

Trade Creditors Borrow Tools of Lenders

Collateral management is an accounting-related service provided by a small number of predominately non-public accounting firms to a wide range of creditors, including commercial banks, finance companies, institutional investors, trade suppliers, and other lenders. Collateral management focuses on the physical confirmation of the existence, quality, and movement of collateral assets related to lending or credit extension.

Traditionally, collateral management was used as a tool for secured creditors, but new innovations have led to its use by trade creditors. This use involves controlling the physical release of large ticket and commodity goods in relation to specific credit limits or selling terms. The requirements are most notably associated with extended terms, seasonal sales, or risks synonymous with highly leveraged or troubled companies.

Investors and traders may turn to third parties to control assets acquired for processing or resale arrangements through host companies. The securities industry is focusing on securing trading assets and increasingly requires independent controls and reporting integrity agreements.

Gaining Perspective

For many years, commercial banks and asset-based lenders employed third-party collateral management firms to lend against trading assets such as inventory, accounts receivable, and installment or chattel paper. Likewise, borrowers wishing to convert these assets into working capital have sought out such services to help obtain new loans or line increases.

But the collateral management industry has changed during its 90-year history and today offers options such as examinations, reporting services, warehouse receipts, and certification programs which enhance financing transactions and give lenders additional comfort in loan administration.

Before the Uniform Commercial Code (UCC), lenders could only grant loans

when they could acquire title to a borrower's inventory or accounts receivable collateral. This meant factoring the accounts receivable and transferring inventory to a public warehouse. Few companies could afford to give up their inventory for very long, however.

In the early 1900's, the concept of field warehousing was created to establish a warehouse at the site of the inventory, instead of moving inventory to a warehouse. Warehousing companies would establish a facility on the borrower's premises and issue receipts to the lender. Under the field warehouse concept, the borrower's employees were transferred to the payroll of the collateral manager to act as agents. Pledged inventories were stored separately, thus establishing bailment.

While banks could establish a "right" to the collateral, they still needed to know that sufficient collateral was always in existence to cover outstanding loans. In time, the collateral control industry also provided lenders with information tools, including monitoring and reporting services.

These informational systems were designed to determine the eligibility of inventory and accounts receivable, and were put in place, either with or without controls on cash proceeds or shipments. Periodic examinations by collateral managers supported lenders without their own full-time staff to handle specialized situations such as commodities, complex manufacturing, retailing, wholesale distribution, and leveraged buyouts.

Lenders seeking maximum protection were backed to varying degrees by the indemnity of the collateral management firm, which had insurance protecting them from claims involving fidelity, errors, omissions, negligence, and casualty claims against physical assets in their custody.

Growing Use of Collateral Management

Global competition, varying economic cycles, inflation, changes in bankruptcy laws, and the wave of leveraged buyouts

have burdened the credit manager with balancing risks and rewards. The collateral management industry has attempted to react with services tied to risk management of physical transfers of selling assets.

Certain businesses—specifically appliance, marine, aircraft, power tool, steel, furniture, seafood, and lumber—have made use of third party control as a basis for internally developed customer finance programs. Warehouse receipts, derived from field warehousing, are used to allow larger quantities of the customer's goods. Under Article 7 of the UCC, issuance of a warehouse receipt demonstrates perfection of title in the seller's favor. This alleviates many of the risks associated with secured creditors who assert prior or senior interests in the same collateral.

Depots or subdistribution branches can be created where title-retained inventories can be housed at the customer's location under the care and custody of a third party.

Certificates indicating supplier inventory levels can be used by the seller's accounting, billing, credit, and treasury departments. The extension of credit can be highly structured or limited to specific instructions. Even credit sales to leveraged or troubled companies can be constructively managed.

The use of inter-creditor agreements can alleviate many of the risks and spell out the requirements in selling customers where a secured creditor possesses a superior lien on receivables and inventory.

The future is uncertain for many of today's leveraged companies. Trade creditors can draw on the consulting and fiduciary skills of competent collateral managers to address opportunities and risks of rapidly growing, high leveraged, or troubled concerns. □

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