Management Methods Manual

Credit Policy Criteria

INTRODUCTION

A credit policy is a vital ingredient for any well-run mechanical contracting business. The essential ingredients of a credit policy are:

- the policy itself, including all rules and regulations to be followed by company personnel;
- the personnel to implement the policy;
- outside sources of credit information and
- legal and/or professional collections services to augment failures of in-house policy.

CREDIT POLICY

A short credit policy in memorandum for should be established for each of your departments. For example, the sales department should have a policy requiring that the same credit terms be stated on each contract. You may wish to have 20 percent down with equipment delivery on each negotiated job, or perhaps have that policy only for sales up to $10,000. For larger jobs you might want a billing policy of no deposit when the order is placed, but a month-to-month billing with terms requiring payment of the net amount of the bill within 10 days (net 10), the exact amount to be determined by labor and materials accrued to the job at the end of each billing period. Service departments may need a different approach, such as naming C.O.D. customers (choose those whose past actions indicate they will not pay without prodding or new accounts on which credit checks are not readily available) and service billing terms as net 10 or 30.

It is better to have a standard policy on company billings, either a net 10 or net 30. Net 10 is preferable because if a customer does not pay within 10 days

TIP

When you can, always use net 10 instead of net 30.

MCAA
Mechanical Contractors Association of America

after invoicing, you have sufficient time to remind him that your invoices are marked net 10. This give you the chance to get paid within a month after the invoice is sent out. Whereas, in net 30 billings, you have to wait a full month to find out if the customer will not pay. The result: it will probably be 60 to 90 days before you can persuade him to pay.

PERSONNEL IMPLEMENTATION

Your credit policy should be in writing and clearly stated. Then, someone should be assigned to act as credit manager. In most companies, this will probably be the treasurer or controller. He, in turn, can delegate the carious tasks, such as collection phone calls or payment and past due notices, to staff in his area. They will report to him the success they are having with accounts receivable and the collection of past due accounts. In the case of sensitive accounts, the credit manager might call upon other officers of the company to approach the delinquent customer.

TIP

Always have a credit manager who can delegate smaller jobs to others.

Salesmen often want to try their hands at collecting special problem accounts and, depending upon the customer, they may do a good job. It is necessary to have an efficient accounts receivable aging report form with columns indicating: “current”, “30 day old”, “60 days old”, and “120 days or older”. The form might also contain such information as the account’s name, address, phone number and person to contact regarding past due amounts. This information can also be kept in a separate card file, which is more easily updated. An “aging” form indicates the status of an account at any time, and you should at least post the amount due on the form under the proper aging column.

Your credit manager should be responsible for the following:

1. Check each new contract on negotiated or bid and spec work to determine the terms of payment and assure that the Billing Department abides by the terms spelled out in the contract, regardless of its originator. Additionally, at the time you agree to a job quotation requiring a bid bond, your credit manager should be aware of the withholding terms offered in the specs. You may not want a job with ridiculous withholding percentages or service guarantees enforced by 5% withheld for one or more years, etc.
2. Check turn-key or “negotiated” work to see that those responsible for writing your firm’s contracts comply with the firm’s credit policy.
3. See that carious departments (service, etc.) do not initiate business with new accounts without the proper credit check, or fail to go

C.O.D. if no credit check has been made. Before the service department makes a call, all new accounts should be referred to the credit manager for a credit check. In a smoothly working system, the credit manager can perform this function in a matter of minutes. This is another excellent reason for assigning credit management authority to an employee with the most appropriate experience.

Those contractors whose operations are basically confined to plan and spec work, and who primarily sign contracts drawn by others, may feel that a credit policy and a credit manager are not necessary. However, even these firms can speed up delayed payments when someone watches cash flow versus billings. Accordingly, a credit manager should be appointed to trace problems on the job site that may be adversely affecting payments. This type of credit policy is just as effective in bringing in slow money as telephoning delinquents from an "aging" report form. The amount of money lost because of late payment is larger than many contractors suspect. Owners must be convinced that chronic slow payments increase overall costs. If cash flow can be expedited, the cost of billings may be reduced by 1% to 3% or more. Try offering your customers 2% for the payments made prior to the tenth of the following month, for example, if your billings offer net 10 days.

IMPORTANT

Even straight forward projects should have a credit manager to help speed up the payment process.

OUTSIDE SOURCES OF CREDIT INFORMATION

Another vital ingredient of credit policy is how to run credit checks on new accounts. Dun & Bradstreet is a good, albeit slow, service for checking an account's dollar volume and financial statement. However, its reliability is not always the best because many contractors refuse to give D&B either adequate or current information. An alternate source of information in this case would be appropriate suppliers who may also be able to steer you to other contractors who have worked with the account and know their paying habits. Barring this, another way of obtaining credit information is to phone competing contractors to see if they have had any experience with this account's paying habits. Surprisingly, many contractors are happy to share this sort of information with their peers. Banks and local credit bureaus are two other excellent sources of credit information.

TIP

You can check with a credit reporting company but it's also good to get references from others who know the account and their habits.

LEGAL AND/OR PROFESSIONAL COLLECTION SERVICES

You can hire a lawyer to write a collection letter or file a construction lien; these tasks should not take more than an hour. Collection agencies not only take more time, but they often charge higher fees than lawyers, regardless of the amount collected. Understand the fee structure of hour;y rate of any agency or lawyer before engaging them for collection services. You can justify

IMPORTANT

Never spend more money on a lawyer or collection service tha nwhat you would get paid.

using a lawyer to collect a large amount of the hourly rate does not exceed, in total, 5% or 10% of the amount collected, perhaps higher. It does not make economical sense to pay an attorney $400 to collect $100. There is a break even point on larger accounts beyond which it pays to turn the collection over to an attorney. On the other hand, collection agencies almost always charge high fees to cover the time spent on accounts they have not been able to collect.

CONSTRUCTION LIENS

A device that you can often use to free money being withheld from a contractor after completion of a job is the construction lien. While the laws of various states differ widely, every state in the nation has some version of a construction lien law.

Construction lien laws benefit two different classes of participants in the construction process. The first is the contractor who has contracted directly with the owner, the man or firm referred to as the "general" or "prime" contractor. Even though he can choose whom he contracts with and, accordingly, should perhaps be held to assume the risk of the owner's credit, it is still reasonable to give him a lien on the owner's property, which has increased in value by his labor. The second class of participant is the person who puts labor and/or material into the construction, but has no direct contractual relationship with the owner. This class includes subcontractors, suppliers (material men) and laborers employed by either prime or subcontractors. Although this class has no privity of contract with the owner (they may not even know who he is), they still add to the value of his land. The reason for providing them a lien on the owner's property is that, should the entity with whom they have contracted

TIP

Lein laws can vary a lot depending on the state the job is in.

with fail to pay, they ought to have a legal claim against the land they have enriched.

The basic problem with the construction lien laws of any state rests with the second class of participant. Often the owner is unaware of the possible lien rights of these claimants. He pays his prime contractor in full only to find, too late, that the contractor is either dishonest or insolvent. As a result, the prime contractor does not pay the more remote claimants. Yet, under the law, they may still have lien rights, which, if successfully exercised, will require the owner to pay twice or face losing him property and its improvements.

The same thing can happen if the prime contractor pays his subs in full, but one of the subs fails to pay his more remote suppliers, sub-subs or laborers. In such cases, even these remote claimants may still have lien rights (though state laws differ widely on this issue, and you should consult your counsel in questions of lien rights). It becomes a question of how remote can you be and still have lien rights. Some states limit those who can secure a lien to the first two, three or four tiers, whereas others impose no limit on the remoteness of the tier. Also, in about half the states, an owner is protected against double liability if he pays his prime in good faith prior to any demand for payment being made against him by a potential lower-tier lien claimant.

In most states, an owner is subject to the risk of either paying twice for his construction or losing his land and its improvements through no fault of his own. As a result, knowledgeable owners, and in some cases their mortgage lenders, insist upon waivers of lien. To further confuse the issue, several archaic state lien laws permit the owner and prime contractor to file with the state recorder's office (where the construction site is located) an agreement stating that the job will be a no-lien job with no duty to notify subcontractors, material men or laborers of that fact. Accordingly, if these persons fail to check the recorder's office on every job, they often operate with a false assumption that they have lien rights.

In short, the lien claimant or potential lien claimant wants his payment guaranteed in some manner and the owner wants to be assured that he will not be compelled to pay twice. The prime contractor is in the middle, pressing the owner for payment and the subcontractors and others fir a waiver of lien to satisfy the owner's demands. Adding to the complexity of such situations, construction mortgage lenders get into the act and will not pay unless they are assured of a secured position ahead of the construction lien claimants and owner-borrowers in the event of foreclosure. The conflicts of interests in this area make it impossible to solve the dilemma to everyone's satisfaction through statutory enactment. Aside from understanding that construction lien laws can

play havoc with your cash flow, it is important to realize that you cannot know enough about this facet of the law in any state in which you operate. Further, no matter how sophisticated you may be in getting a construction lien, it is wise to consult with you attorney on filing requirements and other methods of securing your claims by proper procedure- or in getting rid of a lien by one of your own subcontractors.

BE CAUTIOUS IN GRANTING & OBTAINING WAIVERS OF LIENS

As noted above, the procedures for obtaining payment for work performed on a construction project often conflict with the practical use of liens (the legal mechanism to assure payment). As a subcontractor, you should attempt to retain the protection of a lien by giving the general contractor only:

- conditional waiver of lien, that is a waiver conditioned upon receipt of the progress payment involved (conditional waivers are sometimes placed in escrow with the owner or a title company and released upon receipt of payment);
- a waiver of lien work through a certain date, typically the last 30 days; or
- a waiver of lien for a specified dollar amount. Avoid blanket waivers.

Contract documents frequently require a general contractor to furnish waivers from his subcontractors through the date of the previous progress payment. You should resist any effort by a general contractor operating under such a provision to require you to furnish a more far-reaching waiver.

Of course, you should obtain from your own subcontractors and material suppliers a waiver no less extensive than the waiver that you intend to furnish to the general contractor.

SUBCONTRACTOR CREDIT

IMPORTANT

Always check the credit of your subcontractors!

Finally you should check the credit of your subcontractors. A rule of thumb used by many experienced mechanical contractors is to never have a subcontractor perform a sub-contract in excess of two or three times his net worth. This practice will at least protect you for the last third of their invoicing, should they fail to perform. Obviously, you should never overpay a sub. Always withhold money from him until you are sure he has performed to within 10% of the dollar amount for which he has filed.

A subcontractor should be bound to you by an enforceable legal contract

for each job in question, and if the subcontractor has no net worth to mention and/or you have to bond him- you should weigh whether it is with using his services in the first place. Remember that you may have to finish the job with your own resources, and prying money loose from a bonding company is no easy chore.

PAYMENT AND PERFORMANCE BONDS

Bonding companies are experienced, tough and shrewd. They insist that every “i” be dotted and every “t” be crossed, and they demand high standards of proof before they pay any money.

Accordingly, if you are trying to collect on the bond of a contractor who has failed, be prepared and able to wait, perhaps 2 to 5 years, for your money. Even then, you will probably get only a partial settlement. The burden is always on you to compel the bonding company to divulge information and admit their liability. If you have a company with a good reputation and adequate financing for your projects, you can probably obtain a completion bond for about 1% of the contract price. This guarantees that the bonding company will complete any uncompleted work under you contract and/or pick up material bills then owned in the case of insolvency. If you are bondable and such a bond satisfies the owner, it is a good buy.

TIP

It can take many years to get paid on the bond of a contractor.

When examining a payment bind, be certain you know whether it is a bond for labor and materials. The wording must be scrutinized. Never assume coverage is complete for both labor and materials unless it is clearly stated in the bond.

FEDERAL PROJECTS

Federal and state government construction projects differ from private construction projects in the protection afforded subcontractors and material suppliers. Unlike pricate construction projects, mechanics’ and material men’s liens are not available on public construction projects to ensure that subcontractors and suppliers receive payment for material or services supplied. To alleviate the negative effects that mght result from the unavailability of such liens, federal and state governemnts have created statuses requiring prime contractors to obtain payment bonds designed to provide protection commensurate with that available from mechanics’ and material men’s liens. These statutes also typically require performance binds for the protection of the government.

The frderal statute, known as the “Miller Act”, reuires a payment bond, by which a surety guarantees payment of a prime contractor’s obligations to

qualified subcontractors and suppliers, and a performance bond, by which the government obtains assurances that the contract will be completed. This latter bond is required solely for the protection of the government, and provides no protection to the subcontractors or suppliers.

Tip

A prudent subcontractor or supplier should determine whether its contemplated work falls within the protection of a Miller Act bond.

In any case, a prudent subcontractor or supplier should determine whether its contemplated work falls within the protection of a Miller Act bond. Although there is support for filing a lien against money owed to the prime contractor by the government, parties should not rely on such authority. Additionally, parties should not automatically assume a Miller Act payment bond has been posted, as the government may occasionally neglect to include the bind requirement in the prime contract.

Appropriate areas of inquiry for a subcontractor seeking to determine whether a particular project is subject to the Miller Act include the following:

1. Is the contract a standard form contract (such as Standard Form 23-A, Construction Contracts)? Use of Standard Form 23-A is a strong indication the Miller Act applies.
2. Do the terms of the contract require a Miller Act bond?
3. What is the nature of the work to be performed under the contract? If the work described is primarily construction, a bond is usually required. If the work is divisible into construction and non-construction items, the higher the percentage of construction work, the more likely it is a bond will be required.
4. Was the contract advertised through an Invitation For Bid (IFB)? (Government construction contracts are advertised.) Did the advertisment specify that Miller Act bonds would be required?
5. What are the obligations of the prime contractor; i.e. is the prime contractor simply a construction manager or is the firm required to perform some construction of the project? The probability of a bond requirement increases if the prime contractor is responsible for some construction activities on the project.

Important

The Miller Act bond only protects the government.

The Miller Act performance bond only protects the government, and therefore, failure to require this bond does not affect the rights of ay other party. This is not the case, however, with the failure to provide a payment bond, since it is for the protection of subcontractors and suppliers rather than the government. Generally, the United States is not liable for failing to require Miller Act bonds. To avoid the adverse possibilities, it is always wise to contact legal cousel.

A FINAL CAVEAT

If your average net profit is running two percente, remember that it take $50,000 in new business to make up for each $1,000 this is uncollectible at the year's end.