Strategies to reduce risk with the right contract terms and conditions

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As all credit professionals know – credit, cashflow and collections all work together to protect the lifeblood of many businesses. Without a proper functioning credit team, businesses run the risk of significant impacts on ongoing profitability and viability. Unfortunately, risk is an unavoidable part of the credit function, and well considered credit terms can often provide risk mitigation and safeguards to the business.

What are the impacts of the risk you take on?

Risk takes various forms – but in the credit and collections world the biggest risks include customers failing to pay creditors in accordance with trading terms, and the inability to collect through standard collection processes.

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A failure to pay can quickly result in insolvency and loss, and depending on your exposure, and other liquidity concerns, the impact of lumpy and sometimes 'difficult to collect' credit can be a huge headache to the business.

What's the worst that can happen?

No business wants to unnecessarily litigate to collect. Put simply, it is desirable to work collaboratively with customers to address any non-payment outside of payment terms.

However, if your customer's cash-flow problems are affecting your business, you may need to consider litigation and other enforcement options. There are a number of prudent steps which can be taken to put creditors in the best position to successfully deal with credit risk.

Why does this matter?

Economic data indicates that the economy could be in for a rough ride in the coming months.

Those in the credit industry have long suspected the ATO of having taken, for some time, a "softly, softly" approach with respect to pursuing recalcitrant taxpayers.

These suspicions are borne out by the publicly available information which shows that record debts are owed to the ATO, and that the ATO's total debt book has grown to about $60 billion. Further, winding-up and bankruptcy petitions initiated by the ATO are at lows for modern times.

Could increased ATO activity bring about more insolvency?

Since the pandemic began in 2020, the ATO's overt collection activities (i.e. winding-up and bankruptcy petitions) have been almost non-existent, although there have been some recent indications that the ATO's collection activity is set to ramp-up. In April 2022, the ATO wrote to over 50,000 directors giving them 21 days' notice to pay their tax liabilities, failing which a Director Penalty Notice (DPN) may be issued. This has been seen by some as a 'warning letter' on the part of the ATO and precursor to further action being taken.

Why does this impact on trade creditors?

The ATO's involvement in the insolvency space is well known, and historically, together with the major banks, the ATO has been a major driver of insolvency activity in the economy. Given the ATO's recent aversion to pursuing large-scale enforcement, it is likely that insolvencies will increase if the ATO reverts to its pre-COVID practices.

Statistics show that about 25% of insolvency activity occurs within the building and construction industry. Many readers will themselves have either direct involvement in the building and construction industry, or exposure to that industry.

The building and construction industry otherwise has significant impacts on other parts of the economy, and can result in a domino effect impacting many suppliers and other contractors. Recently, there have been some very high-profile insolvency appointments in the building and construction industry (including, Probuild and Condev).

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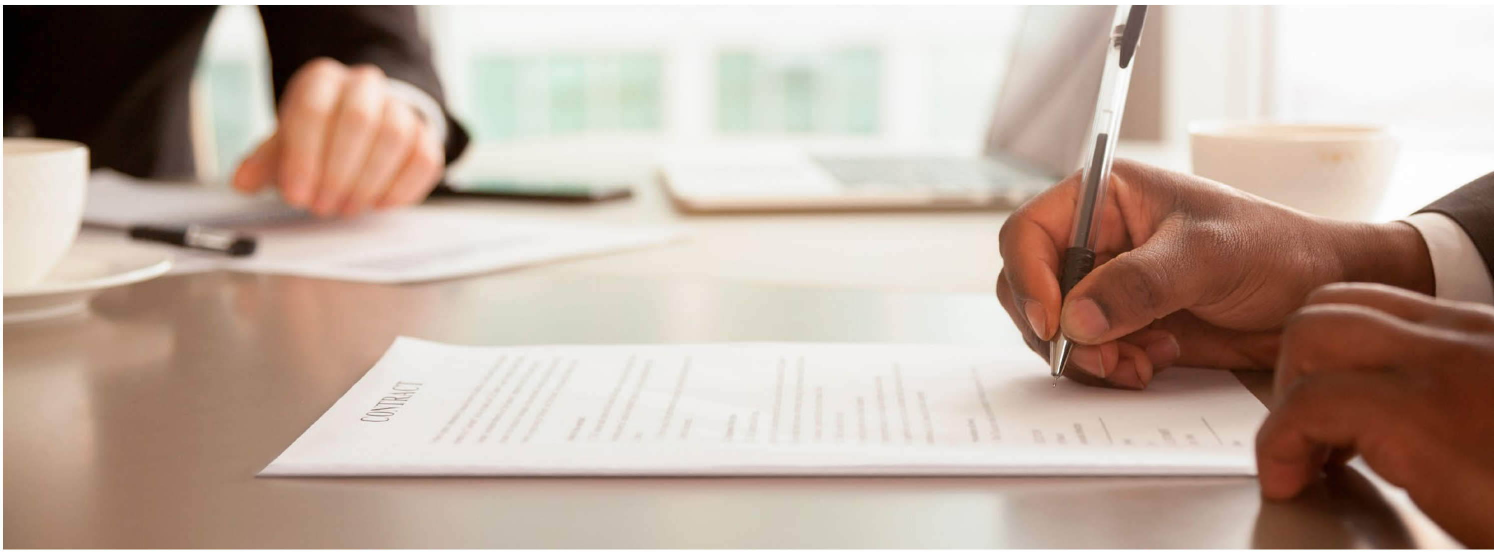

What are we expecting to see in the coming year?

Historic low levels of interest rates have enabled borrowers to borrow more, which has impacted on record high housing prices and inflation. Recent data has confirmed that inflation has surged to 5.1% – the highest level since 2001. Those in the building and construction industries have been particularly hard hit. More broadly, at the time of writing, there are strong indications that the Reserve Bank will raise the official RBA cash rate from the current 0.1%.

There is otherwise severe pressure on supply chains, energy markets, increased global inflation and debt – all on top of a war taking place in Europe. These factors, amongst many others, have worked together to create a degree of recent economic uncertainty.

We are expecting to see a wave of increased insolvency activity over the coming months. This presents businesses with increased risk, and credit managers with challenges. Prudent credit managers will take early steps to mitigate that risk and implement numerous strategies to deal with that risk head-on.

What can you do now, to mitigate this risk?

Whilst this does not form a bullet-proof list for every client in every situation, we consider the clauses set out below to be very important in any credit professional's arsenal.

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What is the simplest, and most effective way to protect your credit risk?

We cannot emphasise enough the importance of having appropriate terms and conditions in place with respect to credit agreements and supplier agreements. Having appropriately worded terms and conditions can mean the difference between a successful recovery and a write off. We are often surprised to see that many businesses do not pay enough attention to this very important aspect of the credit management framework.

Important terms and conditions

Depending on the type of credit risks you are facing, it may be wise to consider including the following in your company's terms and conditions (**T&Cs**):

1. **Personal guarantee and indemnity.** When dealing with incorporated customers, credit agreements could include a personal guarantee and indemnity to be provided by the directors of the creditor and/or other third parties (for example, those who have real estate holdings).

   The inclusion of a properly formulated personal guarantee can mean the difference between a successful recovery and a write-off. Care should be taken in the drafting of a personal guarantee to ensure enforceability by a court (including whether it takes the form of a deed and is properly executed by the parties).

2. **Enforcement costs and expenses.** Creditors may wish to include in the T&Cs a clause allowing for the recovery of ***all*** legal costs and expenses from the debtor. It is important that the wording of such an indemnity clause is compliant with court and judicial expectations. In particular, courts typically require that the subject clause is "sufficiently plain and unambiguous".

   See for example, *Kyabram Property Investments Pty Ltd v Murray* [2005] NSWCA 87 at [12]. There are many instances where courts have criticised the wording of cost clauses and have refused to order the losing party to pay costs on an indemnity basis under a poorly or ineffectively worded clause.

3. **Contractual interest.** Creditors may wish to include in the T&Cs a clause allowing for the charging and payment of reasonable interest at a contractual rate. Depending on which State you are operating in, the statutory rate of interest can be quite low. Currently, in NSW it is only 4.1%.

   However, with an appropriately worded clause, the parties can agree between themselves for a contractual rate of interest which is higher than the rate provided by statute. We regularly observe credit T&Cs including interest rates exceeding 12%.

CLAUSES TO INCLUDE IN CREDIT TERMS & CONDITIONS

- Personal guarantee and indemnity
- Enforcement costs and expenses
- Contractual interest
- Charging
- Retention of title – PPSA
- Certificate
- Privacy

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4. **Charging clause.** Creditors may wish to include in the T&Cs a clause by which the customer or guarantor charges his or her real property to secure all amounts outstanding to the creditor, and for the creditor to lodge a caveat over any such real property. Regularly, we observe credit agreements and guarantees which do not include such a clause, or include a poorly or ineffectively worded clause which does not adequately protect a creditor's interest in real property.

   In addition to the ability to lodge a caveat, the inclusion of such a clause can, in some cases, have a dual purpose with regard to defending a preference claim on the basis that the creditor is a secured creditor and not an unsecured creditor (which is a necessary pre-condition of a preference claim).

5. **Retention of title – PPSA.** Creditors that supply goods on credit may wish to include a clause by which the customer grants a security interest to the creditor/supplier for the purposes of the PPSA. Depending on the circumstances, a creditor may wish to require a PMSI and/or an ALLPAP.

   Further, the T&Cs may, in appropriate circumstances, also include a clause pursuant to which the supplier retains ownership of the subject goods until such time as payment for those goods has been received. The inclusion of such a clause can also have a dual purpose with regard to defending a preference claim on the basis that the creditor is a secured creditor and not an unsecured creditor (which is a necessary pre-condition of a preference claim).

6. **Certificate clause.** Creditors may wish to include a clause whereby an authorised representative of the creditor can issue a written certificate specifying various matters, including the amounts outstanding under the credit agreement, the delivery of goods under the credit agreement, the legal costs incurred and interest accrued, and that such certificate will be treated as conclusive proof of the matters stated therein (including the customer's indebtedness to the creditor).

   Such a clause is very useful in a litigation context which requires the plaintiff/creditor to prove various aspects of its case. See, *Dobbs v National Bank of Australasia Ltd* [1935] HCA 49.

7. **Privacy clause.** Creditors may also wish to include a clause enabling the creditor to undertake credit worthiness checks at the time of opening the account and on an ongoing basis (for example, at the time of an application to increase a credit limit).

   A properly worded privacy clause will also enable a creditor to report any credit defaults to the relevant credit authorities and to otherwise be aware of any such defaults impacting its customers. The absence of such a clause (or a poorly drafted clause) will prevent a creditor from lawfully undertaking the necessary searches and exposing the creditor to claims under the *Privacy Act*.

8. **Other form of security.** Depending on the nature of the customer and industry, creditors may also wish to incorporate more stringent security clauses as a safeguard measure. Such further might include the granting of a mortgage in favour of a creditor, the provision of a bank guarantee, or a guarantee to be provided by third part (such as a parent or holding company).

Holman Webb's Commercial Recovery and Insolvency Group has decades of experience in the credit industry, and understands the importance of implementing suitable credit agreements and terms and conditions.

Chris Hadley (Partner) and Andrew Tanna (Special Counsel) are on call for AICM members requiring assistance with reviewing, drafting or updating credit agreements and terms and conditions. ◇

If you have any questions regarding the content of this article, please don't hesitate to get in touch today:

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