approval of the secured party (*pages 7-27 – 7-28*)

39. What is a secured party entitled to under collection rights?

The secured party may request direct payment from the account debtor/obligor; may compel the performance of other obligations (including enforcing warranties); and may receive and apply funds in its deposit account as a means to reduce its claim against the debtor. (*page 7-28*)

Chapter 8 — Credit Policy and Procedures

1. What is a POLICY?

A policy is a general course of action developed for recurring situations and designed to achieve established objectives. For credit professionals, a policy is a general statement that guides the credit decision-making process. (*page 8-2*)

2. What is the difference between an implied and a stated credit policy?

There are two ways a policy can be disseminated: implied or written. An implied credit policy exists, but it is not officially stated (or written). It has little or no official expression of approval and can be difficult to perceive and, therefore, be left to interpretation. By definition, the understanding of unwritten policy depends on oral communication or on inference from the decisions made by senior credit personnel. A stated credit policy is set forth in writing and usually has the support and approval of senior management. As the policy is available to everyone in the same form, there are usually fewer misunderstandings. A stated policy indicates a basic honesty and integrity in intention. It generates confidence and stability and serves as a good training tool. *(pages 8-2 – 8-3)*

3. What is a PROCEDURE?

A credit procedure describes the actual working steps that should be followed in the appropriate order to accomplish the desired credit result or decision. (*page 8-3*)

4. What are the four elements of a credit policy?

1. *Establishing the credit standard.* This component describes the profile for an acceptable credit customer, including appropriate details and examples.
2. *Determining credit availability*. This component describes how the maximum amount of available credit is computed and managed, including decision criteria for reducing or increasing a customer's availability of credit.
3. *Setting credit terms*. This component stipulates the exact terms of sale for each class of customer.
4. *Defining collection policy.* This component provides criteria for regular collections and exception collection procedures for past due amounts. (*pages 8-3 - 8-4*)

5. What questions build the foundational components of a credit policy?

- *What is the credit department's mission?* This can also be called a vision or purpose. It states the overall objective for the credit function.
- *What are the goals?* Goals can be specifically stated, such as a quantifiable measure, or more generally as an expressed desire to achieve improvement in a specific area.
- *What are the roles and specific authorities of the credit management and staff?* This defines the boundaries of the credit function, often in terms of interactions with other departments.
- *What are the primary criteria for evaluating customer credit?* This describes credit procedures in more detail, listing key aspects of the credit review and analysis processes.
- *What are the normal collection procedures?* This describes the steps to be taken in customer collection activities.
- *What are the company's terms of sale?* Terms should be spelled out by major product line, with any qualifications or restrictions included. (*pages 8-5 – 8-6*)

6. What credit procedures are used in evaluating credit?

Credit decisions should be based primarily on the credit applicant's willingness to pay, as evidenced by its payment history, and on its ability to pay, as evidenced by its financial situation. Other factors relating to the applicant, such as its legal form and the industry in which it operates, plus years in existence, should also be considered. After evaluating the information, however, the decision to offer or refuse credit to a customer is often at the credit

manager's discretion. The 5 Cs of Credit are the basic components of credit evaluation. *See pages 8-8 – 8-9 for a detailed description.*

7. What credit procedures are used for credit approval and administration?

- Terms of Sale. A complete list of the terms offered by the company and a brief explanation of how they are used.
- Terms Codes. Terms of sale can be coded to facilitate processing of information and the code should be shown on all sales orders and invoices. The procedure for administering the codes should be described, including the treatment of multiple codes and exceptions.
- Credit Instructions. Daily routines used to process all orders in accordance with prescribed credit lines and terms. Forms should be shown wherever used.
- Credit Recommendations. Organizations using referral limits that recommend credit for approval to a higher level should include the recommendation form.
- Credit Files. List of information that must be kept up to date, such as current credit agency reports, credit recommendations and financial statements. *(page 8-21)*

8. What credit procedures are used for collections?

- Normal Procedures. Each account is a separate collection problem. Placing it into a category by size or type assists in determining the intensity of collection effort required. Several means for collection follow-up are letter, email, phone, personal visit and joint credit and sales action. Copies of the series of form collection letters should be included.
- Collection Schedule. Collections should use a definite schedule that will provide for systematic review. Details should be described.
- Lockbox System. Descriptions, such as bank procedures and company guidelines for returned check processing, and other tasks, should be included.
- Advance Payments. Procedures for handling these items should be described.
- Customer Deductions. Copies of typical correspondence and departmental guidelines should be included.
- Note Arrangements. Copies of the notes used by the company should be included. In addition, important points in preparing notes should be included, such as correct maturity date, correct interest rate and correct signature.
- Account Referral. If normal collection procedures fail to net the necessary results, the account should be placed with an attorney or collection agency. Typical documentation should be included as exhibits.
- Creditors' Extension Agreements. As a major creditor, a company can initiate or join in a creditors' extension agreement to permit a debtor to set aside existing debt under an established plan. Standard documentation should be included.
- Bankruptcy Proceedings. Standard documentation and procedural guidelines should be included.
- Allowance for Uncollectibles and Write-offs. Guidelines for reporting and handling these items should be discussed. *(pages 8-21 – 8-22)*

Chapter 9 – Credit Applications

1. What information should be required on a credit application?

Information in the credit application should include: date of application, applicant's complete legal name, address and information including mailing address, physical address, P.O. Box, telephone number, fax, email, website, FEIN, accounts payable contact information, years in business, amount of credit requested, lease or own, sales tax exemption, type of business, and NAICS code. *(see pages 9-3 – 9-7)*

2. Why is it important to have the correct legal name of a credit applicant?

Determining the correct legal name of an applicant ensures that the credit application truly functions as a contract and is legally binding. If it becomes necessary to go to court, bringing action against the correct person or entity is required. If the name of the entity is not correct, the case will be dismissed for lack of proper name. (page 9-3)

3. What is an NAICS code?

North American Industry Classification System (NAICS) code identifies their product or service and industry. (page 9-6)

4. Where can one check the legal status of a public corporation?

A credit department can easily check the legal status of a company with the Secretary of State's office or corporation commission, which is usually located in the state capitol complex. Each state office has a corporation information center, which can verify the following: whether a company is, in fact, a corporation, its status (active, inactive or suspended), its full legal name, the date of incorporation, the name of the resident agent and, in some states, the names and addresses of corporate officers and directors. (page 9-8)

5. What security is needed to protect the confidentiality of customer information?

The security requirements include:

- Encryption of all transmitted records and files containing personal information that will travel across public networks, and encryption of all data containing personal information to be transmitted wirelessly.
- Encryption of all personal information stored on laptops or other portable devices.
- Additional system security requirements are secure user authentication, secure access control, reasonable monitoring to detect unauthorized access, reasonably up-to-date firewall protection, reasonably up-to-date security software (including current patches and virus definitions), and education and training of employees. (page 9-9)

6. Why do terms of sale have to be set forth in writing in a credit application?

If a credit application sets forth and otherwise defines the terms and conditions upon which the parties will do business, then once signed the credit application is legally binding, including all information outlined within the agreement. *(9-13)*

7. Why is it important to specify venue in the credit application?

The intent of including this provision on the credit application is to keep any litigation in the credit grantor's location; the venue provision affords the creditor that right. Without this provision, the credit grantor could be required to travel to the venue (customer's location) to bring suit or to defend a lawsuit. *(page 9-14)*

8. Whose signature is needed on the credit application?

An officer or principal of the company applying for credit does not necessarily have to sign the credit application agreement. If there is an authorized representative to sign such documents, then that signer can legally bind the company even if the signer is not an officer or executive of the company. *(page 9-15)*

9. In a shipment contract, when do title and risk of loss pass to the buyer?

In a common shipment contract, both title and risk of loss pass to the buyer when the goods are given to the carrier. The seller has no responsibility for seeing that the goods reach their destination. There are, however, other scenarios further defined under Incoterms. (page 9-16)

10. When should ADR be considered? How does it differ from mediation?

Consider language in the credit application that provides for binding arbitration or mediation should a dispute arise. Mediation or arbitration usually can be set in a matter of days with an arbitrator or mediator experienced in collection or business disputes. Conversely, a hearing or trial by jury could take months or years to be heard by a judge. Arbitration is binding and eliminates litigation or trial by jury whereas mediation is not binding and does not circumvent litigation if either party is not satisfied with the mediator's decision. The decision to add an arbitration or mediation provision in a credit agreement is one that should be made after careful deliberation with management and counsel, to ensure that all appropriate factors are considered. (page 9-22)

11. What are the essential elements of a personal guarantee?

Such elements include the following:

1. It should be termed a "payment guarantee" as opposed to a "performance guarantee." This means that the guarantor agrees to pay the creditor and not perform on a contract.
2. It should be "absolute and unconditional," meaning there is no mistake and that the creditor is not required to fulfill some condition in advance of demanding payment under the guarantee.
3. It should be a "continuing" guarantee. That is, the guarantee continues in force as long as debt exists.
4. It should be "irrevocable," which means the guarantor cannot avoid, or otherwise destroy, the efficacy of the guarantee without written notice to the credit grantor and acceptance by the creditor of the revocation. *(pages 9-26 – 9-27)*

12. What is contained in the ECOA regulations?

Notice: The Federal Equal Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has, in good faith, exercised any right under the Consumer Credit Protection Act. The federal agency that administers compliance with the law concerning this credit is the Federal Trade Commission, Division of Credit Practices, 6th Street and Pennsylvania Avenue, NW, Washington, D.C. 20580. (page 9-28)

Chapter 10 — Terms and Conditions of Sale

1. How does the Robinson-Patman Act apply to terms of sale?

It is important to remember that terms are considered to be an aspect of price; therefore, offering different terms to different customers may violate antitrust laws such as the Robinson-Patman Act. (*page 10-2*)

2. What factors influence credit terms? Provide an explanation for each factor.

Competition (terms are sometimes affected by an industry standard that minimizes competitive aspects); market and product characteristics (perishable items, for instance, have shorter terms of sale); type of customer (different terms for different classes of customers—retail, wholesale and institutional, for example); and profitability (products with higher profit margins may allow for longer terms) are factors that influence terms of sale. (*pages 10-3 – 10-4*)

3. What are the categories of credit terms?

Terms of sale can be separated into three different categories: cash, open and special. (page 10-4)

4. What are PREPAYMENT TERMS?

Prepayment terms are basically cash terms (or closed terms). Payment is received before the transaction or at the time of the transaction. (*page 10-4*)

5. List four types of prepayment terms.

Cash in Advance (CIA), Cash Before Delivery (CBD), Cash with Order (CWO) and Cash on Delivery (COD). (*page 10-5*)

6. What are types of DISCOUNT TERMS?

Discount terms establish specific parameters for a cash discount calculated from the invoice amount if the customer pays with a given period of time (discount period). (*pages 152–153*)

- 8% 10 EOM—An 8% discount is earned if payment is made by the 10th of the month following shipment. If paid later, the discount is forfeited and the invoice is also past due.
- 8% 10th Prox—Similar to 8% 10 EOM.
- 2% 10 MOM—Shipments made from the 1st through the 15th of a given month are due on the 25th of the month; those made from the 16th through the end of the month are due on the 10th of the following month, with the credit period being the same as the discount period.
- 2% 10th Prox, net 30th—A 2% discount is earned if payment is made by the 10th of the month following shipment. The full, undiscounted amount is due by the 30th of the month following shipment. (*pages 10-8 – 10-9*)

12. What are RECEIPT-OF-GOODS TERMS?

Such terms allow the buyer to compute the cash discount period or net credit period from the date the merchandise is received rather than from the invoice date. (*page 10-17*)

13. What is a CONSIGNMENT TERM?

As an alternative to open account sales, consignment terms involve a third party to whom the buyer (consignee) actually sells the goods. Until the goods are sold, title remains with the supplier/manufacturer (known as the consignor). Payment is not due to the consignor until the goods are sold or so moved. Consignment terms usually involve expensive and/or slow-moving inventory such as fine jewelry. (*pages 10-17 - 10-18*)

14. What is FLOOR-PLAN FINANCING?

Floor-plan financing involves an inventory financing company (known as the floor-plan creditor) that has contractual arrangements with both the supplier/seller and the buyer. In some cases, the seller can serve as the financing company. UCC security agreements are often used with this form of financing. (*page 10-18*)

15. What are EXTRA DATING ARRANGEMENTS?

Extra dating terms can be used to extend the net period and/or the discount period. (*pages 10-18 – 10-19)*

16. What are SEASONAL DATING TERMS?

Seasonal dating terms are used when there is a high seasonal demand for a product and sellers wish to encourage off-season purchases. Seasonal terms postpone payments to coincide with the buyers' heavy selling seasons. Such terms are common in the toy and agricultural industries. (*page 10-19*)

17. What is a PRO FORMA INVOICE?

A pro forma invoice is an abbreviated invoice that is sent in advance of a shipment and is widely used in export trading. (*page 10-20*)

Chapter 11—Credit Investigations

1. What are the three core principles that should be followed when exchanging business credit information in industry credit group meetings or other settings?

Antitrust, anti-defamation and confidentiality are the core principles for exchanging business credit information in industry credit group meetings or any setting—whether among two or 200, in a formal meeting or office, or in a parking lot or restaurant. These principles must also be adhered to in conversations among business credit grantors by phone, fax or electronically. *(page 11-2)*

2. What types of behavior constitute antitrust when exchanging business credit information?

Antitrust concerns a credit grantor must consider when inquiring or disseminating information about a customer's credit history, payment pattern, etc. In the context of information exchanged among commercial/business credit grantors, the primary objective is to avoid violating various antitrust laws. The intent of these antitrust regulations is to avoid any behavior that could lead to conspiracy, restraint of trade, price setting or fixing, or boycotting certain customers or suppliers. At the same time, the regulations also attempt to allow for the free-flow of credit information in a very specific manner so that creditors and competitors can avoid fraud, including the non-payment of an outstanding debt. U.S. antitrust laws are designed to give creditors the right to ask and find out how a customer or potential customer meets its obligations. The credit grantors who exchange such information must do so in a manner consistent with these laws. *(see pages 11-3 – 11-4)*

3. Explain the terms LIBEL, SLANDER and matter libelous per se, providing an example of each as it pertains to credit management.

Defamation is a false statement made to others that injures the name or reputation of a third party. The two types of defamation are libel and slander. Libel is defamation in some permanent form, such as printed media or writing in any form, including electronically-generated emails, computer files, folders or documentation. Slander is defamation in a temporary form, such as speech.

Generally, matter libelous per se is any communication that falsely suggests a criminal act or immorality, or which tends to deprive a person in business of public confidence and esteem. *(pages 11-4 – 11-6)*

4. Define direct credit investigation.

Direct investigation occurs when the creditor collects credit information either through direct contact with the customer or through direct contact with noncommercial sources of information such as competitors, banks and other trade references that may have relevant details to share. (page 11-8)

5. Explain the benefits of visiting a customer.

The benefits of customer visits by credit department representatives include:

- Developing and enhancing the customer relationship.
- Strengthening the relationship with the sales department.
- Observing customer facilities (the inventory, condition of the equipment, the plant, the location and attractiveness of retail operations, etc.).
- Discussing financial information in more depth.
- Reviewing financial information that might otherwise be unavailable.
- Observing how other suppliers' products are being used.

- Developing connections between various internal company functions and the customer's counterparts (i.e., logistics departments, advertising departments, etc.).
- Resolving disputes.
- Sharing best practices.
- Discussing account status and collection of payments. *(pages 11-8 – 11-9)*

6. What questions can a credit manager ask a customer during a visit?

Possible questions are, but not limited, to:

1. What is their corporate structure?: Is it a corporation, partnership, LLC, LLP or proprietorship?
2. Do they have affiliated companies? If so, what is their relationship to the company being investigated (vertical: supplier or end-user; horizontal: differentiated by product type or geography, etc.)?
3. What is their product cycle, from ordering to shipment of raw materials to finished product to receipt of cash? What is the impact of seasonality on their business?
4. What are their inventory policies? Are there markdown procedures in place, or other plans to relieve slow-moving stock? What is the size of order backlogs?
5. Who are the principal customers of the company being investigated? How would their creditworthiness be described?
6. What terms of sale do they offer to their customers? What is the payment performance of their customers?
7. What is their market share? What is their product niche? Who is their competition, their advantages or disadvantages (price/quality/delivery), and their relative market shares?
8. Are there plans for expansion, new product developments or curtailments of unsuccessful lines? How will any expansion be financed? How will overhead be eliminated or absorbed if unsuccessful lines are curtailed? Are the facilities owned or leased? If leased, what are the expense implications if facilities are closed? Are the plans realistic? *(page 11-9)*

7. What key factors should be observed during a customer visit?

When visiting a customer's facilities:

- Observe the impact of competition in terms of product use, amount on hand, etc. Try to ensure that you are not misled by what you observe. If there is a large backlog, what factors are involved (heavy buying in advance of season, poor acceptance of the suppliers' product, spot buying due to advantageous pricing, purchase of supplier's product due to credit problem, etc.)?
- Observe what other suppliers are present in the on-hand inventory. This may provide reference information that can be used for follow-up after the visit.
- Observe the efficiency of customer logistics. Is the facility located advantageously to customer locations and supply routes?
- Observe the traffic flow of employees' work areas, receiving and shipping facilities.
- Observe manufacturing efficiency and productivity. Look for signs of excess capacity.
- Are they busy? Depending on the industry, be aware of the kind of activity that should be taking place.
- Does employee morale seem high or low? If possible, ask employees to describe their functions in the organization.
- What is the condition of equipment and other fixed assets?
- Are there plans to relocate any facilities?
- Include the salesperson in the visit to help explain the facility and add their interpretation. Ask the salesperson to compare this operation to competitors' facilities. *(pages 11-10 - 11-11)*

8. What are some important steps in the follow-up process?

Once the customer visit is completed, it is important to make immediate notes about the meeting's discussions, decisions and outcomes, etc. These reports may be referred to as: trip reports, call reports, meeting minutes or customer memos. The documentation of these meetings should be kept in the customer file and may first be circulated among the internal meeting participants or reviewed with company management. Observations made about the facilities, financial information discussed and questions specific to the customer's business should be clearly noted in the documentation. (page 11-14)

9. When contacting a bank for information about a potential account, what questions should be asked?

Useful questions include

- How long has the bank had the account?
- What are the average balances?
- Have there been returned checks?
- Have any loans been granted?
- When, why and how often does the account borrow?
- Are loans guaranteed?
- How would the bank rate the customer? (*pages 268–269*)

10. If a bank reports that an account balance is in the medium four-figure range, what is the numeric balance range for this account?

a. Nominal—under $100
b. 3 figures—from $101 to $999
c. 4 figures—from $1,000 to $9,999
d. 5 figures—from $10,000 to $99,999
e. 6 figures—from $100,000 to $999,999 (*page 269*)

11. Provide the numeric figure ranges for the following dollar ranges:

a. Nominal—under $100
b. 5 figures—from $10,000 to $99,999

12. In addition to trade references and banks, what sources are available when conducting a direct investigation?

Other sources of direct investigation include: county and state government offices, bankruptcy court information, internet, and the customers website. (pages 11-17 – 11-18)

13. What sources are available when conducting an indirect investigation?

Sources include: industry credit groups and commercial (business) credit reporting agencies. *(page 11-18 – 11-26*

14. What are the types of commercial credit reporting agencies?

There are general credit reporting agencies, specialized credit reporting agencies, and aggregating credit reporting agencies. *(page 11-20)*

15. What sources are available when conducting an international investigation?

Sources include: customer-supplied information, bank information, exporter's foreign sales representatives, international credit reporting agencies, FCIB, OECD. *(pages 11-27 – 11-28)*

16. When should existing accounts be reviewed?

Existing accounts should be reviewed periodically and under special events. *(pages 11-28 – 11-29)*

17. How can customer relations strengthened?

Customer relations can be strengthened through written communication, through periodic requests for financial statements, through revision of credit availability, and through sales reps. *(pages 11-29 – 11-30)*

Chapter 12—Business Credit Fraud

1. List four basic questions that can be asked about a credit reference to protect against business credit fraud.

- Are the references unknown?
- Do some or all of the references sound vaguely familiar to known businesses?
- Do the references have an ostentatious sounding name like "World-Wide," "International" or "National"?
- Are most of the references in the same general geographic area as the prospective customer? (*pages 12-3 – 12-4)*

2. Explain how an unusually large number of credit reference requests may indicate a possible business credit fraud?

A creditor should be wary of an unusually large number of credit references. In this situation, a scam artist may be attempting to use the creditor as a reference for more significant orders from other businesses. What may constitute a "large" number of inquiries for one creditor will not for another creditor. Anything that strays from a creditor's "routine" number should be a red flag of sorts. (*page 12-4*)

3. Why can a sudden increase in orders or an unusual product mix be an indicator of a business credit fraud?

Both can be signs that a potential "bust-out" is under way. Be aware of situations where a customer places an order for a product that it normally would not use (i.e., a single restaurant ordering 12 copiers). Also potentially significant is the regular customer that places an order for a mix of products that does not quite make sense (i.e., six of every item offered). (*page 12-5*)

4. Describe why a change in ownership, unverifiable background of principals, hidden ownership and unavailable principals need further investigation and may be warning signs of fraud.
See pages (12-6 – 12-9)

5. List some warning signs of a bad check.

- Check numbers do not change
- Checks do not have perforated sides
- Checks drawn on new accounts
- Checks with no account or routing number
- Checks that smudge when rubbed with a moist fingertip
- Inverted watermark on paper
- Slightly raised rather than flat numbers
- Printed on low quality paper
- Misspelled words
- Poor printing quality
- Checks presented near the end of the business day by customers who seem unwilling to wait until the next business day for their order
- Checks received from customers whose accounts are themselves suspect
- Normal checks presented to honor a previously submitted bad check
- Irregular signatures, such as those with an interruption or gap where the pen has lifted off the paper completely. Ask the signer to write his signature again if possible. Beware of those who seem to be unusually careful and slow as they sign.
- First four digits of routing code are not valid
- District in routing code does not match District in transit number
- Bank identification number in routing code does not match bank identification number in transit code

- Check identification in optical scan numbers at bottom of check does not match check number on face of the check (*pages 12-9 – 12-10*)

6. Why is it important to keep an eye on a customer's assets and make sure they are not improperly removed?

Asset removal is not only limited to inventory or operating cash. Corporate pirates will take anything of value. Look at any balance sheet; there are all kinds of items of value. One of the biggest is, of course, accounts receivable; they simply can be collected and pocketed, or they can be sold or factored to a third party. Many fraudsters, when factoring their accounts receivable, supplement the real receivables with phony receivables.
Even harder assets, such as equipment or real estate, can be converted to the owner's use, through sales or sale-leaseback arrangements.
Despite the difficulty of proving intent, credit and finance professionals should always keep a lookout for a business removing assets at a fast pace. It can be more than mismanagement. The removal of assets can be at once the most obvious or the subtlest of all the fraud warning signs. *(pages 12-10 – 12-11)*

7. Explain how EINs make identity theft easier.

In some respects, an EIN, a business' federal employer identification number, is a business form of a Social Security number because of the ways it is commonly used to uniquely identify the business. An EIN is not provided the same protections as an SSN. Many business identity theft schemes occur, and many fraudulent accounts can be opened, with only a business's name, address and EIN. State business registration information is public record showing details about the business's legal structure, ownership, officers, directors, registered agent and registered address. *(page 12-11)*

Chapter 13—Making Credit Decisions

1. Some companies establish a way to automatically approve small orders. Supply a justification of this policy.

If a potential debtor's initial order is for a small dollar amount, the time and expense of completing a credit investigation may cost more than the actual transaction. Modest first orders could be viewed as a trial shipment that may lead to a long-term, profitable relationship. (*page 13-2*)

2. What is the difference between CREDIT LINE and CREDIT LIMIT?

Credit lines refers to credit that has been committed or will be granted up to a specific amount usually for a given period of time, as in the case of a bank line of credit. A credit limit is the maximum amount that a firm is willing to risk for a given account. (*pages 13-3 – 13-14*)

3. Explain how the profit margin, size and financial condition of the selling company influence its credit decisions.

For a credit grantor, the net profit margins on the products or services sold can significantly influence its credit policies. A higher profit margin would allow the creditor to take on greater credit risk and make more credit available. Conversely, a lower profit margin would lead the creditor to more a conservative stance.

Please note that size and financial condition are not answered directly within the text. A creditor's size and capacity may also have a bearing on its credit decisions. Likewise, a creditor's financial condition can influence its credit terms. (*pages 13-4 – 13-5*)

4. Discuss three common methods used to establish a credit limit.

Credit-granting companies establish their credit limits based on a wide range of factors unique to their own situations. Three common methods include limits that are based on a customer's ability to pay on term (payment record); competitive elements within the creditor's industry (competition); and the expected dollar volume of credit sales over a period of time (expectation of use). (*pages 13-5 – 13-6*)

5. Explain CREDIT SCORING TECHNIQUES and list the benefits for their use.

Using mathematical formulas to assign credit limits is a growing trend among businesses of all sizes. Companies identify the factors they consider most meaningful and input the data into a computer system, which creates a scoring matrix. By using these matrices, credit departments can likely improve efficiency and save time. Likewise, routine decisions can be managed with a properly implemented credit scoring system. Such systems analyze and reduce available data about a customer to a statistical number based on a variety of influencing elements including NAICS code, payment history, principal information, financial data, outside credit information, etc. Credit scores make credit decisions almost scientific and less reliant upon subjective execution. (*pages 13-7 – 13-8*)

6. List some available security devices.

- Guarantee. An instrument containing a promise by a person, persons or company to pay or perform an obligation owed in the event the debtor does not pay or perform. It can take the form of a personal or corporate guarantee.
- Cross-Corporate Guarantee (CCG). This ties a parent company to a subsidiary. Action: If the subsidiary does not pay, the parent company will pay.
- Irrevocable Letter of Credit. This substitutes a bank's credit for that of the customer. It allows the supplier to initiate a draft against the letter of credit upon delivery of goods.
- Subordination Agreement. This agreement can improve a supplier's priority position by establishing a higher priority claim to the customer's assets, especially if a significant portion of a customer's debt is owed to officers or stockholders.

- Security Agreements. Action: Request security documents, such as bond forms for construction, before creating a new account.
- Financing Statements. Article 9 of the Uniform Commercial Code, titled Secured Transactions, deals with the creation of security interests in personal property. The most common forms are inventory, accounts receivable and equipment. Action: These can be used to secure inventory. They can be filed in conjunction with a Purchase Money Security Agreement or Interest (PMSA or PMSI). A PMSI is a security interest or claim on property that enables a supplier to have a priority ranking on their products ahead of other secured creditors. It allows the suppliers to repossess the products sold to the customer should that customer default on their payments.
- Mechanic's Lien. A statutory lien on a building (and usually the land it occupies) in favor of suppliers of material and contractors to secure their interest on a particular construction project. Action: Follow the statutory requirements of each state for filing liens.
- Notice to Owner (NTO). Action: Follow state guidelines for NTO schedules as they vary by state.
- Payment and Performance Bonds. Action: Before relying on a payment bond, the supplier should send a letter to the bonding company to confirm the existence of the bond and learn its coverage with respect to the material. Since the type of project and the notification rules vary substantially, questions should be referred to the legal department through the chief credit professional.
- Bond Claims. They are usually provided by the General Contractor (GC), especially if it is a public job. Occasionally, the sub-contractors under the GC will have to provide their own bonds, but other times the sub-contractors work under the umbrella of the GC. Action: Follow the state guidelines for bond deadlines because these vary by state.
- Joint Check Agreements (JCA). A joint check agreement is a device whereby the ultimate user or beneficiary of material supplied by an original seller agrees with the original seller and its supplier to make all payments to the supplier by checks payable to both the seller and the supplier. Action: When the General Contractor (GC) pays the sub-contractor for materials, the GC writes the check to the sub and seller's company. The sub endorses the check and forwards the check to seller for deposit. This check does not include labor and is for materials only. Sometimes the GC wants to use their own form, but the seller's can use their own form as well.
- Real Estate Mortgages (Deeds of Trust). Sometimes a customer will offer a first or second real estate mortgage (deed of trust) as security for open account arrangements. Action: This can be an effective method of securing an account but a number of factors must be considered, such as determining the value of the property, the marketability of the property, liens and encumbrances on the property, the payoff on the first mortgage, and whether the first mortgage permits a second mortgage.
- Job Contracts. They are terms of sales for specific job. Action: Sales usually handles these, but they can be handled by the credit manager.
- Accounts Receivable (A/R) Insurance. This is a form of credit insurance offered by commercial insurers to businesses. A/R insurance can take the form of multi-buyer insurance (a pool of receivables) or key buyer insurance. Action: The cost-benefit must be weighed. A/R insurance can be particularly useful for new or rapidly growing businesses that cannot afford to do credit checks. For a relatively low fee, A/R insurance protects a company against loss on receivables, including default, bankruptcy or simply slow payment. (pages 13-11 -13-12)

7. List and discuss the characteristics of a MARGINAL ACCOUNT.

A marginal customer is one that falls short of expectations in one or more ways. For instance, a marginal customer may have a weak or inexperienced management team, inadequate finances and/or low credit agency composite scores. Consequently, selling to such a customer may present an abnormal risk even when the customer provides full information. (*pages 13-13 – 13-4*)

8. Why can selling to a marginal account be important to a business?

A well-balanced receivables portfolio should include a percentage of marginal accounts because they satisfy the need for additional business in a specific market. A supplier that has excess production capacity or needs a wider market base

should be willing to take a greater credit risk. In a similar vein, when a supplier has new products to promote or is trying to develop new distribution channels, marginal risks offer the seller an opportunity to maximize effectiveness. (*page 13-14*)

9. When should credit limits be reviewed?

Since all of these factors can change, it is important to review credit limits and to identify the criteria that trigger such reviews. Credit procedures should provide for periodic review of all active files. For active customers, the review should be made annually, timed if possible to coincide with receipt of the year-end financial statements or before the customer's active season. For marginal risks, the review should occur at more frequent intervals: semiannually, quarterly or, in extreme cases, monthly. The periodic review can help keep credit limits flexible in order to meet the business needs of customers, and to accommodate the development of business obtained from aggressive and expanding concerns. The frequency and scope of review will vary with the type of customer, quality of risk and the amount of credit exposure involved. *(page 13-16)*

10. Explain the statement: The longer the credit period, the greater the risk.

When circumstances appear to justify credit terms that extend beyond the usual period, and which are not generally offered to the same class of customer, a credit grantor must determine if there is a reason to extend terms that will satisfy antitrust regulations. Antitrust regulations are intended to avoid anti-competition, restraint of trade and pricing issues. Often, considerations such as geographic anomalies or economic conditions will meet concerns involving antitrust. Other reasons include responding to competitive factors, financial hardship and rehabilitation of the customer. (*page 13-18*)

Chapter 14—International Trade

1. Define COUNTRY CREDIT RISK and list resources that can be used to analyze the risk.

The concept of "country risk" represents several factors that a creditor must consider prior to doing business with companies in other countries. Such factors include political, economic, legal, cultural, geographical and financial risks plus exchange rates and currency convertibility.

Sources of valuable country risk material include FCIB, International Credit Exchange groups sponsored by local NACM Affiliates, Rundt's "World Business Intelligence" (available through FCIB), D&B's monthly publication "International Risk and Payment Review" and similar publications issued by major banks. (*pages 14-2 – 14-5*)

2. Discuss the purpose of LETTERS OF CREDIT and list the types available.

A letter of credit is a written understanding by a bank (issuing bank), acting at the request and on the instructions of its customer (applicant for credit) to:

- Make payments to, or to the order of, a third party (beneficiary)
- Accept and pay bills of exchange (drafts) drawn by the beneficiary
- Authorize another bank to effect such payment or to pay, accept, or negotiate such bills of exchange (drafts)

The terms and conditions of the credit must be complied with before payment, negotiation or acceptance can be made. Types of LCs include the confirmed irrevocable documentary LC, irrevocable documentary LC and standby LC. (*pages 14-6 – 14-12*)

3. What are the types of international methods of payment?

Cash With Order (CWO) is the most commonly used term, and most conservative, if the product or service is unique to the customer. Other payment methods include: consignment, open account, and letters of credit (*pages 14-5 – 14-12*)

4. Explain how credit insurance can be used to mitigate credit risk in international transactions.

Credit insurance is one of the more common and easiest ways to "share the risk" when participating in international transactions. Multi-buyer comprehensive is similar to automobile insurance and usually covers transactions that mature in 180 days or less. There is a fixed annual premium based on risk, a maximum amount of coverage in each category and a deductible for each occurrence. A country limit (multi-buyer) policy is basically the same as multi-buyer comprehensive, but it limits the number of countries covered. Political risk (multi-buyer) is used in the most extreme conditions such as politically unstable countries. This type of policy only covers the insured in the event of war, currency inconvertibility, political unrest, the overthrow of a government or some other specified event. (*pages 14-20 – 14-21*)

5. What is a FACTOR and how can it be used in transacting international sales?

A factor is a financial institution that buys receivables from companies. It is one of the oldest forms of export financing. The factor assumes most of the responsibilities usually held by the seller's credit office including investigating the foreign customer, financing the receivable and collecting the account. (*page 14-21*)

6. What is the difference between factoring and forfaiting?

Factoring is the process by which a business sells its receivables to a financial institution known as a factor.

Forfaiting refers to the concept that the seller forfeits the right to a future payment on a receivable in return for immediate cash.

Unlike factors, forfaiters typically work with exporters who sell capital goods and commodities, or engage in large projects and therefore need to offer extended credit periods from 180 days to seven years or more. In forfaiting, receivables are normally guaranteed by the importer's bank, which allows the exporter to take the transaction off the balance sheet to enhance key financial ratios. The current minimum transaction size for forfaiting is $100,000. In the United States, most users of forfaiting are large, established corporations, but small- and medium-size companies are

slowly embracing forfaiting as they become more aggressive in seeking financing solutions for exports to countries considered high risk. *(pages 14-21 – 14-22)*

7. What is a BANKER'S ACCEPTANCE?

A banker's acceptance is a time draft drawn on and accepted by a bank and payable at a fixed or determinable future date. (*page 14-23*)

8. There are several special challenges associated with collecting international accounts. Discuss these.

International collection efforts may encounter several challenges, which include foreign exchange issues, accurate aging of receivables, communicating through agents and other intermediaries, and, if needed, engaging the services of foreign legal representation and collection agencies. (*page 14-25*)

Chapter 15—Financing and Business Insurance

1. List types of loans provided by banks and explain the key points of each.

- Unsecured loans—Usually loans that cover a borrower's temporary working capital needs.
- Mortgage loans—Long-term loans that are often fixed-rate and have a regularly scheduled prepayment schedule.
- Miscellaneous loans—Loans that are secured by life insurance policies, deposit accounts, stocks and bonds or any other valuable assets owned by the borrower company, its endorsers or its guarantors.
- Equipment loans—Equipment financing enables a company to acquire fixed assets, such as industrial equipment and machinery, and pay for them on an installment basis. (*pages 15-3 – 15-5*)

2. Explain RESTRICTIVE COVENANTS.

Included in loan agreements by banks, restrictive covenants set performance measures that the company is required to meet; otherwise, the bank is allowed to call or renegotiate the loan. Such covenants include an after-acquired clause, acceleration clause and cross-default clause. (*page 15-5*)

3. Explain the purpose of the U.S. Small Business Administration and what is offers.

The U.S. Small Business Administration helps small businesses find financing capital to meet their needs for growth and expansion. The SBA participates in loans made by private lenders or may lend directly when private institutions do not consider the prospect a satisfactory credit risk. (*pages 15-5 – 15-6*)

4. What is an OPERATING LEASE?

Operating leases are short-term rentals of property, plant or equipment. (*pages 15-6 – 15-7*)

5. What is a CAPITAL LEASE?

Under a capital lease, not only is the given asset transferred from lessor to lessee, but substantially all the benefits and risks of ownership are transferred as well. (*page 15-7*)

6. Define the term "LEVERAGED BUYOUT."

A leveraged buyout is a special acquisition process that uses borrowed money (i.e., leverage) to acquire a company. Specifically, a management or venture capital group borrows substantial capital by pledging the assets of the company to be acquired as collateral. (*pages 15-7 - 15-8*)

7. List nine factors to consider when evaluating an LBO (leveraged buyout).

1. The company must have proven products and markets. Unlike venture capital financing, leveraged buyouts aim for reliability and staying power.
2. Key management personnel must have a proven track record. They must be experienced in production, sales, finance and operating the company or one like it.
3. Management should have its own cash invested in risk equity, enough to ensure their total commitment.
4. The company must have a steady and reliable cash flow to support the purchase price, carrying charges and related debt.
5. The physical plant should be reasonably modern so that heavy capital expenditures can be avoided during the payback period.
6. The company's industry should not be vulnerable to sudden technological shifts that can cause obsolescence.
7. Preexisting debt should be minor because the leveraged buyout will add a major layer of new debt.
8. The company should be willing to supply sufficient detailed financial information to creditors, to convince them that the company can handle the heavy debt load.
9. Suppliers should be consulted so that previous trade terms will continue after the buyout. Harsher terms can cause liquidity problems. (*page 15-8*)

8. List nine important items to analyze when reviewing the financial statement of an LBO.

1. Examine cash to uncover any seasonal peaks and valleys.
2. Check trade receivables for the average age of past due receivables and their rate of change. Significant customers that provide 10 percent of sales should be listed. The probability of collecting long overdue accounts needs to be evaluated.
3. Check notes receivable from customers as to nature of loan, terms and history of collection.
4. Examine inventories to determine the current market value, pricing sensitivity and obsolescence factor.
5. Evaluate plant and equipment to assess their remaining useful life by comparing the appraised value with the remaining book value.
6. Check short-term borrowing requirements for peaks and valleys beyond the debt service associated with the buyout.
7. Analyze accounts payable to determine whether there are any payment problems arising from a reduced inventory turnover or slowdown in accounts receivables turnover.
8. Review operating income by product lines, industry segments, geographic locations, trend of major customers, pricing strategies, sales agreements and customer base.
9. Review operating expenses to establish the stability of cost structure by looking into each major element of expense. Lease rates, labor and fringe costs should be checked. Leases need to be examined to see if they are assignable and if they are economically advantageous to the buyer. (*page 15-9*)

10. Briefly describe what a FACTOR is.

A factor is a financial institution to which a business sells its receivables. In advance of the actual shipment of product, factors and clients communicate in order to agree upon which receivables will or will not be purchased. (*page 15-11*)

11. Describe the advantages of factoring and how it works.

Businesses choose this financing tool for various reasons; risk mitigation and administrative expense control are among the relevant considerations:

- Factoring can provide the same benefits as borrowing against receivables. A factor can close the gap between a business's operating cycle and the time allowed for payment by suppliers. For example, factoring is popular in industries where terms granted by suppliers are shorter than terms granted to customers (carpet manufacturing).
- Receivables are sometimes purchased on a non-recourse basis. This insulates the seller from bad debt losses on factored receivables.
- Because factoring involves the outright sale of receivables, it allows a business to avoid some of the costs associated with the collection process. Therefore, businesses that seek to minimize middle management costs sometimes use factoring (smaller apparel manufacturers).
- A factor does not assume responsibility for deductions taken by the seller's customers. Sellers must post to their own records any payments received from the factor against factored accounts receivable. For these reasons, a seller must usually maintain some level of credit and accounts receivable staffing to reconcile records, research and collect deductions and manage any sales made at seller risk. Seller risk includes receivables sold to factors on a recourse basis and credit extensions made by the seller without approval from the factor. *(page 15-11)*
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12. List the important questions to ask about a factoring arrangement.

- What is the contractual advance percentage? Is it fully used?
- Are there any arrangements for unstructured overdrafts? If so, what are they?
- Are there any overdrafts outstanding? If so, how much?
- If an arrangement calls for overdrafts in addition to advances, what are the reasons for this situation?
- Are the overdrafts stated as an amount over 100 percent of the purchased receivables or over the contractual advance percentage?

- Have overdrafts been requested but refused or restricted?
- Is the item Due From Factor pledged to a third party, such as a bank, to secure a loan?
- Is there an intercompany offset situation?
- Does the factor have other affiliates or subsidiaries that are suppliers of credit to the customer? (*page 15-14*)

(The final three questions are applicable when the maturity agreement calls for payment on the average due date.)

13. How do factors differ from finance companies?

Finance companies do not actually purchase receivables or other assets as factors do. Instead, they make loans based on the value of the asset and expect repayment of the loans by their clients. (*page 15-14*)

12. What are the advantages of trade credit insurance?

There are various advantages to trade credit insurance, but the ideal purchaser includes

1. A seller seeking to protect itself from unforeseeable catastrophic risk (for example the bankruptcy of a key customer without any warning or tell-tale signs, which would normally alert the insurer to the risk and cause the insurer to cancel the insurance as it relates to such customer); or
2. A seller that cannot afford the resources to perform in-house credit analysis and prefers to outsource the credit risk management to an insurer (for example, the monitoring of 50,000 small customers).

For more information see pages 15-14 – 15-17

13. What is a trade receivable put?

Trade receivable put options, or puts, protect a seller's accounts receivable on a single-account, non-cancelable basis in the event that the seller's customer files for bankruptcy during the period of the put. Receivable puts amount to a promise by one party to buy a seller's trade receivables claim in the instance of a buyer's default or bankruptcy. In a put, a seller delivers a product to their customer and undertakes that receivable, then purchases the right to put those outstanding receivables to, for example, a financial institution in the instance of a credit event, meaning either a bankruptcy filing or a liquidation. When that credit event occurs, the put is triggered, and pays the seller a predetermined level of protection on the claim. (pages 15-17 – 15-18)

Chapter 16 — Negotiable Instruments

1. Define the term NEGOTIABLE INSTRUMENT.

A negotiable instrument is a written document, signed by the maker or drawer, and containing an unconditional promise to pay (or order to pay) a certain sum of money on delivery or at a definite time to the bearer (or to the order of). Also defined as an instrument that can be transferred from party to party and accepted as a substitute for money. (*page 16-2*)

2. Give a brief explanation of the elements of a negotiable instrument.

Under UCC 3-104(1), in order for an instrument to be negotiable, it must

1. Be in writing
2. Be signed by the maker or the drawer
3. Be an unconditional promise or order to pay
4. State a specific sum of money
5. Be payable on demand or at a definite time
6. Be payable to order or to bearer (*pages 16-2 – 16-5*)

3. List two basic types of negotiable instruments.

Drafts, checks, notes and certificates of deposit. (*page 16-5*)

4. What is a CHECK?

A draft on which the drawee is a bank that is ordered to pay on demand. (*page 16-6)*

5. Define the following terms:

a. BANK DRAFT—A check drawn by one bank on another bank in which it has funds on deposit in favor of a third person. Also known as a teller's check or treasurer's check.

b. CASHIER'S CHECK—A check drawn by a bank upon itself. The financial institution is both the drawer and the drawee.

c. CERTIFIED CHECK—A check that is guaranteed by the bank.

d. MONEY ORDER—Although usually presumed to have the significance of cash, money orders can be sold by financial institutions, the U.S Postal Service or privately owned companies. One must be cautious when accepting money orders, especially those issued by privately owned companies that may not have the sufficient cash on hand to cover the money order when it's presented for payment.

e. TRAVELER'S CHECK—An instrument similar to a cashier's check in that the issuing financial institution is both drawer and drawee.

f. POSTDATED CHECK—A check may be postdated when the drawer has insufficient funds in the bank but expects to have sufficient funds to cover the amount the check at a future date.

g. SIGHT AND TIME DRAFTS—A sight draft is payable as soon as it is presented to the drawee for payment. A time draft is not payable until the lapse of a particular time period stated on the draft.

h. DOMESTIC BILL OF EXCHANGE—A draft that is drawn and payable in the United States

i. DEMAND NOTE—A note that is payable whenever the payee demands payment.

j. Promissory Note –

Promissory notes come in the following forms:

- Single-name paper is a note signed by only one maker. No one else is liable on it.
- Double-name paper is a promissory note signed by two or more makers or signed by the maker and endorsed by others. With additional people standing behind the note, the likelihood of payment is increased.

k. COLLATERAL NOTE—A note that is secured by certain collateral, such as stocks, bonds, personal property or mortgages. The creditor holds the collateral while the note is outstanding.

l. JUDGMENT NOTE—A type of promissory note controlled by state laws, which have many technical requirements associated with them. *(pages 16-6 – 16-9)*

6. Define the concept of NEGOTIATION.

The transfer of an instrument in such a form that the transferee becomes a holder (or person who is in possession of instrument issued or endorsed to that person, to that person's order, to bearer or in blank). (*page 16-9*)

7. List and describe the different types of ENDORSEMENTS.

- A blank endorsement consists of the signature alone written on the instrument, which does not have a specific endorsee.
- Special endorsement (*see* below)
- Restrictive endorsement (*see* below)
- Conditional endorsement (*see* below)
- Endorsements for deposit or collection (*see* below)
- Qualified endorsement (*see* below)
- A general endorsement is without reservation or qualification. (*pages 16-10 – 16-12*)

13. What is the general rule for handling a check marked "Paid in Full"?

If the claim is liquidated and there is no dispute as to the amount due, a check for a lesser amount than the claim, even though marked "Paid in Full," does not settle the account. The creditor may keep the check and sue for the balance. If, however, there is a bona fide dispute as to the amount of the claim, and the same claim is not liquidated, a check sent and marked "Paid in Full" or "In full payment of account" IS payment in full. Consequently, the creditor must either return the check and sue for the amount claimed or accept the check as complete payment. Whether a bona fide dispute exists can be a matter of dispute in itself, and obviously a debtor wishing to pay a lesser sum can very easily make such a claim.
A good practice before accepting a check marked "Paid in Full" is to be very certain there is no dispute. (*pages 16-12 – 16-13)*)

Chapter 17—Bankruptcy Code Proceedings

1. Provide a brief definition of the following Chapters of the Bankruptcy Code:

a. CHAPTER 7—Known as a liquidation bankruptcy (or straight bankruptcy) in which a trustee is appointed by the United States Trustee in order to liquidate nonexempt assets.

b. CHAPTER 9—A Chapter 9 bankruptcy pertains to municipalities and governmental units. It may only be filed on a voluntary basis.

c. CHAPTER 11—The business reorganization chapter, which involves a debtor in possession that is attempting to rehabilitate a business. (A small business may reorganize under an expedited Chapter 11 proceeding. A small business is defined as a business with total debts of less than $2,343,000.)

d. CHAPTER 12—This bankruptcy chapter is commenced only by a voluntary petition by family farmers who have debt up to $3,792,650 and family fisherman who have debts up to $1,757,475. Its purpose is to provide family farmers and family fisherman with a chance to reorganize debt and retain their assets.

e. CHAPTER 13—Known as the wage earners plan. Any individual with regular wages or income is eligible to file under Chapter 13, including certain professionals or business owners. Current debt limits for eligibility are $360,475 for unsecured debt and $1,081,400 for secured debts.

f. CHAPTER 15—This chapter provides mechanisms to deal with multi-national insolvencies. It works toward establishing cooperation among U.S. courts, trustees and debtors and their foreign counterparts. *(page 17-2)*

2. What is the purpose of an AUTOMATIC STAY in bankruptcy?

The purpose of an automatic stay is to ensure a fair distribution of the debtor's nonexempt, unencumbered assets among creditors. It prohibits any action to collect the debt from the debtor or the debtor's property. Governmental agencies, such as the IRS, cannot seize or file liens against the assets of the debtor, without permission of the Bankruptcy Court. Generally, creditors cannot offset credits or returns against the debtor's debt. Any violation of the stay is in contempt of court and may be punishable by fines and fees. (*page 17-3*)

3. What are the basic duties of a trustee?

In a Chapter 7 case, an interim trustee is appointed to take possession of nonexempt assets and sell them for the benefit of creditors. The trustee also presides at the § 341 meeting of creditors. During this meeting, the creditors may elect a different trustee. If no other trustee is elected, then the interim trustee assumes a permanent part in the process. (*page 17-5*)

4. In a Chapter 7, trustees must satisfy claims in a particular order. List the priority of claims in order.

In a Chapter 7 case, the following listing represents the priority of claims:

- secured creditors
- priority claims (i.e., domestic support obligations)
- administrative expenses
- involuntary case claims
- wages and compensation claims
- employee benefit plans
- grain producers or fisherman claims
- customer deposits
- taxes
- unsecured claims of a federal depository institutions regulatory agency
- claims arising from the unlawful operation of a motor vehicle or vessel
- unsecured creditors
- preferred stockholders
- common stockholders (*pages 17-6 – 17-7*)

5. What is the purpose of Chapter 11?

Chapter 11 is one of the most important provisions of the Bankruptcy Code. It was designed to be a single, unified way of dealing with reorganization of most businesses. One objective of Chapter 11 is to reorganize a troubled debtor while maximizing the return to creditors. Another objective is to retain employment and other economic benefits that the community derives from the business. (*pages 17-7 – 17-15*)

6. Who are the key players in a Chapter 11 proceeding?

The key players in a Chapter 11 case include the judge, who decides the relevant legal issues; the U.S. Trustee, who appoints the creditors' committee and has general oversight responsibility; secured creditors; equity security holders; the debtor; and the creditors' committee. (*page 17-8*)

7. What is the role of a creditors' committee in a Chapter 11 proceeding?

In Chapter 11 proceedings, the creditors' committee plays an integral role. Initially organized by the United States Trustee, the committee protects the interests of all unsecured creditors while also overseeing the debtor's operations until, and sometimes after, the confirmation of the plan of reorganization. The creditors' committee also investigates the debtor's affairs and monitors its business activities.

Additionally, the committee may have to deal with fraudulent or preferential transfer actions, sometimes against committee members. It may also ask the court for the authority to pursue an avoidance action against a secured creditor with an improperly perfected claim. A particular strength of the committee is its ability to recommend or oppose confirmation of a proposed plan of reorganization. (*pages 17-9 – 17-10*)

8. How long does a debtor have to assume or reject executory contracts, with court approval, under a Chapter 11 proceeding?

With court approval, the debtor has up to the earlier of confirmation of a Chapter 11 plan or 120 days after the bankruptcy filing to assume or reject unexpired leases of nonresidential real property. The court may extend this period for up to one additional 90-day period, provided it is granted before the expiration of the initial 120-day period. (*pages 17-10 – 17-11*)

9. Define the term CLAIM, under the Bankruptcy Code.

Under the Bankruptcy Code, a claim is a right to payment or a right to some equitable remedy such as injunctive relief in the event of a breach of contract. A claim may be contingent or disputed and may not have matured at the time of filing. (*page 17-11*)

10. How is a small business defined under Chapter 11 of the Bankruptcy Code?

A small business is defined as a person engaged in commercial or business activities, excluding real estate, whose aggregate noncontingent liquidated and unsecured debts as of the date of the petition do not exceed $2,343,000. (*page 17-11*)

11. How are claims classified under the Bankruptcy Code?

Under the Bankruptcy Code, claims are secured, priority, undersecured or unsecured. (*page 17-12*)

12. What information is contained in a plan of reorganization?

The most important part of a plan of reorganization is the classification and treatment of claims. (*pages 17-12 – 17-13*)

13. In order for a plan of reorganization to be accepted, what is necessary?

At least one class of creditors must accept the plan before the court will consider it. (*page 17-13*)

14. What is the ABSOLUTE PRIORITY RULE?

The absolute priority rule prevents confirmation of a reorganization plan without the consent of the necessary classes of creditors if the plan provides that the shareholders in the corporation, or the individual debtor in an individual case, will retain an interest in assets after confirmation. (*pages 17-14*)

15. What two conditions must a plan satisfy under Chapter 12?

- Creditors are to receive what they would receive under liquidation (the liquidation test).
- All the debtor's disposable income for at least three years must be paid to creditors (the best efforts test). (*page 17-15*)

16. List the three criteria for filings under Chapter 13.

The three criteria for filing under Chapter 13 are: (1) the debtor must be an individual; (2) the individual must have regular income; and (3) the debt's limit is $360,475 in unsecured debt and $1,081,400 in secured debt. (*page 17-16*)

17. Why is it important to establish a systematic response system for bankruptcy cases?

Since bankruptcy cases can be quite complex, it's important for creditors to have a systematic response system in place. On a basic level, a creditor must make certain that information reaches appropriate parties within the timeframe defined by the Bankruptcy Code. For example, a proof of claim must be filed within 90 days after the first date set for the § 341 meeting in Chapter 7 cases. Whoever is overseeing the bankruptcy cases must keep track of meeting deadlines for creditors and objections to the sale of assets, among other responsibilities. (*page 17-17*)

18. Under what Chapters of the Bankruptcy Code must a proof of claim be filed?

In cases under Chapters 7, 12 and 13, the filing of a proof of claim is generally required to participate in any distribution of the bankruptcy estate assets to unsecured creditors. (*page 17-17*)

19. Before a preferential payment to an unsecured creditor can be recovered, what must the trustee prove?

To prove a preference, the trustee or the debtor in possession must prove that a transfer of the debtor's assets was made

- To or for the benefit of a creditor
- For or on account of an antecedent debt
- While the debtor was insolvent
- Within 90 days of the petition for relief, or within one year if the transfer was made to an insider
- The effect of the transfer was to give the creditor more than the creditor would otherwise receive in a Chapter 7 liquidation (*page 17-28*)

20. What are the exceptions to the preference rules?

Exceptions to the preferences rules include:

- A transfer to a creditor that is intended to be and is contemporaneous with the extension of credit or the delivery of goods by the creditor
- Subsequent new value is given to the debtor after receipt of payment
- Payment in the ordinary course of business or financial affairs of the debtor and the creditor; or made according to ordinary business terms
- Preference actions for recovery of less than $5,475 cannot be pursued
- Preference actions to recover less than $10,950 can be commenced only in the district court for the district where the trade creditor is located (*page 17-28*)

21. What is a FRAUDULENT TRANSFER?

Two types of fraudulent transfer are currently described in Bankruptcy Code 548 (a) and (b). They are

- The transfer of the debtor's property made with the actual intent to hinder, delay or defraud creditors is one type. The debtor's intent is usually inferred from the circumstances of the transfer.
- The transfer of property for less than market value at a time when the debtor was insolvent or undercapitalized. (*page 17-29*)

Chapter 18 — Bankruptcy Alternatives

1. List warning signs of financial distress.

The seven signs of financial distress are

- The debtor has stopped discounting bills
- There is a general slowdown in payments
- Lawsuits are being initiated against the debtor
- Tax liens or vendor liens are being filed against the debtor
- The debtor is constantly shifting from one supplier to another
- The debtor is in default with its lending institution
- The debtor's financial condition is deteriorating (*page 18-2*)

2. Explain the difference between INSOLVENCY and NON-LIQUIDITY.

A debtor whose liabilities exceed its assets is insolvent. A debtor that cannot pay debts as they become due is not liquid. (*page 18-2*)

3. What may a secured claim consist of?

Secured claims may consist of mortgages on the debtor's real property, other secured assets or any perfected security interests in property subject to the Uniform Commercial Code. (*page 18-4*)

4. What may a priority claim consist of?

Priority claims may consist of taxes, wages and unpaid rent, which under federal or state laws are entitled to priority payment over unsecured claims. (*page 18-4*)

5. Why is unity important in voluntary settlements?

Without the full cooperation of all creditors as well as the debtor, a voluntary settlement will not succeed. (*page 18-4*)

6. Explain the important requirements of a creditors' committee.

A creditors' committee usually comprises five or seven of the largest unsecured creditors and possibly augmented by one or two representatives for smaller creditors. All members of the committee must be knowledgeable about the work and responsibilities they will encounter as well as the time commitment of the assignment. (*pages 18-4 – 18-5*)

7. What items should be examined by the creditors' committee?

Working with an outside accountant, the creditors' committee should review an independent examination of the debtor's financial records. They should also examine current inventory counts and valuation, if appropriate, and several years' worth of tax records. The committee will likely search for the causes of the debtor's financial distress by looking at administrative and operational expenses; sales volume; and range of markup on goods. (*pages 18-4 – 18-5*)

8. List the causes of financial distress.

Causes of financial distress may include excessive rent and overhead; high general and administrative expenses which include salaries; exorbitant withdrawals from the business; declining sales volume; or inadequate markup on goods. Managerial incompetence and/or dishonest approaches may also cause financial distress. (*page 18-5*)

9. Define MEDIATION.

Mediation is a form of alternative dispute resolution. It is a non-binding attempt by parties to solve a dispute using an independent mediator or facilitator in order to allow the parties to reach common ground. Unlike arbitration, mediation can be chosen after the dispute has arisen. (*page 18-6*)

10. Define ARBITRATION.

Arbitration is a form of alternative dispute resolution where the parties use an independent arbitrator to act in lieu of a judge and/or jury in resolving a dispute. Arbitration is usually provided for in a contract; it may be a faster and less expensive option than litigation. (*page 18-6)*

11. What is an EXTENSION AGREEMENT?

Under an extension agreement, the debtor proposes to pay creditors in full over a period of time. Basically, it is a means to defer the payment of debts. (*page 18-7*)

12. What is a COMBINATION SETTLEMENT?

A combination settlement is a voluntary settlement that provides both a pro rata cash payment and an extension of time. For example, a combination settlement may comprise a cash payment of 20% plus three future installments of 5% each, or a total of 35% in full settlement. (*page 18-8*)

13. What is an ASSIGNMENT FOR THE BENEFIT OF CREDITORS?

This technique basically assumes that the business, in effect, belongs to the creditors. In some cases, the creditors' committee may request or insist that the debtor execute an assignment for the benefit of creditors, to be held in escrow by the committee. If the debtor defaults in performance of extension payments, the assignment becomes effective. The assignee may then liquidate the assets for the benefit of all creditors. (*pages 18-10 – 18-14*)

14. What are the different ways to evaluate settlement offers?

The methods of evaluating a settlement offer are: one-time partial payment and present value of serial payments. See pages 18-15 – 18-16 to see the benefits and costs of each method.