Key Considerations Regarding a Distressed Debtor
There are two ways of handling the affairs of insolvent or financially distressed business debtors: (1) keep the debtor in business and restore the business to profitability; or, (2) put the debtor out of business, realize the assets and distribute the proceeds among creditors.

When possible, most creditors prefer to rehabilitate a distressed debtor by voluntary out-of-court settlement. When rehabilitation is not possible, they may liquidate assets outside of bankruptcy proceedings through a general assignment for the benefit of creditors. Credit professionals who are familiar with both of these methods, as well as their advantages and disadvantages, will be able to participate effectively in whatever action is taken when a customer becomes insolvent. The following are important considerations regarding potentially distressed debtors:

Look for Warning Signs
To restore distressed debtors to solvency and maintain them as a customer, you must act promptly. The astute credit professional learns to recognize symptoms of approaching business difficulties. Learn to be alert to changes in a customer's business behavior that may signal financial distress. Warning signs to look for include: a debtor that has stopped discounting bills; a general slowdown in payments to vendors; others instituting lawsuits or tax or vendor liens against the debtor; a debtor constantly shifting from one source of supply to another; a debtor in default with its lending institution(s); or, the financial condition of the company deteriorating.

Public Information
In most metropolitan centers, legal or business newspapers list new actions brought and liens filed. In smaller cities, this information may be available by subscription from private companies. In addition, there is an increasing amount of publicly available information concerning lien filings, lawsuits and financial information through numerous electronic database services. Credit professionals may subscribe to such publications or in larger corporations, instruct their counsel to check these listings daily to ascertain whether any of these actions are being instituted against their customers. Reports of credit agencies and trade associations should also be consulted regularly as they usually include this information in their reports.

Solvent Doesn't Necessarily Mean Liquid
In business, a debtor may be solvent or insolvent, but not liquid. A debtor with liabilities exceeding assets is deemed insolvent. A debtor that cannot pay debts as they become due is not liquid.
Credit professionals should learn to distinguish between a business that can be salvaged and rehabilitated financially and one that should be liquidated for the benefit of creditors, in or out of a bankruptcy proceeding.

Credit professionals should also learn to recognize the dishonest debtor that could be rehabilitated, but should instead be liquidated and prosecuted. Careful consideration should be given to whether a company can be rehabilitated with the current management in place or whether the rehabilitation should be under the guidance of a trustee. There can be situations where you can realize a better recovery in a workout plan with a trustee in place than in a bankruptcy plan which could have massive administrative claims. Management's ability to adapt to a different business perspective and plan of action would be an influential factor in this determination. Prosecution of a dishonest debtor is frequently desirable, but not always in the creditors' best interest. The cost would usually come out of the estate, and therefore reduce the amount available for creditors' claim, anyway.

Source: NACM-National