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Chapter 22s – why do they occur and are they necessarily a bad thing?

BY ANTHONY SCHNELLING AND JOHN PIDCOCK

The recent Chapter 11 filing of US Airways has increased the awareness of and scrutiny on repeat filers in the bankruptcy arena. While there is no official name in the Bankruptcy Code for repeat filers, the industry nicknames them "Chapter 22s". The Bankruptcy Code does not explicitly provide for recidivist filers. However, it also does not ban them. Theoretically, the feasibility analysis required for confirmation of a plan of reorganisation should ensure that companies which emerge from Chapter 11 are ready to survive and will not quickly return to the protected status of Chapter 11. Unfortunately, statistics show that this presumption is false often enough to give rise to an accepted nickname for repeat filers.

Three questions spring to mind. What is a Chapter 22, is there a common theme in such filings and is a Chapter 22 or higher (some serial filers like Trans World Airlines, Braniff, Memorex and Grand Union filed three times) a bad thing? In our view a Chapter 22 is a bankruptcy filing which springs out of substantially the same set of circumstances as the initial filing and generally follows shortly upon confirmation of the original plan. US Airways which emerged from its initial bankruptcy in March 2003 and refilled for Chapter 11 protection in September 2004, having not altered its focus or business in the interim, qualifies as a Chapter 22. LTV, which emerged from its initial bankruptcy in June 1993 and did not re-file for Chapter 11 protection until December 2000 would not qualify as a Chapter 22 case in our view because, during the intervening seven years, the company changed its circumstances and structure from a conglomerate format to a company focused on steel production.

During the past three decades there have been clearly defined drivers for each cycle of bankruptcies which occurred. In the 1980s, the common driver was overleveraging. In the 1990s, it was failed corporate roll-ups and greed (the dot–com/telecom craze). In the early 21st century, it has been corporate governance failures and outsourcing. Yet in each of these cycles we find Chapter 22 filings which don't fit the general pattern of the applicable bankruptcy cycle. Why?

The easiest answer is found in companies like Horizon Coal which originally emerged in April 2002 and refiled for protection in November 2002 or Grand Union which filed three times in the 1990s and early years of the 21st century. Here, there were no particular systemic issues which prevented Horizon or Grand Union from being successfully restructured; the debtor just got its business model and structure wrong and the companies were unable to survive outside of Chapter 11.

A more complex answer is to be found in bankruptcy filings in industries like airlines, steel, coal (Horizon is atypical of coal bankruptcies in that its second filing was not so much the result of systemic weakness in the industry as its inability to accurately project the market) paper and textiles. Each of these industries and their constituent players are subject to systemic weakness and frequent bouts of restructuring. These industries suffer from one or more of the following common factors. They are capital intensive, subject to offshore predatory competition, have excess capacity, are dominated by unions, have legacy pension contracts, under funded pensions, high fixed cost structures, energy dependence or price inelasticity. The very fabric of these industries screams out for repeated failures by individual entrants as the business cycle plays itself out. Nothing will change this dynamic in the airline industry, for example, until the various constituencies are able, if ever, to systematically alter the business model and eliminate those factors which act as a permanent drag on long term health – legacy pensions, unsupportable labor contracts, excess capacity. Those airlines like Southwest, which survive and indeed thrive, never had legacy cost issues and have scrupulously avoided excess capacity through judicious route selection and have carefully managed their labour pool. To the extent that the core business remains intact in a restructuring in the airline industry the result, as the emerged company comes under renewed pressure, will almost always be a new Chapter 11. There is little incentive to break up the assets and redeploy them more efficiently under a new corporate structure because potential buyers cannot eliminate the systemic pressures which caused these assets to be uneconomic in the first place. The alternative to restructuring is complete fire-sale liquidation as with Eastern Airlines and Braniff (which did not liquidate until after its third serial filing).

A somewhat different but equally complex situation exists in the retail industry. While there are numerous examples of Chapter 22 filers (Ames, Bradley's, Bill's Dollar Stores, Edison Brothers) and there are systemic issues at play in this industry (the industry is over-boxed, there is excess capacity and over-lap in product offerings), the industry does not suffer from the same intractable level of labour and pension issues and has more flexibility to re-deploy assets than the industries discussed above. In addition, the availability of the lease rejection process in Chapter 11 means that many companies can and do use the serial Chapter 11 process to shed unproductive outlets as a conscious tactic in seeking to re-focus their business to be more profitable. Nonetheless, because of the relative ease of entry afforded by lower capital requirements and the relative absence of high cost union labor with large legacy pensions, the assets of a failing retail company are more easily re-deployed through the Section 363 sale process. This ▸▸

means that while the rate of failing business may not be markedly different from that in the more capital intensive industries discussed above, there are real alternatives to repeat Chapter 11 filings and fire sale liquidations. Companies more often disappear as corporate entities by redeploying their assets and labour through a sale to a company with a new retail concept and a need for well located space. The rate of failure may be the same but the rate of recidivism is thus much lower.

This brings us to the final question – are repeat Chapter 11 filings necessarily a bad thing? There are real negatives to serial filings in that they cause a great deal of waste. To name a few negatives we need only consider the drain on the judicial system, the high fees for professionals and the strain on creditor financial health and relations. However, there are also benefits if the alternative is fire sale liquidation of assets and loss of jobs. In industries where serial filing is almost a part of the accepted business cycle, such filings mean that employment will continue for thousands of people, suppliers will continue to function and their employees will continue to work, the economy as a whole will continue to be served with vital products and services, complex asset groups can be disposed in an orderly fashion, holders of securities (other than common shares) have an opportunity to monetise their holdings – even if at a loss. The public at large can also hope that one day the disparate players in these industries will finally grapple effectively with the difficult political and social issues which stand in the way of a comprehensive overall of these industries and a return to long term secular profitability. ■

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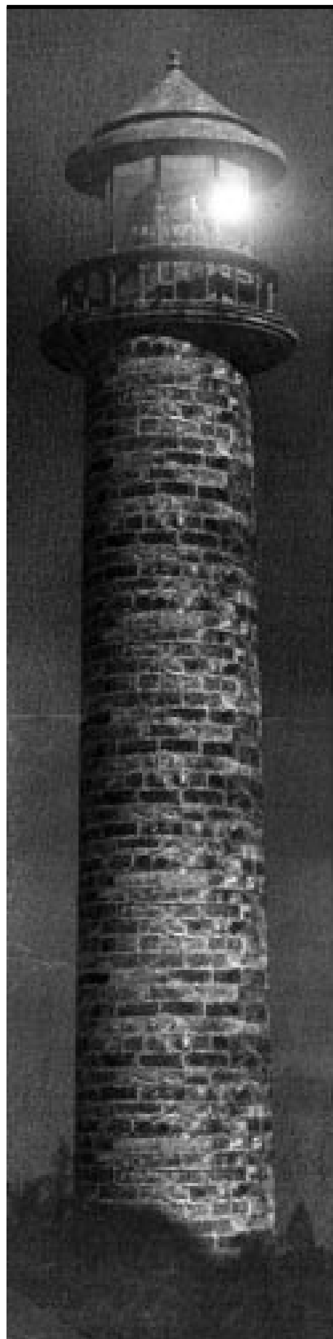

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