



The Next Wave

Ironically, a recovery could actually spur fresh business bankruptcies.

BY KURT M. CARLSON

U.S. commercial bankruptcy attorneys are certainly busy today, but are about to get even busier. Despite some recent positive data, there are signs that commercial chapters 11 and 7 filings are likely to accelerate—oddly enough—even as the economy appears to improve.

According to the Administrative Office of the U.S. Courts, which tracks federal court filings of all types, Chapter 11 business filings increased by a whopping 91% nationwide during the 12 months that ended on June 30, compared to the same period the year before. Likewise, business filings during the second quarter of 2009 reached the highest level nationally since the second quarter of 1993.

A snapshot in time, provided by the data from earlier this year, illustrates the trend. During March 2009, there were 5,501 business bankruptcy filings in the United States. That number partially includes 1,429 Chapter 11 cases, many of which fail or are “liquidating 11s,” and 3,636 that are straight liquidation Chapter 7s. Compare those figures with the same month in 2008 and 2007. In March 2008, there were 3,005 business bankruptcy filings (including 544 Chapter 11 cases and 2,123 Chapter 7s). In March 2007, there were 2,279 business bankruptcy fil-

ings (including 448 Chapter 11 cases and 1,483 Chapter 7s). Comparing the month of March from 2007 to 2009, then, there was a 141% increase in bankruptcy filings. Tony

All businesses need to worry about the coming acceleration of filings.



Pugh, “Bankruptcy filings slow in 3rd quarter,” Miami Herald, Oct. 11, 2009, www.miamiherald.com/news/nation/story/1276862.html.

For those hoping that the trend is changing, some recent data might offer false encouragement. According to Automated Access to Court Electronic Records, an Oklahoma City bankruptcy management and data company, the third quarter of 2009 saw the first quarterly decline—4.5%—in



commercial filings since the overhaul of the bankruptcy laws in 2005.

However, despite the third-quarter statistical improvement, it is important to note that the filing rate for all bankruptcies—commercial and personal—still hovers at about 6,000 a day. *Id.* That rate has held fairly steady since March. In addition, with unemployment approaching 10% and commercial credit and consumer spending still tight, it is likely that the third-quarter decline will prove a temporary respite in what will become an increasingly active commercial bankruptcy scene in the United States. Many experts believe that gradual economic and business recovery will lead to significantly increased Chapter 11 filings because more capital will become available to file, while fortunes will not improve enough to truly save businesses that are hanging in the balance.

The Chapter 11 process requires significant capital. Ironically, a business that wishes to file needs an entity, such as a bank, that is willing to put money into the process in order for the bankruptcy to even have a chance to work. With that in mind, it is highly likely that many companies now in dire straits have delayed Chapter 11 filings in the hope that revenue and cash flow will improve enough for them to reorganize.

At the same time, more companies are choosing liquidation over reorganization because it costs less. Liquidation is simpler than restructuring, which requires operational changes as well as the retooling of a multitude of balance-sheet obligations. Restructuring also takes more time, which flies in the face of the interests of creditors who increasingly are demanding speed and certainty—particularly during these difficult economic times. They themselves often are under pressure and less likely than ever to remain patient.

MACROECONOMIC REALITIES

Making matters even worse are the macroeconomic realities that many American businesses face. For businesses of all sizes that find themselves in crisis, the chances of a strong recovery that would help them avoid bankruptcy are slim. Consider, for example, the multitude of industry sectors that have been limping along for the past few years. In the real estate arena, markets have not improved, vacancy rates continue to climb and rent concessions are commonplace. Talk of a commercial real estate bubble that has yet to burst is widespread. Meanwhile, those in manufactur-

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ing continue to cut costs and hours, closing down lines and laying off more people. General Motors Co. and Chrysler LLC may exit bankruptcy with government assistance, but how likely are they to see robust sales with unemployment in the double digits?

Will the holiday season, with Christmas displays arriving in early October, single-handedly save both the manufacturing and retail sectors? It truly would be a Christmas miracle worth wishing for, but it appears that business miracles are in short supply this season, as industry observers predict lean sales. It is likely that the only bright spot in the economy in the near term will come from the offices of bankruptcy professionals burning the midnight oil trying to keep pace with their workloads. Overall, the credit crisis has hurt the entire U.S. commercial market, creating an increasingly uphill climb for almost every business sector.

That is why all businesses need to worry about the coming acceleration of bankruptcy filings. This trend is going to make the ride rougher for all businesses—even those that have withstood the downturn fairly well to date.

Within this context, businesses can consider a number of strategies that will help them survive even while those around them fail. For creditors, it is more important than ever to keep customers current on their payments. Suppliers must be aware of their expanded reclamation rights in the context of a bankruptcy—and have a clear understanding of which jurisdictions still allow critical-vendor designations and how to employ setoff and recoupment rights. For lenders, now is a good time to closely scrutinize asset-based portfolios and tackle any reporting deficiencies to allow better analysis of actual risks before they become “troubled loans.” And landlords who ordinarily rely on leases, state law and the Bankruptcy Code as their best safeguards should look at

other collateral (e.g., guarantees and letters of credit) to mitigate credit risks and determine how solid their tenants truly are.

On a strategic level, businesses should be aware of which sectors are seeing the greatest number of filings. For example, according to data recently released by Equifax Inc., the credit reporting agency, the bankruptcy rate for the transportation industry exceeded all other sectors during the second quarter of 2009. A full 2.4% of transportation businesses petitioned for bankruptcy during that quarter alone. “Equifax Commercial Information Solutions Releases New Quarterly Trend Data,” Reuters, Sept. 30, 2009, at www.reuters.com/article/pressrelease/idUS186579+30-Sep-2009+BW20090930. Businesses with exposure to that industry—manufacturers that use trucking companies to move products, for instance—need to be particularly vigilant with their transportation-sector partners.

It is always difficult to predict what will happen with American business. But the evidence clearly suggests that there will be an upward trend in commercial bankruptcies that could indeed send additional waves of pain through our economy. Perhaps of most concern is that this trend will likely result in increased unemployment, additional business losses and a myriad of other negative consequences unimaginable at this time. That is why even strong companies employ, or have on retainer, bankruptcy-savvy attorneys who can help protect them from the misfortunes of other businesses that will not survive the next 24 months.