



# **COLLATERAL MANAGEMENT: Keeping Your Customers Through Troubled Times**

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**by Richard J. Maturi**

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**T**o ship or not to ship. That is the question that constantly torments a financial manager dealing with a financially troubled customer. No matter what the answer, the supplier takes a huge risk. If the customer goes bankrupt, the supplier may never get paid. (Goods can sometimes be recovered by filing—with in 10 days of delivery—a formal notice of intent to reclaim, but this remedy will protect only shipments made in the previous 10 days that have not already been consumed or resold in the normal course of business.) If, instead, the supplier decides to cut off sales to a major customer, it will probably wind up hurting itself in the process.



A service called collateral management may resolve the dilemma. Offered by a small number of management and consulting firms, collateral management enables suppliers to continue providing goods to customers while legally maintaining ownership of the goods in the event of bankruptcy. The critical element of collateral management is ensuring that the supplier's product is segregated completely from the rest of the customer's inventory. Third-party controlled distribution operators maintain partitioned warehouses or storage areas secured by their own locks and posted with signs that provide notice of vendor control to other interested parties such as financial institution lending officers.

Individual vendors can attempt to set up their own controlled distribution facilities at their customers' plants, but the cost is prohibitive, and in most instances, these vendors lack the expertise to run the operations efficiently.

According to Marilyn Shea-Stonum, a partner in the Cleveland office of the law firm Jones Day Reavis & Pogue, "Properly administered, the field warehouse concept is a very useful device for protecting the supplier's goods. With more and more financing in today's society becoming asset based, it makes sense as an unsecured creditor to safeguard your assets."

"Some vendors try to circumvent the physical control provisions of the bankruptcy code through written con-

tracts, but these are usually overturned by bankruptcy judges," warns Shea-Stonum, who specializes in bankruptcy cases. In other words, should the customer eventually file under Chapter 11, bankruptcy courts will probably not recognize written contracts as sufficient evidence of vendor ownership of the goods. Vendor control must be established not only on paper, but in fact as well.

Dallas-based DiversiCorp Inc. offers a collateral management service called "controlled distribution." It allows trade creditors to place their product in the debtor's warehouse while retaining title to the goods by using a locked and segregated subleased storage area. DiversiCorp agents maintain on-site custody and physical control of the goods, with the vendor providing instructions for the delivery, receipt, and issuance of the product as well as invoicing and payment terms. These instructions can range from the very restrictive—no release of goods unless approved by the supplier—to the most relaxed—unlimited release until further notice by the supplier.

Controlled distribution services can be useful even if the customer has already filed for Chapter 11 protection. Vendors, of course, have some additional protection when shipping to a company already in Chapter 11, because such shipments receive a high priority for payment as an administrative claim. Still, they stand behind other administrative claims, such as taxes, ongoing legal and banking fees, and employee liabilities. And since, according to the Turnaround Management Association of Chapel Hill, North Carolina, only about 25 percent of all companies filing for Chapter 11 ever return to financial health, the risk of shipping goods remains high. Those 75 percent that do not recover seldom have enough cash to meet their administrative claims.

Yet, DiversiCorp actually prefers servicing companies that are already in Chapter 11. Explains Jim Mayer, the company's president and chief executive officer, "Chapter 11 is less risky because these companies are under a very strict method of operations and are subject to court scrutiny." On the other hand, SLT Warehouse Co. of St.

Louis, which has been providing controlled distribution services for more than 60 years, prefers dealing with companies that have not yet filed, and only reluctantly takes on clients already in Chapter 11. Jack G. Moses, SLT vice president of marketing and sales, believes that such companies are "too risky." SLT, he says, will accept such a client only if "we have had a good relationship in the past with the company's supplier or commercial lender."

Mayer points out that suppliers can use controlled distribution services to expand sales to customers with solid financial records as well as to protect current sales to those in trouble. Controlled distribution permits profitable businesses to store, on their own property, the higher levels of inventory they must maintain to increase sales, without having to spend their cash to pay for the inventory until the goods are actually needed. This is, in effect, a form of just-in-time inventory control.

Leslie Beich, credit manager for Chaparral Steel Co. in Midlothian, Texas, says controlled distribution first protects its inventory at troubled companies and then permits those companies' sales to expand when they have succeeded in their financial workouts. "It allows us to give our troubled customers time to work out their financial problems without taking on additional risk," said Beich.

DiversiCorp also offers a variety of auxiliary consulting services along with its controlled distribution program. For example, it will conduct a comprehensive business survey of the debtor company, auditing all areas of the company's operating procedures, paying careful attention to cash flow and aging of payables. In addition, DiversiCorp will conduct ongoing examinations of the customer's accounts receivable and accounts payable records. And it will keep an eye out for preferential payments made to other vendors, which can be very important when a customer is having financial difficulties.

Suppliers aren't the only ones to benefit from controlled distribution services. The customer will benefit,

as will its major lenders. Most valuable to the customer, of course, is the unhindered flow of goods it needs to continue conducting business. But SLT's Moses believes that troubled companies can also improve their business discipline through collateral management. He contends that inadequate inventory controls and purchasing policies are often among the problems that lead a company into financial distress. Such companies, he says, can learn valuable lessons merely by watching SLT's methods and later applying them to their own inventory. "Those firms profit from our years of experience. Typically, we help establish controls and an operating discipline that never existed before," Moses reports.

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*The companies  
most likely to use  
controlled distribu-  
tion services sell  
products with high  
unit prices.*

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Banks and other major creditors also gain when a client's inventory is supported by suppliers. According to Russ Whites, vice president for commercial lending with the Mercantile Bank N.A. in St. Louis, "Controlled distribution operations often provide a greater comfort level for collateralizing extensions of credit. Bankers are not inventory experts; therefore, it sometimes makes sense to have inventory services provided by professional third-parties."

The fees for controlled distribution services average from 2.5 to 4 percent of the value of the inventory. Depending on the complexity of the situation, fees are paid by the vendor or its customer, or by both, according to prior agreement. Normally, the customer pays the fees if it is in financial trouble and the supplier requires controlled distribution services as a condition for shipping

goods. More imaginative agreements can be worked out if the supplier is using the service to expand sales. Some vendors absorb the fees as an incentive to customers to increase inventory. In other cases, the supplier may absorb the fees if the customer increases sales to a targeted level for a given period. If the customer fails, it must absorb the fees.

Controlled distribution services are not cost-effective in every situation. According to both Mayer and Moses, accounts under \$200,000 are not economical to establish. The companies most likely to use these services—including hard goods suppliers and manufacturers in the furniture, power tool, heating, and air conditioning industries—sell products with high unit prices. Before accepting an account, DiversiCorp, for example, initiates a comprehensive business survey to determine the feasibility of establishing a program. "Evidence of problematic accounting records; questions concerning integrity, such as suspected fraud; high-risk industries, such as toxic waste; and goods too numerous to control efficiently are the most common reasons for turning down an account," says DiversiCorp's Mayer.

**Passing title and protecting yourself, too**

While typically the supplier must both segregate its goods by maintaining separate storage facilities and retain formal title to its goods in order to protect its interest from secured creditors, DiversiCorp does offer an alternative method that permits the vendor and its customer to ignore some of these conditions. DiversiCorp will customize its controlled distribution services so that title can, in some cases, pass to the customer. The supplier carries the amount of inventory on its books as an account receivable, either by using a purchase money security interest vehicle, which makes the vendor a secured creditor, or by signing special agreements that waive a bank's—or other senior creditor's—potential lien against the goods.

Although title passes to the distrib-

## CREDIT MANAGEMENT

utor, the supplier maintains control over the release of goods, basing it on actual sales of the distributor and subsequent payment to the supplier. The supplier gains many of the benefits of traditional controlled distribution services, including the ability to ship directly to the distributor in economical lots, while avoiding many of the bureaucratic burdens. This approach eliminates the need to post signs stating vendor ownership at warehouse facilities and allows products on the display floor to remain part of the program.

A controlled distribution program can marry nicely with other business credit management strategies. For instance, a supplier carrying business credit insurance on several of its cus-

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tomers may have its coverage limits raised or premiums lowered because of the lower risk associated with controlling the release of product to the customer and retaining title.

DiversiCorp's George Thorson, executive vice president and general manager of the collateral management division, views controlled distribution services as providing new and exciting opportunities for supplier/customer relationships. "By getting everyone involved, from the sales manager to the production manager to the chief financial officer," he explains, "you can forge a whole new overall strategy of doing business. This concept can affect how you run the production line, warehouse, ship, and more—right through the entire organization." ■

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## About DiversiCorp, Inc.

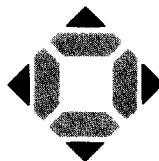
DiversiCorp, Inc. was chartered from Diversified Consulting Associates ("DCA") at the end of fiscal 1983. DCA was and still is a specialized consulting service providing creditors with external, third-party expertise in workout; crisis management; legal-related issues of reorganization and bankruptcy; viability evaluations; and liquidation. Its team of consultants is headed by members of the Institute of Management Consultants, American Bankruptcy Institute, Turnaround Management Association, and conforms to rigid requirements with respect to competency and integrity.

Recognizing the market need, DCA developed **Collateral Management Services**, which added additional capability from a single organization to provide administration and control of collateral and other assets.

Finally, DiversiCorp needed to structure and arrange specialized financing associated with takeouts. This included asset-based facilities, leveraged buyouts, and bulk sales. The entity created for this purpose is now known as **DiversiCorp Financial Services**.

Together, DiversiCorp is a *unique* provider of services creditors need most today in maintaining collateral positions, asset control, troubled account recovery, and non-bank lending alternatives. DiversiCorp, Inc. is positioning itself nationally as an integrated credit support service.

Contact us today to learn more about DiversiCorp, Inc. and its affiliate members, Collateral Management Services, DiversiCorp Financial Services, and Diversified Consulting Associates.



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