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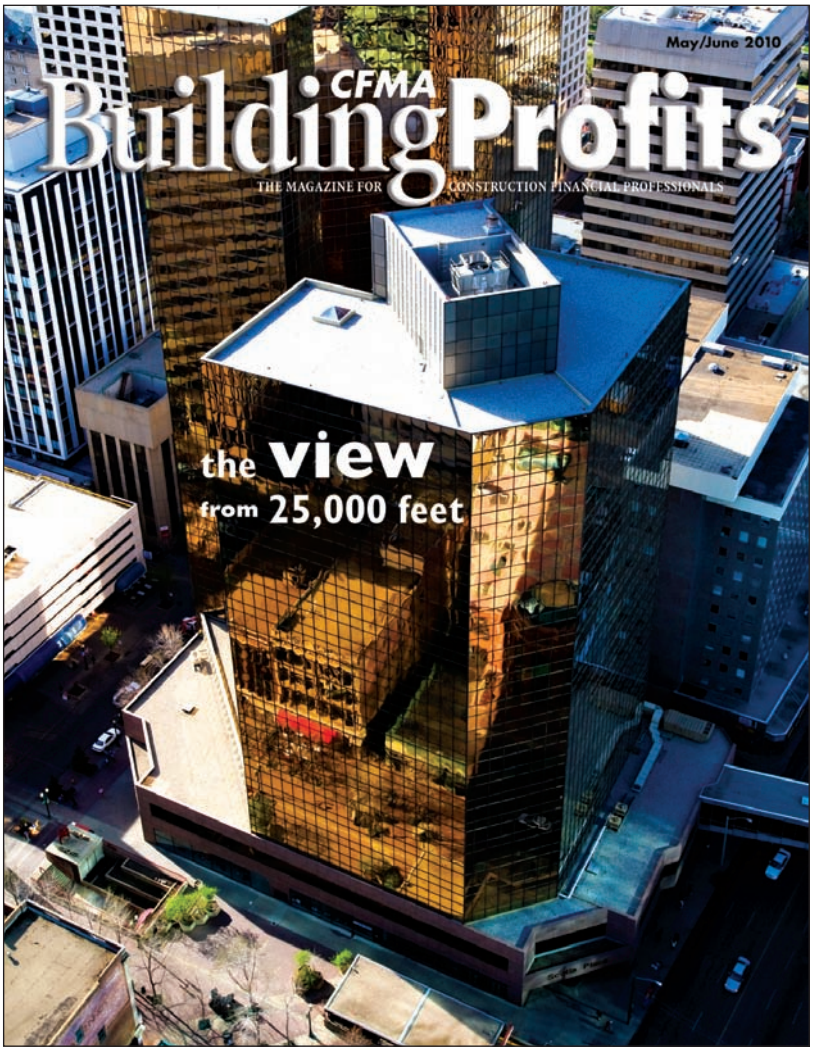


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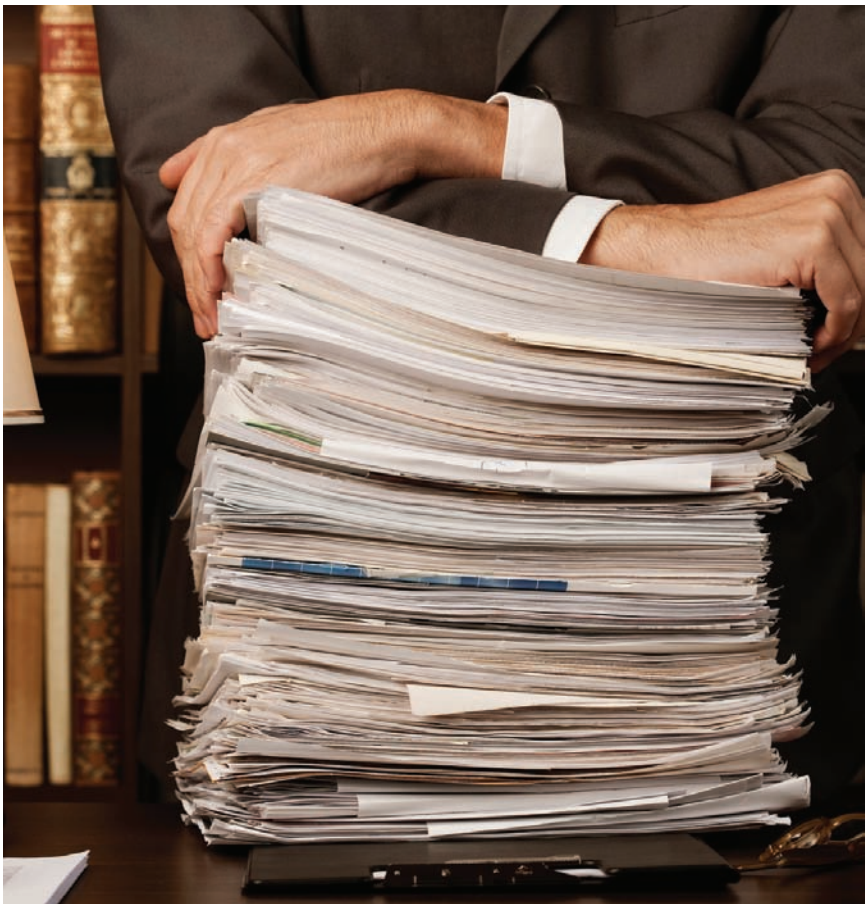
**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**
*The Source & Resource for Construction Financial Professionals*

BY ANTONY L. SANACORY

# IMPROVING THE COLLECTION OF RECEIVABLES: *Strategies & Experiences of an Attorney*



Unlike an estate-bottled reserve cabernet, A/R rarely age well – regardless of the temperature at which they are stored.

So, while it may seem obvious in today's economy that every contractor needs a defined pre-project collections strategy, not every contractor has one (or at least not the best one).

As an attorney, I have witnessed first-hand a variety of collections strategies, typically in litigation. In this article, I will present the most effective and practical strategies I have seen.

Collecting A/R impacts a company's bottom line as much as any other effort to generate income. And, many of the steps make good business sense, irrespective of credit and collections considerations.

Imagine how you could improve customer service (and potentially open up more sales opportunities) if you knew:

1) Your customers better;
2) Who their customers were; and
3) The other projects they were working on.

The same information that helps you provide superior service also enables you to make informed decisions about extending additional credit and locating potential sources of payment (which comes in handy during litigation).

As you evaluate your own collections plan and credit management issues, consider discussing the following topics with your legal counsel.

## Before a Project Begins

### Gather & Analyze Information

Few factors will impact your collections rate more than the quality of the individuals and companies with whom you decide to partner. Unfortunately, you usually

**"LITIGATION** can be a little like **SMOKING CIGARETTES** – it **STINKS** and is **BAD FOR YOUR HEALTH** . . . However, unlike smoking, **LITIGATION** is sometimes **NECESSARY."**

learn that a customer is trouble only after it's too late. In a recent case, a contractor represented in open court that he had never been sued before. We later found out that he had been sued nearly 20 times in the previous five years alone.

In another case, a GC claimed that – in 35 years – he had never terminated a subcontractor for any reason until he terminated my client. During the course of the lawsuit we learned that, on that very project, the GC had terminated three other subcontractors, its own project superintendent, and the woman who recorded the minutes of the project meetings (and withheld their pay, too).

Because it may be impractical to foresee whether or not a customer will be troublesome or to limit your sales efforts to only the most creditworthy, you should find other ways to prepare for the possibility of a nonpaying customer. At the outset:

- *Be certain you know who is actually responsible for payment.* Are you dealing with a project-specific entity or a parent corporation? What is the customer's payment track record? Are they litigious?
- *Ask for financial information and references.* While some customers might resist providing detailed financial information or references (which alone might be a warning sign), most will understand your need to make informed credit decisions, particularly in this economy. After all, your investors, lenders, and other business partners expect nothing less.

  The more you know about your customers, their other projects, and their business partners, the better you will be able to assess appropriate levels of credit and the easier it will be to locate assets and sources of revenue in litigation.
- *Gather additional information from industry contacts.* Why limit yourself to your customer's references? Find out the other entities involved in the project and whether any are "problem" companies. For the same reason you check your customer's references, you should also contact your industry peers.
- *Research prior litigation history.* A number of services provide detailed information about larger companies. And, smaller companies can be researched in their home county, where you can request copies of any complaints that have been filed in local courts.
- *Consider whether the owner (or another contractor) can pay you directly.* It's not always feasible to ask for special treatment from the owner, but it's not out of the question either – particularly in exceptional cases (e.g., if your exposure will be significant). If you present this in a way that allows all parties to see a benefit, your customer might even appreciate the suggestion.
- *Find out if more protection is available.* Ask for a security interest, retainer, deposit, guarantee, or similar instrument or clause. This may chill some deals, but it may also smoke out high-risk ventures early on.
- *Document everything.* Many unexpected recoveries begin with the simple phrase "I found a note in the file." File notes regarding conversations and communication can reveal the location of assets, commitments by other contractors to financially support your customer, personal guarantees, and other potential sources of payment.

  If payment was withheld due to alleged defects that were raised only when a major payment became past due, then the absence of any prior complaints will be evident in your files, highlighting the suspicious timing of the complaints. (For additional information, see "Protect Your Construction Claims: Proper Documentation – A Must!" by Jeffrey D. Firestone & Andrew J. Natale in the March/April 2010 issue.)

From a business and customer relations standpoint, all of these precautionary steps are appropriate and supportable. Customers with solid credentials should be willing to provide additional information, and those that protest too much should alert you to concerns *before* you sign a contract.

### Contracts – Beware!

A contractor once told me that his contract was on the dashboard of his pickup truck. I asked if he would get it and he responded, "Get what? The dashboard?" It turns out that he was driving his truck when he quoted a project, so he wrote the contract amount on his dashboard. While the "dashboard contract" has many shortcomings, there is something appealing about its simplicity.

## COMMON CONTRACT PROVISIONS & POTENTIAL UNINTENDED CONSEQUENCES

| CONTRACT PROVISIONS | UNINTENDED CONSEQUENCES |
|---|---|
| **TIME IS OF THE ESSENCE:** Requires a strict schedule for delivery, and that a breaching party will likely have caused material harm by any delay. | Delay in performance may not be your company's fault and may be inconsequential to the project schedule. In litigation, a customer invoking such a provision may have disproportionate leverage (a basis to terminate the contract or to withhold payment). |
| **FLOW-DOWN:** Binds subcontractors and suppliers to a project's master construction contract. | Why litigate two contracts when you only need one? This provision could incorporate contract provisions, including retainages, that you have never reviewed or drawings and specifications that have yet to be drawn. |
| **VENUE:** Defines the place where you can enforce a contract. | Could complicate lien enforcement or the addition of other parties necessary to the lawsuit, but not bound by the venue provision. |
| **ARBITRATION:** Requires disputes to be resolved in arbitration. | For smaller disputes, arbitration may be more expensive than litigation. Could complicate lien enforcement. |
| **COOPERATION CLAUSES:** Agreement to take actions necessary to implement the purposes of the contract. | Parties often differ over what constitutes necessary cooperation (fact-intensive disputes that could be costly to litigate). |
| **INDEMNITY:** Requires compensation to another party for certain losses suffered during performance of the contract. | Depending on the nature of your work, an indemnity may be irrelevant or provide little additional protections. Even if the indemnity seems narrowly focused, a defendant may assert an indemnification claim as a set-off in litigation. |
| **LIMITATION ON CONSEQUENTIAL DAMAGES:** Limits damages resulting indirectly from a breach (e.g., lost opportunities or overhead). | Could actually simplify collections. Limits the types of damages that can be asserted as a set-off against your company. (Also limits the types of damages that you can claim.) |
| **WARRANTY OF FITNESS FOR PURPOSE OR USE:** Guarantees the performance of equipment or materials installed. | If the designer or owner selects the equipment you are installing or delivering, why should you guarantee that they selected properly? |
| **RETAINAGE:** Permits the owner to withhold portions of payments until it accepts the project. | Could create substantial delay in payment and a litigation advantage to the party withholding the payment. |
| **PAY-WHEN-PAID (OR PAY-IF-PAID):** Sets the timing of payment to a subcontractor to the timing when the contractor gets paid. | May be critical to a GC, but subcontractors need to be certain that it is fair and appropriate in each project. |

When documenting an agreement with your customers, you cannot control what contractual protections they will request. They too have risk concerns to manage, lenders and customers to satisfy, and scheduling and commercial demands they will seek to address through their contract terms with your company.

Even though your company will have to meet its customers' needs, it should not agree to terms that exceed those needs, that create ambiguities, or that make it difficult to collect what it is owed. A clever defense lawyer will analyze each contract provision to see if any can be read to undermine your company's claim.

None of the provisions listed at left are "bad," *per se*. To the contrary, some may contain critical protections for your company. However, they should be given the same attention and focus as those that cover scope of work and payment, since they could delay (or even preclude) receipt of payment.

### Have a Defined Plan to Preserve Your Lien & Bond Claims

One of my first assignments as a lawyer was to analyze four liens that were filed against a property in bankruptcy. Three of the liens, all under $50,000, were properly perfected and paid. The fourth lien was a $2 million claim, but was perfected a day late (two months was longer than the "sixty days" prescribed in the statute). That claim was paid two cents on the dollar as part of the bankruptcy proceeding.

Most state laws that govern liens, bonds, and prompt payment require notices to be filed at the outset of a contractor's involvement on a project or that invoices be prepared in a certain way. Carefully consider which statutory protections might apply, who will be responsible to ensure that claims are properly documented, and whether your company has the appropriate personnel and processes to ensure that filings are timely.

There are also a number of reputable services that specialize in lien and Uniform Commercial Code (UCC) filings that can help you and that are, typically, fairly cost-effective. If you are working on a project that is eligible under the Prompt Payment Act, P.L. 97-177 *(http://uscode.house.gov/download/pls/31C39.txt)*, then discuss your contract documents and invoicing policies with an attorney.

### If Something Doesn't Feel Right, Then It Probably Isn't

When I first began practicing law, I worked for a senior partner who would quip to construction clients, "At the very first nonpayment, you should pick up every piece of equipment you have on site – every dozer, excavator, shovel, pick, and scrap of silt fence. Leave the site. Then call me."

While my mentor would say this with a tinge of sarcasm, his point was undeniable: All too often, contractors ignore obvious warning signs and proceed deeper and deeper into a project with no realistic hope of payment.

A contractor's reaction when payment is withheld (particularly if it's a company that provides excellent work and has a culture focused on customer satisfaction) may be to respond with self-criticism, giving the *customer* the benefit of the doubt.

But, lawyers know that payments are not only withheld for poor or defective performance, but also for reasons unrelated to contractor performance. It may be that no remedial measure will ever be good enough and that your company will never get paid for its work going forward, regardless of any efforts to respond to your customer's complaints.

Withholding payment is a serious remedy. If a customer has withheld payment claiming defective work, pause a moment and ask, "What is going on here, really?" Encourage your project team to give *itself* the benefit of the doubt. Also consider whether something unrelated to performance is motivating the decision to withhold payment. For example:

**1)** Are the complaints nonspecific and difficult to respond to (e.g., wrong equipment or insufficient personnel) or are they verifiable and material (e.g., failure to complete installation of equipment on time)?

**2)** Did the complaints come from out of the blue and surprise your team?

**3)** Does nonpayment seem proportionate to the defects alleged?

**4)** Have any circumstances unrelated to your work recently changed (e.g., the owner's loss of interest in completing the project or a dramatic rise in project cost)?

Carefully consider and discuss these examples when a customer is withholding payment for purportedly defective work. And, my mentor was right – you need to call your lawyer!

## When Things Go Wrong, Set Clear Litigation Objectives

Litigation can be a little like smoking cigarettes – it stinks and is bad for your health. And, once you start a lawsuit, it can be hard to stop. However, unlike smoking, litigation is sometimes necessary. Here are a number of ways to minimize the health detriments of litigation:

**1)** Know where the costs of litigation truly reside;

**2)** Streamline your case;

**3)** Make sure your resolve is unmistakable and the result inevitable; and

**4)** Focus your litigation efforts on cases that are likely to pay.

### Costs of Litigation

If you've been involved in enough lawsuits, then you've probably seen at least one case with "runaway" costs. (Sometimes, that is the defendant's strategy.) So, before you commence lit-

igation, talk with your lawyer about case procedure, the accrual of costs and fees, and how costs could elevate based on the specific characteristics of your case.

Discuss in detail exactly what you hope to achieve in the lawsuit, what you will need to prove, how the other party is likely to respond, what they will say about your work, and the easiest ways to address such allegations without becoming distracted. Discuss any procedural roadblocks, third-party claims, or problematic contract provisions (as previously mentioned).

You might consider paying for litigation costs on a contingency basis (i.e., your lawyer will be paid a percentage of whatever is recovered). This payment method may be more favorable than an hourly fee arrangement, but keep in mind that if a seasoned lawyer has assessed your case and is willing to take on the risk, then he likely believes his recovery will exceed his investment in the case.

### Streamline Your Case

Your case should be as streamlined and clear as possible *before* you commence a lawsuit. When there are hard feelings toward the nonpaying customer or even the perception that a professional reputation is at stake, contractors often want to pursue every amount that might be due and to argue even the smallest points.

While these are important considerations, focus on what ultimately matters to your company – the prompt and efficient collection of what is clearly due. This may involve shedding those portions of your claim that will be hotly contested and pursuing the amounts that your customer cannot credibly dispute. In other cases, the factual disputes may be so numerous that there are no benefits to streamlining. This is a judgment call you and your lawyer will make together.

### Your Resolve Should Be Unmistakable & the Result Inevitable

The point of streamlining your case is not to let the nonpaying customer off the hook. To the contrary, the goal is to send an unmistakable message that the day of payment is inevitable and imminent. Clearly communicate that your company is committed to collecting – and collecting quickly (even if that means garnishing every single project your customer has). Typically, when faced with blunt reality, a nonpaying customer will come to the table and deal with its obligations.

### Focus Your Litigation Efforts on the Cases that Are Likely to Pay

Remember the research you did at the outset of the project? The more information you have, the better your decisions. Some nonpaying customers may never be able to pay, while others are temporarily unable, and some just refuse to pay. If you can distinguish between these three situations, then it will be obvious where your collection efforts should be focused.

For marginal recovery prospects, there are a number of ways to efficiently secure a judgment in a reduced amount. Or, if a case is truly hopeless, you may decide to forego litigation altogether. But, you cannot make these decisions with bad information.

## Track & Communicate Your Collections Improvements

Good credit managers rely on instinct and common sense as much as software and data. Consequently, it's sometimes difficult to communicate any improvements in collections policies. Moreover, some of the strategies suggested in this article require cooperation from other departments within your company, and the benefits may not always be realized immediately.

As a result, it's important to implement a tracking method so that you can articulate any successes you have. This could be as simple as providing summary reports of the accounts that have been collected and the efforts that made a difference in obtaining payment. Or, your report could use more complicated metrics, such as average recovery rate, average cost per dollar collected, or average time to collect.

Regardless of how you measure progress, you should be able to communicate how your efforts have benefited your company. Its leadership must understand the value you bring, and your team should be recognized for its progress in improving collections. BP

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Tony is an active member of CFMA's Georgia Chapter and serves on its Education Committee. He received his Bachelor's Degree from The Pennsylvania State University and his Law Degree from Duke University.

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