Chapter 11 – Is it Better the Second Time Around?

PREPARED FOR:

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What makes a Chapter 11 bankruptcy filing successful?

In a simplified manner, does a company file again or liquidate? If not, then the Chapter 11 was successful, but…

How many Chapter 11s are "successful"?

- Only about 55% of all Chapter 11 debtors never file again or liquidate
- When we look at companies with assets >$100M and >$500M, the successful percentage increases to approximately 63% and 71%, respectively

Is every repeat filing a "failure"?

- Repeat filings (colloquially referred to as "Chapter 22s") can be broken into two categories: (1) those that file again within 60 months of the first and (2) those that file after 60 months of the first
- Of the repeat filings in (2) above, the greatest concentration of filers is in the 84+ months bucket

How many companies are repeat filers?

- Only about 15% of debtors that emerge from bankruptcy (either through a sale or as a continuing entity) file again
- However, if we look only at companies that emerge as continuing, independent entities, that number increases to 18.25%

Is there anything we as professionals can do?

- There are certain indicators and benchmarks that stakeholders, professionals, and the court system can use to assess whether a plan of reorganization is set up for success

Bankruptcy Code Section 1129(a)(11) can be viewed to define "success" as follows:

Confirmation of the plan is not likely to be followed by the liquidation or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

1 - Edward I. Altman, *Revisiting the Recidivism - Chapter 22 Phenomenon in the U.S. Bankruptcy System*, 8 Brook. J. Corp. Fin. & Com. L. (2014).

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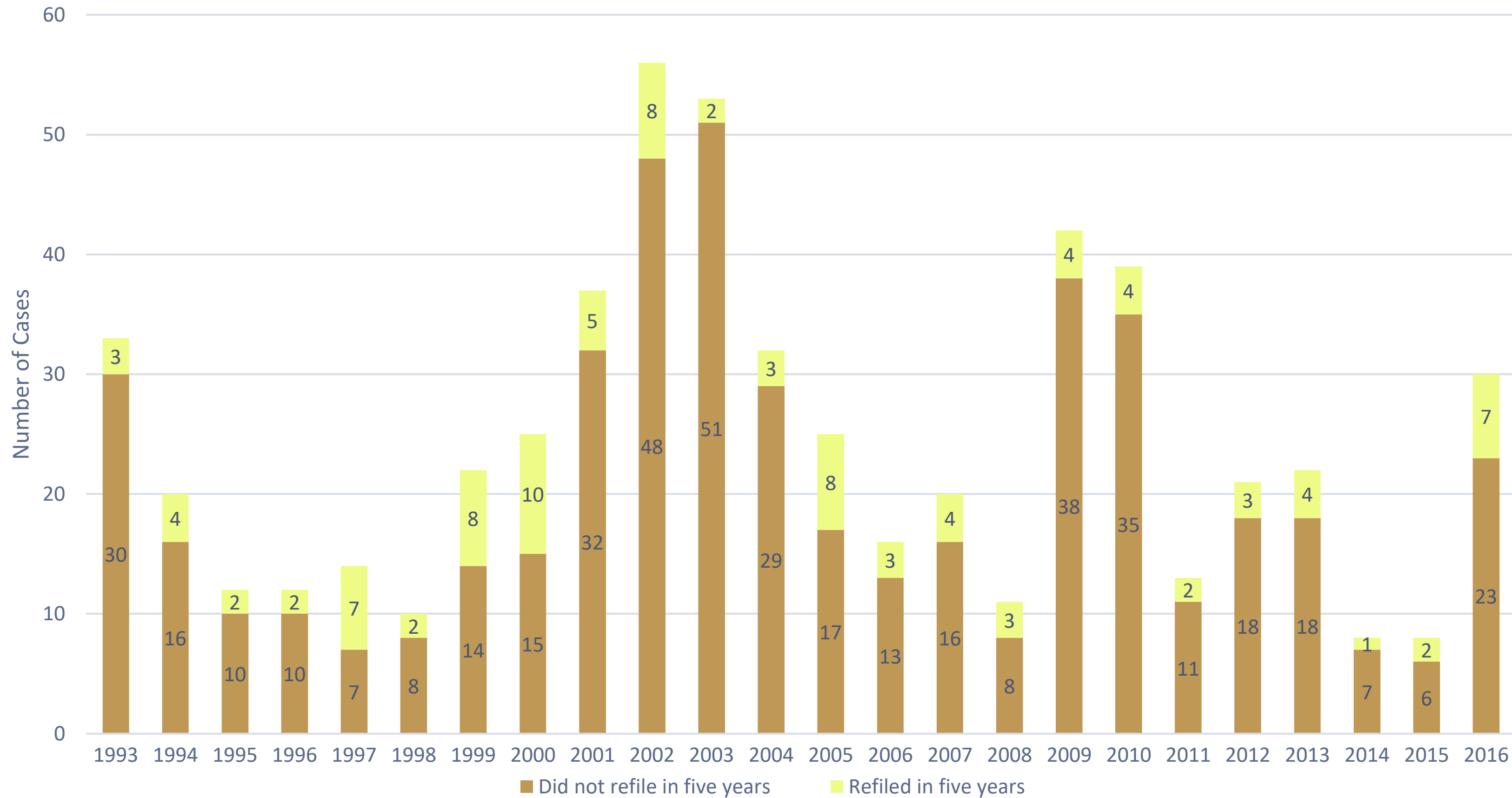
How successful are Chapter 22 filings?



Approximately 21% of all Chapter 22 debtors file **again** within five years, exceeding the 15% of Chapter 11 debtors that file again.

Source: Florida-UCLA-LoPucki Bankruptcy Research Database

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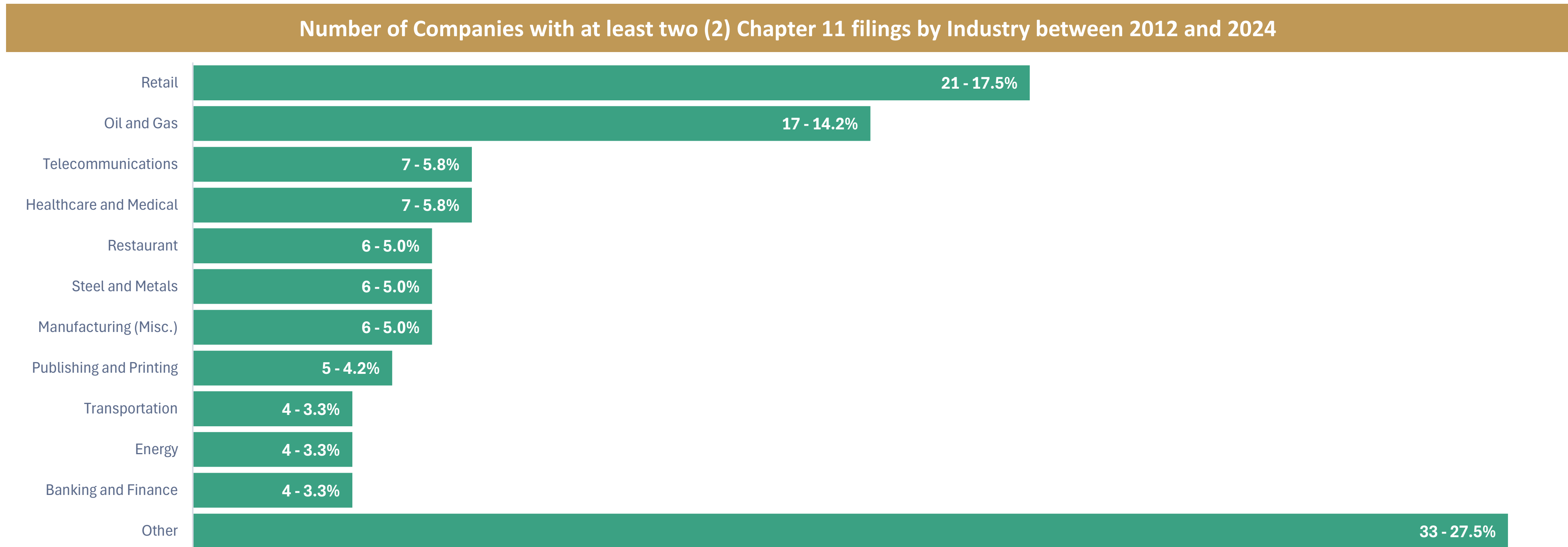
Do certain industries have more repeat filings than others?



The “Other” category represents 17 industries with fewer than four companies with at least two Chapter 11 filings between 2012 and 2024.

Note: Excludes data from Q4 of 2023

Source: Selected data obtained from the Reorg Research and Debtwire case databases with filings occurring between 2012 and 2024 with asset sizes of companies greater than or equal to $50M.

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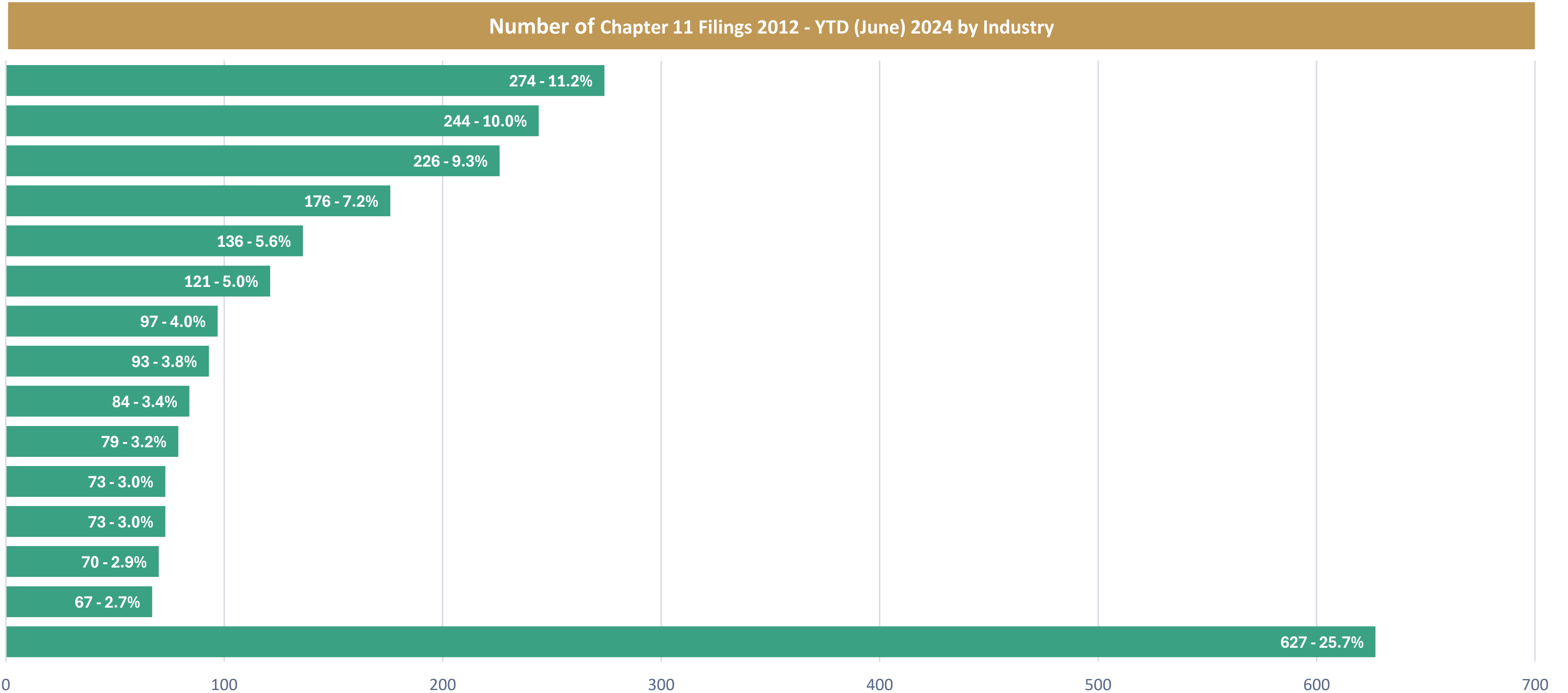
And how does that stack up against all Chapter 11 filings?



The “Other” category represents 17 industries with fewer than 49 companies (2% of all filings) filing Chapter 11

Note: Excludes data from Q4 of 2023

Source: Selected data obtained from the Reorg Research and Debtwire case databases with filings occurring between 2012 and 2024 with asset sizes of companies greater than or equal to $50M.

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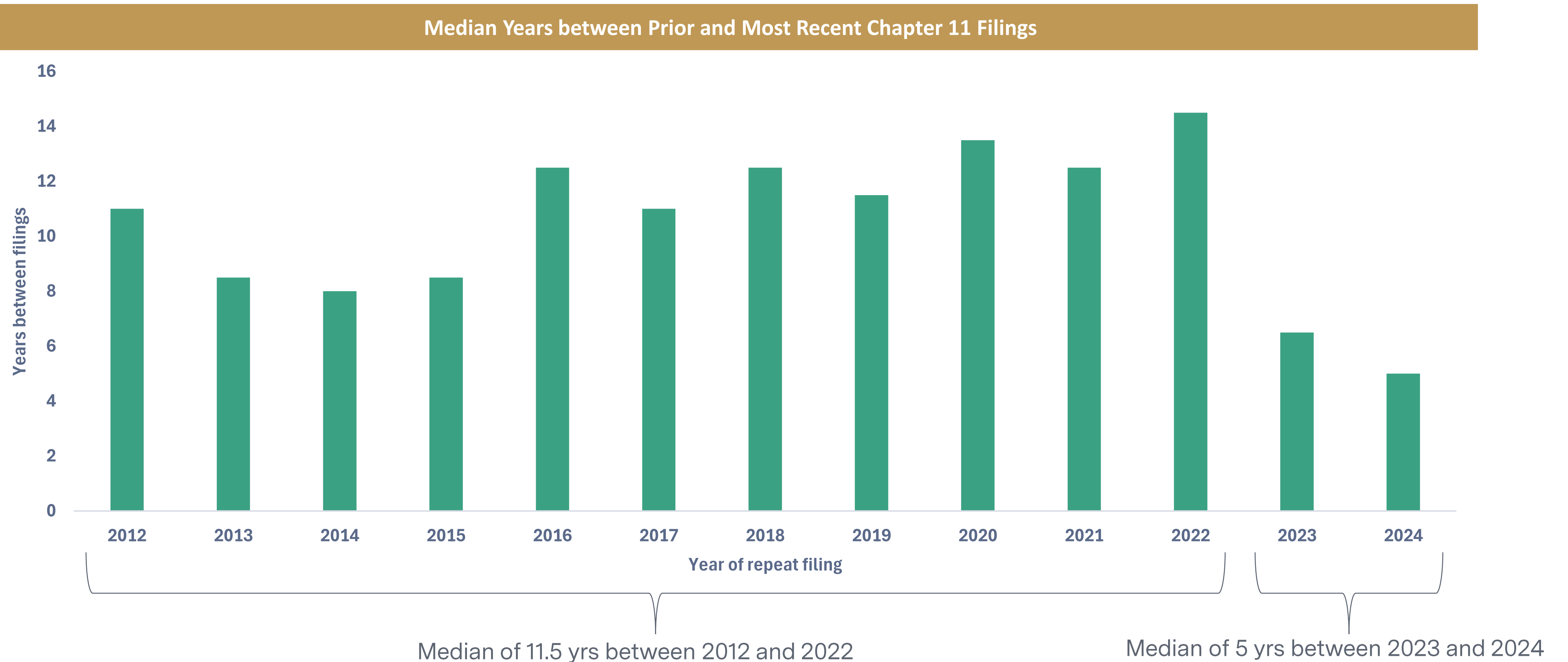
Are repeat filings happening more frequently?

In 2023 and 2024, the median time between repeat filings dropped dramatically and now sits at that 5-year demarcation…is COVID to blame, or are there other factors at play?



Note: Excludes data from Q4 of 2023

Source: Selected data obtained from the Reorg Research and Debtwire case databases with filings occurring between 2012 and 2024 with asset sizes of companies greater than or equal to $50M.

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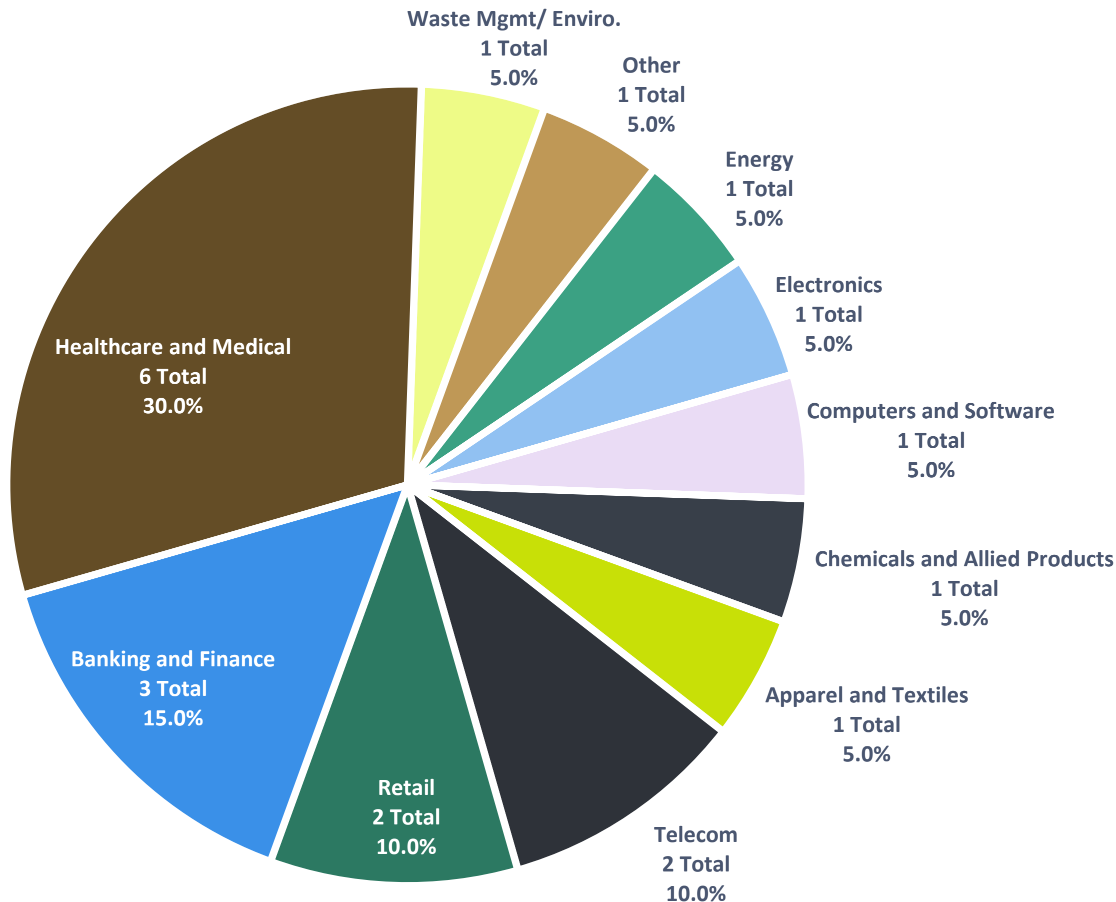
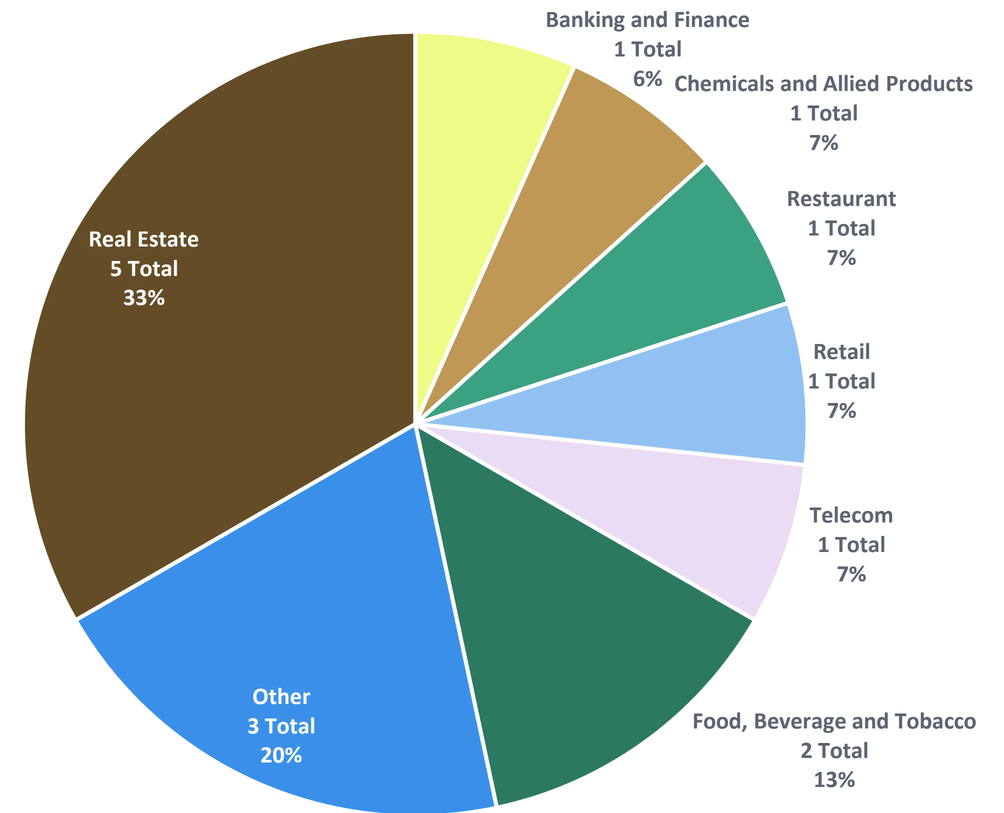
What industries had repeat filings in 2023-24? Were some quicker to return to the well?

2023 Repeat Filings – 20 Total



2024 YTD June Repeat Filings – 15 Total



Note: Excludes data from Q4 of 2023

Source: Selected data obtained from the Reorg Research and Debtwire case databases with filings occurring between 2012 and 2024 with asset sizes of companies greater than or equal to $50M.

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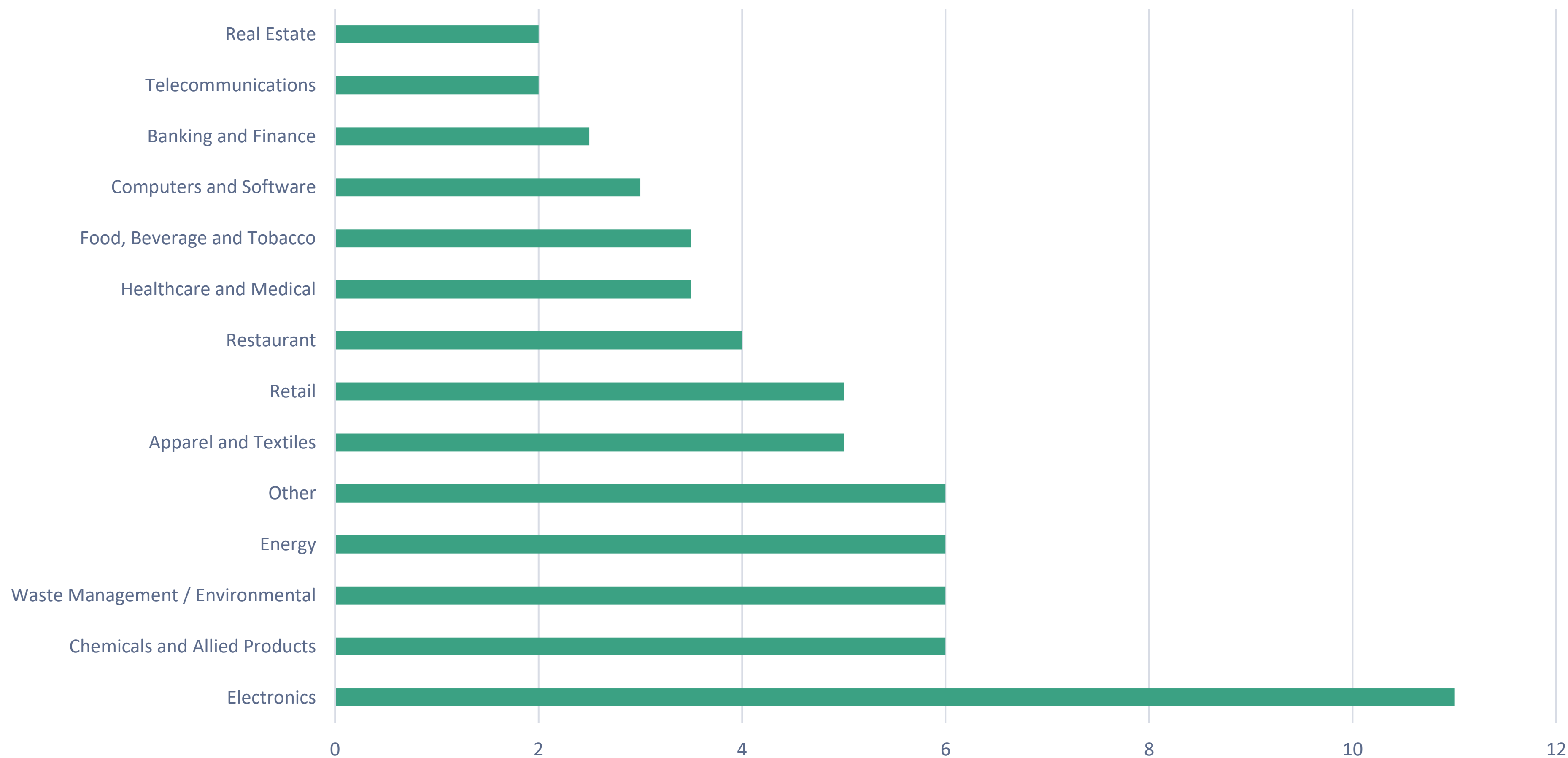
What industries had repeat filings in 2023-24? Were some quicker to return to the well? (continued)



Note: Apparel and Textiles, Energy, Waste Management, and Computers and Software only had one repeat filing during 2023 and 2024

Note: Excludes data from Q4 of 2023

Source: Selected data obtained from the Reorg Research and Debtwire case databases with filings occurring between 2012 and 2024 with asset sizes of companies greater than or equal to $50M.

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Causes of a Chapter 22

The (over) simplified reasons for multiple filings

Balance Sheet

Companies that emerge from Chapter 11 without properly resizing the balance sheet are often setting themselves up for failure. The average debtor emerges from Chapter 11 with higher leverage than typical in their respective industries, suggesting that even with the protections and advantages afforded a debtor by the bankruptcy system, companies emerge from bankruptcy in a more precarious financial position than their industry peers.[2] In cases where emerging debtor balance sheets are far worse off compared to industry peers, a repeat filing could be looming, and potentially even foreseen/predicted with a degree of certainty by the stakeholders, financial advisors, and the court itself.

Operations

Within the protections afforded by the American bankruptcy system, many debtors still do not address operational issues, such as reducing real estate footprints, eliminating unprofitable business units, making significant headcount reductions, reevaluating senior management, or revising business strategy. Debtors that do not make enough of the tough changes to business operations required to emerge as a stronger continuing entity are creating significant headwinds immediately upon emergence.[3]

2 -Randall A. Heron et al., *Financial Restructuring in Fresh-Start Chapter 11 Reorganizations*, 38 FIN. MGMT. 727 (2009).
3 - Allen Michel et al., After Bankruptcy: Can Ugly Ducklings Turn into Swans?, 54 FIN. ANALYSTS J. 31 (1998).

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Assessing feasibility…

"A judge is bound by the record that is presented. If you have good lawyers, they will present a record that establishes feasibility…Lawyers may disclose assumptions, but in the absence of discovery…it's hard for a judge to know what's a wild assumption and what's not."

- Judge Barbara Houser (ret.), Dallas

or the lack thereof

"I frequently questioned the assumptions [underlying the financial projections]…even if everyone was in agreement, I would require testimony at the confirmation hearing. Occasionally, I required them to provide different scenarios varying a couple of the key assumptions in their projections."

- Judge Lisa Fenning (ret.), Los Angeles

In either case, judges have to rely on the evidence
– including the expertise and insight of third parties –
to make the determination as to whether or not a plan is feasible

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An introduction to the Z”-Score

And how we can use it to assess the viability of a plan of reorganization

- The Z-Score was originally developed by Profs. Altman and Hotchkiss and refined over the years
- The original Z-Score model required firms to be public, as one of the factors included the Market Value of Equity
- The Z”-Score is not only available to public companies, but private companies as well
- Scores above 0.0 are equivalent to the non-default zones of bonds, and scores below 0.0 are in the default zone

$$Z'' = 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4$$

X_1	$\frac{\text{Current Assets – Current Liabilities}}{\text{Total Assets}}$
X_2	$\frac{\text{Retained Earnings}}{\text{Total Assets}}$
X_3	$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}}$
X_4	$\frac{\text{Book Value of Equity}}{\text{Total Liabilities}}$

Sources: ALTMAN & HOTCHKISS, *supra* note 2.

1 - Edward I. Altman, *Revisiting the Recidivism - Chapter 22 Phenomenon in the U.S. Bankruptcy System*, 8 Brook. J. Corp. Fin. & Com. L. (2014).

Bond Rating Equivalent	Average Z”-Score +3.25
AAA/AA+	8.15
AA/AA-	7.16
A+	6.85
A	6.65
A-	6.40
BBB+	6.25
BBB	5.85
BBB-	5.65
BB+	5.25
BB	4.95
BB-	4.75
B+	4.5
B	4.15
B-	3.75
CCC+	3.20
CCC	2.50
CCC-	1.75
CC/D	0.00

**S&P bond rating data from 1996, with a constant term of 3.25 added to the Z” formula*

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Assessing the balance sheet and the Z”-Score

Can we, collectively, assess the likelihood of a repeat filing by analyzing the proposed post-emergence financial statements of a debtor?

Profile	Z”-Scores (and what they say)
Single Filers	**Single filers have a stronger Z”-Score than repeat filers** • The median single filer emerges from bankruptcy with a Z”-Score of 4.75, equivalent to a BB- rating • One-year post emergence, the Z”-Score increases to 5.21, equivalent of a BB+ rating
Repeat Filers	**Repeat filers emerge from their initial Chapter 11 with a weaker Z”-Score compared to single filer emergences** • The median repeat filer emerges from the first bankruptcy with a Z”-Score of 3.02, equivalent to a CCC+ rating • One-year post emergence, the Z”-Score ***decreases*** to 2.70, equivalent to CCC bond rating • **A newly rated CCC bond has a 53.8% likelihood of defaulting by the sixth year after the rating assignment**

Debtors, creditors, other parties-in-interest – and the courts – have the ability to calculate and consider Z”-Scores as part of negotiating and confirming a plan of reorganization (POR). Z”-Scores can (and should, argued by Altman) be used to assess the viability of a POR.

1 - Edward I. Altman, *Revisiting the Recidivism - Chapter 22 Phenomenon in the U.S. Bankruptcy System*, 8 Brook. J. Corp. Fin. & Com. L. (2014).

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Continuing operating issues following Chapter 11 emergence

Operating losses that persist following Chapter 11 emergence are not uncommon

"This was entirely an operational issue…[Brookstone, Sailing Capital, and Sanpower] didn't take advantage of the bankruptcy to better its operations. Management was worried about making [the store footprint] too small, and the brick & mortar was the major driver of [the lack of] profitability…"

- Craig Boucher
  Senior Managing Director, Accordion
  CRO of Brookstone during its
  bankruptcy in 2014

Operations vs. balance sheet	While some companies carry far too much debt following emergence from the first Chapter 11, most companies cite operational issues as the reason for a subsequent filing
Operating losses	More than two-thirds of repeat filers underperformed peers for up to 5 years following emergence from their first Chapter 11 As many as 40% of the entities experience operating losses in each of the first three years following emergence from their first Chapter 11
Optimistic projections	Michel, Shaked, and McHugh show in their research that projections provided by two-time filers are significantly higher than industry peers that only file a single time

2 -Randall A. Heron et al., *Financial Restructuring in Fresh-Start Chapter 11 Reorganizations*, 38 FIN. MGMT. 727 (2009).
3 - Allen Michel et al., After Bankruptcy: Can Ugly Ducklings Turn into Swans?, 54 FIN. ANALYSTS J. 31 (1998).

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The implications of submitted financial projections

"The importance of these projections cannot be overestimated. They are reviewed by a wide range of parties…to determine the likelihood of repayment following a company's emergence from Chapter 11…"

- Allen Michel, Israel Shaked, and Christopher McHugh in their article *"After Bankruptcy: Can Ugly Ducklings Turn into Swans" (1998)*

01

Financial projections under the Bankruptcy Code are required to prove that the plan of reorganization is "feasible"

- ✓ Includes description of the general economic conditions assumed such as interest rates and inflation
- ✓ Performance related projections/assumptions such as expected sales growth, SG&A, taxes, net operating income/losses, and estimated date of emergence from bankruptcy
- ✓ Estimate of the enterprise value of the reorganized company

02

What is the relationship between projected performance and actual performance of debtors?

- ✓ Approximately 40% of debtors continued to suffer net losses following bankruptcy, and 32% of companies either filed bankruptcy again or restructured out of court
- ✓ Simplified, debtors can either over- or under-project their future performance
- ✓ Data from Michel, Shaked, and McHugh's research shows that over-projecting is far more likely to occur than under projecting

03

"Good" Variance vs. "Bad" Variances

- ✓ In Year 1 post-emergence, 72.7% of companies missed on Net Sales; Net income and equity projections were missed 62.5% and 74.1%, respectively
- ✓ Current assets and long-term debt were under-projected by 63.2% and 53.% of companies
- ✓ Current assets being under-projected are not necessarily a reflection of improved performance

04

Implications of (over) projections

- ✓ Data suggests that companies with under-performance in Year 1 continued to under-perform in years 2 and 3
- ✓ Projections that are overstated are inherently leading the courts in the direction of the plan being deemed "feasible"
- ✓ Over-projecting future performance only increase the likelihood of a future Chapter 22

3 - Allen Michel et al., After Bankruptcy: Can Ugly Ducklings Turn into Swans?, 54 FIN. ANALYSTS J. 31 (1998).

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The role and impact of a financial advisor

Creating detailed (and accurate) financial projections

- Accurate financial projections are integral to the feasibility test of a plan of reorganization
- Projections show the ability of a debtor to satisfy long-term and short-term debt obligations
- Inaccurate projections hamper a debtor's ability to satisfy debt obligations, and as such, increase the likelihood of a subsequent Chapter 11 or other reorganization, further deteriorating the value outlined to the stakeholders in the POR

Advise and resize the balance sheet

- A company should seek to emerge from bankruptcy with leverage that is similar to that of "healthy" industry peers
- The use of the Z"-Score (or a similar benchmarking method) to assess the balance sheet size (in conjunction with financial projections) should be used by all parties involved, particularly financial advisors, to determine the likelihood of success of an initial Chapter 11

Provide support for the "feasibility" of a plan

From the Bankruptcy Code Section 1129(a)(11) that financial advisors are called to testify on: "the court shall confirm a plan only if all of the following requirements are met: Confirmation of the plan is not likely to be followed by the liquidation or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan"

Preserving value for stakeholders

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Case Study: Chapter 22 for a leading print and digital communications provider

OSG

After the first bankruptcy

The client is one of the largest providers of outsourced print, mail and digital communications and recently emerged from a prepackaged Chapter 11 that left the company with an overleveraged balance sheet and loss-making operations in the UK. Accordion was retained as CRO and Chief Transformation Officer upon emergence. An unachievable business plan, dysfunctional executive leadership, and under-invested and underperforming operations were identified as the key challenges.

The second restructuring process

In collaboration with the Company's Board of Directors, Accordion's CRO:

1. Drove a change in leadership of the entire US C-suite replacing it with an industry veteran team that brought renewed operational and strategic focus to the US platform
2. Redeveloped the business plan through an extensive bottom's up evaluation leading to major changes
3. Organized and stood up a robust project management office that brought discipline, accountability and focus to an existing list of 300 "high" priority projects within the Company
4. Built the projections and worked closely with the Company's investment bankers and attorneys to craft a consensual prepackaged debt/equity restructuring that deleveraged the balance sheet and provided the Company with the requisite liquidity and capital to address its legacy operational deficiencies
5. Orchestrated an exit from the UK operations that was highly complex due to pensions, unions, legacy technology deficiencies, and cash-losing operations
6. Completed consensual pre-packaged Chapter 11 approximately 14 months after emerging from the first Chapter 11.

After the second bankruptcy

The Company has a renewed strategic focus led by an industry veteran executive team and sufficient capital and liquidity to drive performance improvement. Service levels have achieved industry high standards, and the company is exceeding expectations in both operational and financial performance. The UK operations, which presented significant financial exposure to the viability of the US operations were divested / wound down with little or no disruption to the US core assets.

OUTSOURCED MARKETING / PRINT MAIL & DIGITAL COMMUNICATIONS

KEY METRIC

- Divestiture of risky, highly complex UK loss-making business segment
- Balance sheet de-levered from >13X to <4X
- Annual operating cash flow improved from negative $97M to positive $45M due to deleveraging, exit from UK operations and improved operational focus in the US
- Communications and relationships with customers is greatly improved resulting substantially improved NPS scores
- Service Level Adjustments (errors) improved from approximately 15% to nearly zero

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Alix

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The Quid Pro Quo of Chapter 22

Do the Benefits Outweigh the Costs?

BY MELISSA KIBLER KNOLL, CTP, SENIOR MANAGING DIRECTOR & K. BRAD HAYES, SENIOR VICE PRESIDENT, MESIROW FINANCIAL CONSULTING, LLC

Bankruptcy neophytes frantically scouring Title 11 of the United States Code to locate "Chapter 22" should search no more—it does not exist. However, according to New Generation Research, Inc., that has not stopped more than 200 companies since 1978 from filing Chapter 22, the colloquial term used by many restructuring professionals to describe a debtor's second attempt at Chapter 11 reorganization. Some have filed "Chapter 33" in a third attempt at rehabilitation, and one company, Trans Texas Gas Corporation, even managed a "Chapter 44," filing first in 1974 under the Bankruptcy Act and then again in 1983, 1999, and 2002 under the Bankruptcy Code.

Chapter 11 provides an orderly mechanism for the reorganization of a troubled company's financial and operational affairs—in effect, a second chance. To facilitate this objective, the code modifies certain rights that would otherwise exist outside of bankruptcy, balanced by protections through both bankruptcy and applicable non-bankruptcy law, to effectuate potential benefit to society and constituents.

When it passed the Bankruptcy Reform Act of 1978, Congress said that "[t]he purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and produce a return for its stockholders. The premise...is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap....If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than liquidate, because it preserves jobs and assets." (H.R. Rep. No. 595, reprinted in 1978 U.S.C.C.A.N. 5963, 6179).

However, the idea that the opportunity to reorganize and continue as a going concern is a preferable option is not universal; many other countries' insolvency laws historically and currently favor receivership or liquidation, similar to Chapter 7 under the Bankruptcy Code. The ability to reorganize under Chapter 11 is perhaps the most distinguishing feature separating U.S. bankruptcy law from international standards governing the orderly resolution of insolvent organizations. As a result, the U.S. has been viewed as the leader of the debtor-driven model that other countries have recently begun to emulate in various ways, shapes, and forms.

But what happens when a debtor fails to fully rehabilitate under Chapter 11 and finds itself on the brink of Chapter 22? What are the benefits of allowing a second, third, or fourth chance at reorganization? Is the need to seek additional protection a failure of Chapter 11 or just another step toward recovery? What are the costs of Chapter 22? This article first examines common paths to Chapter 22 and whether multiple filings can be reliably predicted. It then considers the quid pro quo—what do constituents get (i.e., the benefits) in exchange for what they give (i.e., the costs) when providing multiple opportunities for a company to reorganize under the code?

Common Paths to Chapter 22

Bankruptcy Code Section 1129(a) (11) requires a plan of reorganization to be feasible. Under the aptly named feasibility test, a plan proponent must prove, and the court must find, that the plan is not likely to be followed by liquidation or the need for further financial reorganization unless proposed in the plan. What, then, results in post-emergence failure to meet this tenet of the code in repeat bankruptcy filings?

Causes of financial distress leading to bankruptcy, Chapter 11 or otherwise, include both internal and external drivers. Internal drivers often stem from excessive financial leverage, poor management, and/or operational shortcomings; external drivers can involve secular market declines, technological change, increased competition, and economic downturns.

In addition, based on filings from 2009 to 2012, certain industries comprise a disproportionate number of filings and may be inherently prone to Chapter 22, as illustrated in **Figure 1** (page 10). However, the two most common themes persistent among Chapter 22 filers appear to be (a) excessive leverage and (b) persistent operational problems post-emergence.

When a debtor fails to deleverage sufficiently in bankruptcy, the "rehabilitated" company is far more susceptible to other internal and external drivers of financial distress. But why do debtors fail to right-size their capital structures when given the chance? One explanation may be the varied financial interests of parties pushing leverage to levels unsustainable in the long term. The debtor is forced to accept unfavorable compromises in negotiating a plan of reorganization with creditors jockeying to maintain and improve their positions in the capital structure.

As a result, while the debtor's initial plan proposal may have contemplated "reasonable" leverage metrics and a debt-to-equity conversion, creditor negotiations may end with a highly speculative financial structure, consistent with a "junk" issuer, upon emergence. Any shortfall in the company's business plan, whether due to internal or external drivers, may tilt that highly speculative credit into default post-emergence and necessitate a second reorganization.

The second common factor leading to Chapter 22, the failure to address operational problems, exacerbates issues arising from excessive leverage. While certain operational problems such as continued industry or secular decline may be difficult to address, few are irreparable. Failure to address weak management teams, shed underperforming businesses and/or products, or achieve necessary labor or cost savings ultimately harms all stakeholders.

Two relatively recent developments—the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and the increased use of prepackaged and prenegotiated bankruptcies, known as prepacks—potentially impair a company's ability to address operational problems during the Chapter 11 process.

For example, BAPCPA shortened both the period in which a debtor has the exclusive right to file a plan of reorganization to no more than 18 months and the deadline for assuming nonresidential real estate leases, which now is not more than 210 days. One

continued on page 10

continued from page 9

result of these and other provisions is that certain debtors, particularly large debtors, are left with too little time to identify and address operational problems adequately prior to emergence.

The increased prevalence of prepacks may be due in part to BAPCPA, in combination with other market factors. While prepacks are not new, some believe that the reduced time frames for Chapter 11 processes, combined with increased administrative costs, have encouraged more management teams to seek prepacks. The quick exit from bankruptcy proceedings and the need to resolve difficult issues in advance provide management less opportunity to address operational problems.

For example, labor and other contract and lease negotiations are time-consuming and complex, and significant modifications may not be achievable in a prepack. These issues may cause management to focus primarily on balance sheet solutions. Only time will tell whether these factors will in turn result in a significant change in the landscape for Chapter 22.

Is Chapter 22 Predictable?

One debtor, not atypical of an emerging company, recently confirmed its Chapter 11 plan and received a B- corporate rating, the lowest tranche of "highly speculative" ratings, and a CCC+ bank loan rating, denoting "substantial risk," in an industry prone to distress. While such post-emergence ratings are not unusual, it would hardly be shocking if this reorganized debtor finds its way onto the list of Chapter 33s since this was the company's second trip through Chapter 11. Despite all of that, Standard & Poor's (S&P) *still* assigned a "stable" outlook to this entity based on the company's "more manageable capital structure."

While no company emerges from Chapter 11 intending to reenter bankruptcy, excessive leverage and failure to address operational problems may increase that likelihood. But what amount of debt is excessive and what operational shortcomings must be addressed to provide a trier of fact and other stakeholders a reasonable basis to conclude that a plan is feasible?

Professor Edward I. Altman of New York University's Stern School of Business published a study in the *Journal of Corporate Renewal* (January/February 2010) examining the ability of his well-known Z-Scores to predict the likelihood that a debtor will file Chapter 22. Z-Scores are financial tools used to assess the creditworthiness of companies. Variants of the Z-Score, designed originally for manufacturing companies, include the Z'-Score for private companies and Z"-Score for non-manufacturing companies.

Altman's Z-Score weights various financial ratios involving liquidity, profitability, operating efficiency, asset turnover, and market value indications to quantify a firm's health. Generally speaking, the lower the score, the higher the odds that a company will file for bankruptcy. Scores higher than 3.0 are considered healthy, while scores below 1.8 are considered in the distressed zone; scores in between are considered to be in a grey area.

Altman discovered that, based on his sample and analysis, the average post-emergence Z"-Score of Chapter 22 filers was 2.67 (median of 3.05), considerably lower than other Chapter 11 filers, with their average Z"-Score of 4.73 (median of 4.38). Altman concluded that companies that eventually filed a second bankruptcy had significantly worse financial profiles immediately following

Figure 1

Chapter 22s and 33s by Industry (2009-YTD March 2012; years listed are for subsequent filings)

Industry	Companies
Automotive	Hayes Lemmerz International, Inc. (2009); Holley Performance Products Inc. (2009); J.L. French Automotive Castings, Inc. (2009); Meridian Automotive Systems, Inc. (2009)
Aviation	ATA Airlines (Global Aviation Holdings Inc.) (2012)
Banking & Finance	FIRSTPLUS Financial Group, Inc. (2009)
Computers & Software	Silicon Graphics, Inc. (2009)
Energy	Composite Technology Corporation (2011)
Entertainment	Movie Gallery, Inc. (2010)
Food, Beverage & Tobacco	Hostess Brands, Inc. (2012)
Health Care & Medical	InSight Health Services Holdings Corp. (2010); Tetragenex Pharmaceuticals, Inc. (2009, 2010)
Manufacturing	Davi Skin, Inc. (2010); Foamex International Inc. (2009); Fountain Powerboat Industries, Inc. (2012); Moll Industries, Inc. (2010); Neenah Enterprises, Inc. (2010); SKYE International, Inc. (2011); TVI Corporation (2009)
Oil & Gas	Eagle Geophysical, Inc. (2009)
Other	Hines Nurseries (2010)
Packaging & Paper	Constar International Inc. (2011); Pilant Corporation (2009)
Publishing	Vertis Holdings, Inc. (2010)
Restaurant	Buffets Restaurants Holdings, Inc. (2012)
Retail	Eddie Bauer Holdings, Inc. (2009); Filene's Basement, Inc. (2009, 2011); Fortunoff Holdings, LLC (2009); Goody's, LLC (2009); Loehmann's Holdings, Inc. (2010); Ultimate Electronics, Inc. (2011); Ultra Stores, Inc. (2009)
Supermarket	Bruno's Supermarkets, LLC (2009); The Penn Traffic Company (2009)
Telecommunications	eNucleus, Inc. (2009); Satelites Mexicanos, S.A. de C.V. (2011); TerreStar Corporation (2011)
Transportation	TBS Shipping International (2012); Trico Marine Services, Inc. (2010)

Source: New Generation Research, Inc.

emergence than did companies that remained going concerns for at least five years post-emergence.

Additional quantifiable data, including comparisons of common liquidity measures; leverage metrics, such as debt-to-earnings, debt-to-equity, total liabilities-to-earnings, total liabilities-to-total assets, interest coverage, and fixed charge coverage; and industry averages provide some gauge of a debtor's leverage prior to plan confirmation. While the adequacy of operational changes may be more difficult to measure, benchmarking labor costs, operating costs, margins, and other profitability metrics may provide some insight into the depth and breadth of management's restructuring actions—or lack of them. The achievability of a debtor's projections, which incorporate all of these factors, is clearly central to assessing the future viability of the enterprise.

No advisor, stakeholder, debtor, or court has a crystal ball capable of definitively predicting whether a plan of reorganization will be successful or if a subsequent Chapter 11 filing is inevitable. Indeed, courts are unlikely to raise the issue of feasibility *sua sponte* and override the business judgment of the parties with a financial stake in the restructuring if no objections are raised. Unforeseen post-emergence developments may also be to blame for certain Chapter 22 filings.

However, it is folly to believe that certain subsequent filings could not have been at least suspected, if not anticipated, and action taken to reduce, but not eliminate, the probability of occurrence. **Figure 2** (page 12) illustrates selected data from certain recent Chapter 22 filings available at or about the time of their preceding Chapter 11 emergence. With median Z-Scores and total liabilities-to-total assets of 1.30 and 84.9 percent, respectively, is it surprising that these companies subsequently refiled Chapter 11?

A Balanced Approach

In Chapter 11, a debtor is granted certain rights and protections, such as the automatic stay and the exclusive right to propose a plan of reorganization. Are these and other rights and protections too costly to warrant a second chance at rehabilitation, or are the offsetting rights and protections afforded a debtor's stakeholders in Chapter 11 sufficient to protect them in a Chapter 22? Two provisions applying to all classes of creditors and interest holders seek to balance the rights of the debtor and its stakeholders—the best interests test and the absolute priority rule.

First, Section 1129(a)(7) of the code requires that a confirmable Chapter 11 plan provide that each class of claims or interests receive or retain not less than the amount they would have received in liquidation under Chapter 7. Commonly referred to as the "best interests test," this safety net considers whether stakeholders' anticipated recoveries through the reorganization process are equal to or exceed the amounts projected in a hypothetical liquidation.

Additionally, Section 1129(b)(2) of the code requires that a plan be "fair and equitable" and incorporates provisions governing the consideration to be distributed to different classes of claims and interests. Embodied within these provisions is the absolute priority rule, which ensures that no junior claimant will receive any recovery unless more

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senior claimants are paid in full or they agree to such treatment.

Furthermore, stakeholders receive detailed financial disclosures and are provided the right to vote if their claims are impaired under the plan of reorganization. These provisions operate in conjunction with other sections of the code and applicable non-bankruptcy law to facilitate the reorganization of the debtor while protecting the basic rights of the creditors and other stakeholders.

Secured creditors are enjoined by the automatic stay from foreclosing on their collateral or otherwise collecting or attempting to collect amounts due, but under Section 361 of the code they may seek adequate protection to guard against any diminution in the value of their collateral. Furthermore, many current debtor-in-possession (DIP) financing arrangements include a "roll-up" of prepetition debt, under which the prepetition balance is "repaid" by the DIP facility. This effectively converts the prepetition debt to the same super-priority status as incremental post-petition advances.

While employees are often asked to take substantial wage reductions, accept changes to long-established work rules (for unionized workforces), and bear sweeping layoffs, such requests are often at the heart of operational restructuring initiatives necessary to prevent or at least reduce the risk of a subsequent filing. Compared to the alternative of liquidation, in which all jobs and benefits are likely lost, labor concessions necessary to improve long-term corporate health, continue employment of at least some staff, and potentially maintain retiree benefits may be a reasonable exchange.

Furthermore, current and former employees are afforded numerous protections under both bankruptcy and applicable non-bankruptcy law. Section 1113 of the code requires, *inter alia*, good-faith negotiations and exchange of information with collective bargaining units, while Section 1114 imposes similar safeguards in connection with the modification of retiree benefits. In addition, non-bankruptcy labor and benefits protections under the Worker Adjustment and Retraining Notification Act of 1988, the Employee Retirement Income Security Act of 1974, and the related Pension Benefit Guaranty Corporation provisions remain in force and serve to provide additional safety nets for employee interests.

For vendors and contract parties, a primary consideration is that Chapter 11 provides an opportunity to continue a customer (or supplier) relationship, presumably with a stronger, healthier post-emergence entity. While debtors can reject unexpired leases and other executory contracts under Section 365, the code also provides for breach of contract damages for such parties, with certain limits, such as those under Section 502(b)(6) for nonresidential real estate.

Implicitly, Congress concluded that at least some societal benefit exists in rehabilitation and that access to multiple Chapter 11 filings warrants taxpayer support. This support traditionally has been indirect, in the form of special tax benefits for reorganizing companies or payment extensions for prepetition taxes over five years. In return, governments receive continued income, property, and other tax revenues. Less obvious may be the reduced strain on social welfare and safety net programs

Figure 2

Chapter 22s and 33s Upon First Chapter 11 Emergence

Debtor[1]	Effective Date	Z-Score[2]	Total Liab./ Total Assets[2]	Total Debt/ EBITDA[2]
Composite Tech. Company	11/18/05	-13.81	225.90%	n/a
Constar International Inc.	6/2/09	2.24	77.70%	1.9x
Foamex LP	2/12/07	2.05	147.00%	5.9x
Hayes Lemmerz	6/3/03	1.3	74.50%	3.2x
Insight Health Services Corp.	8/1/07	0.82	92.20%	5.5x
Loemann's Holdings Inc.	10/31/00	3.7	59.10%	0.9x
Movie Gallery Inc.	5/20/08	-1.71	233.80%	n/a
Neenah Enterprises Inc.	10/8/03	0.93	107.30%	8.9x
Penn Traffic Co.	4/13/05	4.82	63.60%	1.6x
Pliant Corp.	7/19/06	1.06	118.50%	7.7x
Satelites Mexicanos	12/4/06	n/a	92.20%	6.3x
Silicon Graphics	10/17/06	8.02	18.70%	n/a
Terrestar Corporation	5/1/02	0.65	21.90%	n/a
Trico Marine	3/15/05	2.61	67.00%	2.9x
Median		**1.3**	**84.90%**	**4.4x**

Source: Capital IQ; New Generation Research, Inc.

[1]Includes debtors that reentered bankruptcy from 2009 to March 2012
[2]Based on financial information available as of or about the effective date of emergence. Includes only companies that were public upon emergnece

because continued employment leads to fewer welfare and aid recipients, as well as certain intangible benefits.

Each of these provisions balances the costs and benefits in Chapter 11, which apply equally in Chapter 22 or beyond. However, Chapter 22 is not without its costs. There is the obvious administrative expense of Chapter 11, which is not insignificant. One can view this cost as an investment that should generate a return, albeit one that is difficult to measure. The administrative cost of a second Chapter 11 is more questionable, especially when it is aimed at achieving the goals of the first.

Bankruptcy is also fraught with uncertainty and risk to both the business and the reorganization; what could have been done once may not be possible the second time around. Everyone stands to lose if the company continues to decline and does not arrest the deterioration that caused the original and subsequent filings. In that circumstance, one could argue that parties in interest would have been better off liquidating the company and taking their money and going home in the first place.

However, many parties still benefit in the interim, even if the result is a second bankruptcy filing—employees maintain jobs, retirees retain benefits, vendors make profits on sales, and financial creditors receive interest. And in the quest to achieve the hoped for benefits of reorganization, the only sure way to fail is never to try.

Sharing the Pain

There are benefits to Chapter 11, regardless of a debtor's past transgressions and previous filings. The Bankruptcy Code is a rehabilitation framework that provides parties in interest an opportunity to negotiate under the protections of bankruptcy and applicable non-bankruptcy law to preserve going concern value at the potential risk of eroding liquidation value.

But Chapter 11 is not carte blanche—it requires careful assessment of the likelihood of success to position a company to realize the incremental value that may be achieved. Bankruptcy relies on a shared-pain concept to achieve the greater good, and if there is not sufficient compromise by the parties, the goals of Chapter 11 will not be achieved. As previously discussed, the code provides the debtor and the court certain powers to force that shared pain. In exchange, it requires, among other things, that a plan be feasible, which in turn necessitates transparency and sufficient information about the likelihood of a successful reorganization under a range of potential future circumstances.

Finally, the reality is that Chapter 11 is ever-changing as Congress amends the code, case law develops, and markets evolve. Remaining open to reexamining the code's effectiveness in achieving its framers' objectives and addressing current business challenges is essential. In that regard, the American Bankruptcy Institute (ABI) last year announced the formation of the Commission to Study the Reform of Chapter 11. Comprised of many of the stalwarts of bankruptcy theory and practice, the commission's mission statement is as follows:

"In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the

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current Bankruptcy Code, the [c]ommission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders."

The commission will collect and analyze data, case law, and commentary on 13 separate study topics, which range from financial and governance matters to all aspects of the reorganization plan process. The commission's outreach methods will include public hearings around the country, and a website has been established at commission.abi.org. Funded by ABI's endowment and general funds, the commission will issue a final report in 2014.

As part of this process, many of the fundamental purposes of Chapter 11 and potential drivers of Chapter 22 will be addressed, including the effects of BAPCPA and prepacks.

The commission's activities and recommendations are expected to form the basis of a more efficient and effective process for addressing and resolving today's business financial distress in a manner that maintains the flexibility and balance that Chapter 11 has achieved but perhaps also strengthens it in ways that will lessen the likelihood and cost of Chapter 22 and subsequent filings. J

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