

DEBT COLLECTION: SURVIVING THE RECESSION

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Businesses must be vigilant about collection of payments from their customers. In this global recession, it is even more critical to monitor cash flow and to promptly collect outstanding receivables. This article will discuss procedures and considerations to obtain payment of outstanding receivables and other payables, as well as the procedures to collect a debt that has become past due. This article will also discuss attachments and other quick seizure remedies to give the creditor priority for full payment, considerations which are critical for survival in a recession.

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A creditor will always have the most leverage and flexibility before the debt is incurred.

This is a critical point since a creditor has far fewer options available to try to collect the debt after the debt is incurred. Before products or services are sold on credit, the seller should have a written agreement with the buyer and should take precautions to have adequate security for payment. After the products or services are delivered to the customer, it is often too late to obtain any security for payment.

Successful financial business management includes the establishment of procedures to verify that customers are credit worthy, procedures to make sure that customers do not exceed established limits on their credit, and when accounts receivable become past due, the creditor must follow effective collection procedures. Consistent collection practices will improve cash flow and ensure the survival or success of the business. In the current economy where buyers are often forced to choose which debt to pay, it is vitally important for creditors to avoid developing a reputation among customers as being slow to collect payment of accounts receivables.

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I. ESTABLISHMENT OF CREDIT

The most important step in credit management is to establish procedures to be careful before granting credit to buyers unless they are likely be able to repay it.

A. Credit Application and Credit Agreement

Every customer should fill out and sign a detailed written Credit Application and Credit Agreement before any credit is extended. If the customer defaults and the seller is forced to sue to collect payment, the lawsuit will be based upon this Credit Agreement.

The Credit Application and Credit Agreement should request the legal name and business address of the customer as well as all shareholders (if it is a corporation), members or partners, detailed financial information regarding the customer, including names of banks and bank account numbers, and a release for the creditor to confirm the credit information provided. The Credit Application and Credit Agreement should also include a provision that in the event a lawsuit is required to collect any debt, that the creditor will be entitled to also collect its legal fees and costs of collection. Even if these terms are printed on the invoice,

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it is easier to enforce them if they are included in the Credit Application and Credit Agreement.

The Credit Application and Credit Agreement also include the obligation to repay the credit and must be signed by the customer. If credit is being extended to a corporation, limited liability company ("LLC") or limited partnership, the Credit Application and Credit Agreement should also include a personal guarantee (which is discussed below).

B. Personal Guarantee

If the customer is a corporation, LLC or limited partnership, the seller should have the principal shareholders, members or limited partners sign a personal guarantee for payment of the debt. Shareholders are generally not liable for a corporation's debts. Members of an LLC are similarly not liable for LLC debts, and limited partners are not liable for the debts of the limited partnership. If the corporation, LLC or limited partnership does not have the assets to pay the debt, the creditor most likely will be unable to collect the debt. In closely held corporations, LLCs and limited partnerships, it is easy for the company to transfer funds to its

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shareholders, members or limited partners, which can result in the company being unable to pay its debts. The most effective way to prevent this is to require that the principal shareholders, members and limited partners sign personal guarantees.

A personal guarantee is a separate contract in which the shareholder, member or limited partner, known as the “guarantor” agrees to guarantee payment of the debts of the company. If the guarantee is signed at the same time that credit is extended to the company, the extension of credit is sufficient consideration for the guarantee to be enforceable; however, if the guarantee is signed after credit is extended, there must be separate consideration, such as a change in the terms of the credit to make the guarantee enforceable. It will be much easier to enforce a guarantee if it is signed at the time that credit is extended.

California law protects guarantors from changes in the terms of the loan or credit that could adversely affect them. Therefore, if the seller increases the credit line to the customer, or extends payment terms, without obtaining the written consent of the guarantor, the

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guarantee may be void. If the seller decides to make any changes to the loan or credit that has been extended, the seller should always obtain the written consent of the guarantor at the time of the change. This is true even if the guarantor is the principal shareholder or member of the company.

C. Monitor the Credit

Once the seller has decided to extend credit to a customer, the seller should establish a credit limit. The credit limit should be based upon a reasonable estimation of what the customer will be able to repay.

It is very important that this credit limit be enforced. Many collection cases occur because the seller, in an attempt to increase sales, has allowed a customer to exceed the established credit limit. It is very important that salesmen do not have that ability to increase credit limits or to make sales on credit that will exceed a customer's credit limit.

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If customers do request an increase in their credit limit, it should be treated as a new application for credit. The customer should be asked to complete a new Credit Application and Contract, the customer's credit references should be checked and the guarantor(s) should be required to sign a new guarantee reflecting the increase in the credit limit.

II. LITIGATION TO COLLECT PAST DUE DEBTS

A. Begin Collection Early

The longer a business waits to begin collection of a past due debt, the less likely it is to collect the full amount. Once a debt becomes more than sixty (60) days old, the likelihood of collection drops dramatically. Once a debtor falls behind in payments, they generally continue to fall farther behind. It is important to begin collection proceedings as soon as possible to increase the likelihood of collection.

Additionally, there should be a company policy not to extend further credit to a company that is behind on its payments. Even if the customer's outstanding balance is less than the

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credit limit, no further credit should be extended if the customer is not making timely payments.

This can be one of the most effective means of collecting overdue payments. Once customers realize that they cannot continue to purchase on credit, they often arrange for prompt payment.

B. Demand Letter

The first step for a creditor is to call the debtor or send a letter to the debtor to demand that the debt be paid. The letter should include a deadline for payment and should clearly describe the amount due, along with the other elements discussed below. The first letter should be sent as soon as the debt becomes past due. We generally recommend that the first letter be friendly in tone, state that payment has not been received and request that payments be brought current as soon as possible.

If the debtor has not paid within ten (10) days after the initial letter, we recommend sending a second letter with a stronger tone and threatening collection action if the obligation is not paid. It is generally more effective to have a lawyer send this letter instead of the

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creditor or collection agencies, since the creditor recognizes that lawyers have the ability to enforce the creditor's rights to collection. This letter should also ask the debtor to contact the creditor if the debt cannot be immediately paid to arrange a payment plan. Finally, the letter should state that the creditor will take legal action to collect the debt. As lawyers for our clients, we will add a statement that the letter is the final warning before a lawsuit is filed and that no other letters will be sent to the debtor.

It is important that these letters are sent out promptly. Many companies are having to choose which obligations to pay, and you want to make sure that you are at the top of their list. The best way to do that is to establish a reputation for watching past due accounts and taking prompt action to collect them.

C. Installment Payments

If the debtor does not have the money to pay the debt in full, the creditor may want to consider negotiating a settlement agreement which allows the debtor to make installment payments. The settlement agreement and installment payment plan should be in writing and

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the creditor should also obtain additional security to assure payment. The debtor's financial condition may be worsening, so the creditor should insist on security in exchange for accepting payments on an installment plan.

The additional security can take the form of personal guarantees, if the individual guarantor is credit worthy, a security interest in personal property such as accounts receivable or inventory, if there are no senior liens, or a security interest in real property if there is equity that is available. The security interest in real property is the ideal security; however, very few trade customers are able to provide such security.

Any installment payment agreement must also include a provision that if the debtor fails to make any installment payment on time, then the creditor can enter a court judgment against the debtor immediately for the entire amount of the debt due and begin to enforce the judgment.

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D. The Collection Lawsuit

If the debtor does not respond to the demand letter, the next step is to file a lawsuit to collect the debt. Once a strongly worded demand letter is sent out and the debtor does not respond, we have found that it does not make sense to continue to send letters.

Remember that time is on the debtor's side, the longer the creditor waits to take action, the less likely the creditor will be to collect.

In California, if the debt is less than \$5,000 (or \$7,500 if the creditor is a natural person), the creditor has the option to file a lawsuit in Small Claims Court. The Small Claims Court filing fee is low, attorneys are not allowed to participate in small claims court, and the cases are usually decided quickly. The disadvantage is that the creditor cannot appeal if the creditor loses the case, but the debtor is allowed to appeal if the debtor loses. Creditors can chose to sue in Superior Court instead of Small Claims Court on these small claims.

Collection lawsuits are generally filed in state Superior Court. There are two separate divisions in the state Superior Court. The Limited Jurisdiction division handles cases less than

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\$25,000 and the Unlimited Jurisdiction handles all other cases. In Limited Jurisdiction cases, the filing fees are lower, discovery is limited and cases are generally resolved faster.

After the lawsuit is filed, the debtor must be served with a summons and complaint.

There are strict rules for this service that must be followed, and service must be performed by a third party, not the creditor. Once the debtor has been served, the debtor generally has thirty (30) days after receipt of the summons to file an answer. The debtor may also file a Cross-Complaint if the debtor believes that it has its own claims against the creditor.

After the debtor has filed an answer, the parties engage in the process of discovery, where they attempt to discover facts and documents held by the other side. Discovery consists of written interrogatories, requests for admissions, requests for production of documents and oral depositions. Generally, in collection cases, discovery is more limited, unless there are claims that the goods were defective or that the debtor is not liable for the goods.

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After the discovery process ends, the Court will schedule a trial date. In California, courts try to get at least ninety percent (90%) of their cases to trial within one (1) year. As a practical matter, most cases are settled prior to trial. The parties enter into a written settlement agreement which will be enforced as if it were a judgment.

E. Judgment

If the creditor cannot settle the case, the creditor must obtain a judgment against the debtor. Unless the debtor raises an issue regarding the validity of the debt, judgments are obtained by a default or after a short trial. If the validity of the debt is challenged, then the trial can become much more complicated.

III. PRE-JUDGEMENT REMEDIES

California allows creditors to take advantage of certain prejudgment remedies during the collection lawsuit. These pre-judgment remedies allow the creditor to seize assets of debtor before the judgment is issued in order to assure payment of the judgment.

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A. Application for Attachment

Creditors should always consider filing an Application for Attachment concurrently with the filing of the lawsuit. A lawsuit can take a year or longer and debtors can deplete their assets during the course of the lawsuit. Attachment is a legal procedure in which the Court orders the Sheriff to seize property of the debtor immediately. The creditor can choose the property, and creditors generally try to attach bank accounts, accounts receivable or inventory. The Sheriff holds the property that has been seized until the completion of the case, at which time the Court will issue an order to the Sheriff to deliver the property to the parties.

Attachment is effective for two (2) reasons. First, attachment gives the creditor a means to seize the debtor's assets immediately to assure that a judgment can be collected. Second, a successful attachment generally forces the debtor to settle quickly because its assets have already been seized.

Attachments may only be sought against corporations, LLC's, partnerships and individuals engaged in a trade or business. Attachments may not be sought against

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consumers. The creditor files the Application for Attachment and the court will set a hearing approximately one (1) month later. During the hearing, the creditor will have to convince the court that it is more likely than not that the creditor will win the lawsuit in order to obtain a Writ of Attachment. Creditors can also obtain a Temporary Protective Order during this period to prohibit the debtor from making any payments outside the ordinary course of business.

The best asset to attach is the debtor's bank accounts, in which case the sheriff literally takes money out of the debtor's account and holds it until either a settlement is reached or a judgment is entered. It is also possible to attach other assets such as equipment or inventory; however, the business must pay for the storage of such assets until a judgment is entered and the assets can be sold.

B. Claim and Delivery

If the debtor has pledged personal property as security for the debt, the creditor should consider a claim and delivery proceeding in which the Court can order such property to be turned over to the creditor. Unlike an attachment, the creditor must specifically identify the

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property that is to be subject to the claim and delivery order. If the creditor can convince the Court that it is likely to win the case, the Court will issue an Order directing the Sheriff to seize the specific property of the debtor that has been pledged as security. The Sheriff will then deliver this property to creditor in satisfaction, or partial satisfaction of the debt.

Creditors selling large items such as vehicles, industrial machinery or similar assets should obtain a security interest in the asset which is being sold. The creditor must file a form with the Secretary of State (known as a UCC-1) in order to perfect the security interest in the asset. The security interest will allow the creditor to recover the assets in a claim and delivery action relatively quickly.

IV. ENFORCEMENT OF THE JUDGMENT

Once a creditor obtains a judgment, the creditor must enforce the judgment to collect the debt. The first step is to record the judgment in any county where the debtor owns real property, and with the Secretary of State in any state where the debtor owns personal property. By recording the debt, the debt becomes a lien on the real or personal property.

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This procedure is very effective with real property because a buyer or a lender will insist that the lien be paid off before buying or lending on the property. The debtor cannot sell or refinance the real property without paying off the debt. In California, judgments earn interest at the rate of ten percent (10%) per year, so the longer the debtor waits to pay off the judgment, the bigger the judgment gets. If the debtor does not sell or refinance the property, it is also possible for the creditor to obtain a court order to sell the property.

The creditor can also enforce the judgment by seizing assets of the debtor such as bank accounts, equipment or other assets. If the creditor has attached the assets, all assets attached are paid to the creditor as part of the judgment. If there has been no attachment, or if the assets attached are not enough to pay off the judgment, then the creditor can continue to seize assets until the judgment is paid.

The creditor can obtain an Order for Examination of Judgment Debtor. Once this Order is served on the debtor, the debtor must appear in Court and bring any documents that have been requested by the creditor. The debtor will be sworn to tell the truth and then the

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creditor can ask any questions regarding finances or assets. If the debtor refuses to answer, the creditor can ask the Judge to force the debtor to answer or risk going to jail.

If the debtor is an individual and is employed, the creditor can seize a portion of his earnings, in what is known as a “wage garnishment.” The Court will issue an order to the Sheriff to be served on the debtor’s employer. The employer must pay a portion of the wages (approximately twenty-five percent) to the Sheriff to be delivered to the creditor until the judgment is paid in full.

If the debtor operates a retail business, the creditor can obtain an order to put a “keeper” in the business. The keeper will seize a portion of the all revenue received by the business until the judgment is paid.

Judgments in California are good for a period of ten (10) years and can be renewed for an additional ten (10) year period. It is very important to start the renewal process at least six (6) months prior to the expiration date of the judgment to assure adequate time to complete the renewal process.

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V. BANKRUPTCY

A Bankruptcy filing of the debtor is an automatic stay of all collection litigation against the debtor but not guarantors. A creditor cannot resume collection litigation against debtors until the Bankruptcy Court has granted relief from stay to proceed with the lawsuit.

Bankruptcy is to provide for the orderly and fair proportionate payment or distribution of assets to creditors, but it can be slow with very little payment. There are several categories of creditors including secured and unsecured. The recent increase in bankruptcy filings highlight how important it is for creditors to follow credit procedures and to have security or personal guarantees to ensure payment.

The bankruptcy filing date is the "Petition date." Creditors must be aware of the differences in pre-petition debt and post-petition debt. Creditors should also be aware that creditors may have to return to the debtor any preferential transfers or payments received within the preferential transfer period (ninety (90) days before the petition date, or one (1)

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years before for insiders) for past due amounts. Similarly, a creditor may challenge any preferential or fraudulent payments or transfers made within the preferential transfer period to other creditors or insiders as unfair or fraudulent.

VI. CONSUMER DEBT

There are special rules that apply to collection of consumer debts, and large fines or penalties if those rules are violated. If any debt is likely to be considered a consumer debt, the creditor must follow the rules for collection of consumer debt.

Consumer debt is any debt associated with rent on a residence, medical bills, utility bills, personal insurance, student loans and consumer credit cards. Rent on a business location, insurance policies for a business or credit cards in the name of a business would not be consumer debt. Anyone attempting to collect a consumer debt is considered a debt collector. If the debt is consumer debt, the first communication to the debtor must include a statement that the writer is attempting to collect a debt and any information received will be used for that

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purpose. This is true whether the first communication is a telephone call or a letter. All further communications must disclose that the communication is from a debt collector.

In addition, when contacting a consumer, the debt collector cannot make any misleading statements. For instance, the debt collector cannot pretend that he has found some money for a consumer and tell a consumer that the consumer will receive the money if the consumer provides information about bank accounts. Debt collectors cannot contact a consumer at work, and cannot contact a consumer before 8:00 a.m. or after 9:00 p.m. These rules are to prevent harassment of consumers. If the debt collector violates any of these rules, there is a \$1,000 penalty for each violation. It is possible to incur penalties much greater than the debt which is being collected.

VII. CONCLUSION

Creditors can improve their own financial condition and reduce their bad debt losses by establishing proper credit and collection procedures. Well drafted credit applications and credit agreement, as well as a reputation for consistent and fair collection procedures, should

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improve cash flow through increased voluntary customer payments. Our firm has substantial experience and success in collections. We have successfully represented creditors in collections throughout the U.S., including banks, finance companies, and corporations in many different industries.