Prioritize Your Debt

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The scenario: A company's cash flow is pinched, but the stack of bills to lenders and creditors is piling up fast.

The tactic: Steal a page from the Chapter 11 handbook: Follow the "absolute priority rule" and pay off debts in order of importance.

In a recession, sluggish demand and slower-paying customers can put a serious squeeze on cash flow, making it tough to keep paying the most important bills. One of the most important tactics finance managers need to follow in a serious market slump, says Sheila Smith, financial advisory services principal and national leader of restructuring at Deloitte, is to plot out the timing of major expenses, such as renewals of credit lines, bond-debt servicing fees, and balloon payments on debt. Look at which ones are due in the next three, six, or nine months, Smith says, and then stockpile reserves to fund them. In the normal course of business, this might be easy to do without deciding which of those is or isn't critical to business. But in a deep financial crisis, prioritizing can help companies save and prepare.

If a company can't pay all its suppliers or partners on time, or if it has multiple suppliers across several categories (three office-supply accounts, two travel agencies, etc.), then managers need to create a hierarchy that dictates which accounts get cash first, second, third, and so on. By never paying priority vendors late and exercising more liberty with second-tier partners, the company can assure that its most important business functions are under control and preserve short-term cash flow.

Prioritizing debt is a trick that healthy companies can learn from bankrupt ones. In a bankruptcy, a company follows the so-called "absolute priority rule," in which the company pays off debts in a clearly delineated hierarchy. Outside of bankruptcy the hierarchy is not predetermined, but companies can still use a priority-setting process to establish a smart strategy for who, what, where, and when they're spending money, Smith says. For example, an aviation company definitely needs to pay a cockpit-door manufacturer on time. But the same firm may have hundreds of light bulb vendors to choose from, so paying one late has few consequences other than changing vendor.

Smith gives another example: A company that works with three overnight mail vendors might want to choose one as the "critical" or most important vendor who always gets paid on time, then designate the other two vendors as "B" and "C" priorities who can get paid later in the billing cycle.

Caution: Prioritizing vendors, suppliers, and debtors can lead to less negotiating power if these parties wise up to their ranking. Lower-priority vendors may decide not to work as cooperatively down the line. On the flip side, companies can try using prioritization as a launch point for negotiation with priority partners — i.e., "We'll ship 70 percent of our overnight volume with your company if you shed 15 percent of the fee."