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Chapter 11 Filings Plummet 38% In Fiscal Year 2005

Tuesday, March 14, 2006 --- As the economy grew stronger and willing lenders flooded the market, company bankruptcy filings in the U.S. dropped dramatically, according to statistics released this week by the Administrative Office of the U.S. Courts.

On Tuesday, the office revealed that the number of businesses seeking to file Chapter 11 plunged 38% for the fiscal year ending on Sept. 30, 2005.

Only 5,776 businesses sought Chapter 11 protection, significantly down from the 9,436 corporations looking to file the previous year.

The court administrative office releases quarterly and annual bankruptcy-related information based on the federal fiscal calendar, covering the period from October 1 through September 30.

In a slight downturn, business bankruptcies, which include all Chapter 7, Chapter 11, Chapter 12 and Chapter 13 nonconsumer bankruptcy petitions, fell from 34,817 in 2004 to 34,222 for fiscal year 2005.

The bankruptcy filings overall, however, soared to a record high of 1,782,643, heralding a 10% increase.

In the last quarter alone, the filings skyrocketed 37% to 542,002, marking the highest number of filings in U.S. bankruptcy court ever in any three-month period.

Personal Chapter 7 filings comprised the overwhelming majority of these filings, as consumers rushed to enter claims prior to the new Bankruptcy Abuse Prevention and Consumer Protection Act taking effect, according to analysts.

The new law, which went into effect in October 2005, will make it more difficult for consumers to wipe out their debts under bankruptcy protection, which might account for the recent filing stampede.

But while the total filing increase may be unsurprising, the plunge in Chapter 11 filings, in advance of the bankruptcy law taking effect, has fueled speculation over the reasons for the decline.

“I don’t think it’s that surprising,” says Ivan Kallick, a partner at Manatt, Phelps and Phillips LLP.

“The cost is getting so expensive that a lot of mid-range companies that ordinarily might have gone that route are giving a second thought to it," says Kallick.

Ken Yager, a managing consultant at Morris-Anderson & Associates, believes there are few other "very divergent" factors that help account for the numbers.

"First, profitability is up," says Yager, emphasizing how strong the economy is right now.

"We have had ten quarters of profitability—companies are healing themselves," he said.

He also points to the "brand new set of liquidity" in the market as another factor in the decline, a sentiment echoed by Howard Brownstein, a principal at NachmanHaysBrownstein, Inc.

As new creditors like hedge funds enter the arena, better negotiators and flexible financing have helped prevent companies from immediately being forced to file for Chapter 11.

"The liquidity in the market is enormous," says Brownstein. "It is easier than it might be for companies to finance their way out of trouble."

Yager concurs, adding that there are "another layer or two of responses" in place now which will prevent companies from collapsing into bankruptcy.

Yager also cites creditors' past refusal to lend to companies as a major reason for the filing nosedive.

"If you don't lend, you are not going to have situations going to bankruptcy," says Yager.

In 2002 and 2003 nobody was lending, which resulted in creditors not facing bankruptcy proceedings a few years down the road, asserts Yager.

While a nearly 40% tumble is significant, Yager believes the next set of numbers will show an even "more precipitous drop off."

In the months right after the new bankruptcy law passed, there was very little happening in the bankruptcy world, according to Yager.

"I know a number of bankruptcy lawyers who all got to work on their handicap in November and December," he says.

After the law changed last October, companies were reluctant to file, says Yager.

"At that point, if you hadn't filed for bankruptcy, nobody wanted to be the guinea pig for the new laws," he says.

The changes to the nation's bankruptcy laws have restricted the time companies have to reject lease agreements and how long they can linger in Chapter 11 before filing a reorganization plan.

Even now, “quite a few companies are holding their breath, looking for alternatives,” says Yager.

“They are waiting for things like Dana Corp to go through and see how the judges are going to handle the new laws,” he says.

Still, Yager predicts that such a steep decline will be short-lived, though there may be a permanent reduction in bankruptcies overall in the years to come.

“There will be a return to something normal, larger than we were seeing right now,” says Yager, especially among the companies waiting to see the effects of the revised bankruptcy law.

“You can only hold your breath for so long,” he says.

Brownstein agrees, saying that most turnaround experts can smell and hear the next wave but can’t quite see it just yet.

“The forces are building,” he says, citing high interest rates, a protracted war, high fuel costs, and a nervous populace as potential issues in the coming months.

"There are a lot of factors out there that suggest there will be another wave,” says Brownstein. "Next September, the results may be very different."

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