CRAIN'S DETROIT BUSINESS

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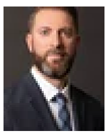
Analysis: 'Zombie companies' filing for bankruptcy a sign of normalcy



DUSTIN WALSH
Health Care

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Bankruptcies are on the rise, but experts say the vast majority of those companies filing are holdovers that were suffering prior to the pandemic and were able to limp along thanks to copious government stimulus.

Reading the business headlines these days, you might come to the conclusion that companies are failing en masse as economic decline and rising costs sink operations. Crain's has reported on several commercial bankruptcies — the Chapter 11 of auto supplier Gissing North America and T.H. Marsh Construction Co. for example — this month alone.

But the creditor purge is much less a harbinger of impending economic collapse than a simple return to normal.

Bankruptcies *are* on the rise, but experts say the vast majority of those companies filing are holdovers that were suffering prior to the pandemic and were able to limp along thanks to copious government stimulus.

"Most are zombie companies that had been propped up by stimulus spending," said Alex Calderone, president of turnaround advisory firm Calderone Advisory Group. "Under normal circumstances, they would have failed much sooner."

The data bears this out. In 2020, the U.S. Bankruptcy Court for the Eastern District of Michigan in Detroit saw only a trickle of bankruptcy filings. There were only six commercial bankruptcies in all of 2020 to be exact, and most were small businesses with little means to access capital during the early days of the pandemic.

Through July 31 of this year, the court has fielded at least 17 corporate bankruptcy filings, and some of notable size. Gissing, for instance, sought protection for up to $100 million in liabilities and owes $13.3 million in product to Tesla Inc.

It's unclear how distressed Gissing was during the pandemic days of 2020, but the supplier did seek and receive a $4.65 million loan from the $953 billion Payment Protection Program established through the Coronavirus Aid, Relief and Economic Security Act (CARES Act) to maintain employment during mandated business shutdowns in an attempt to control the virus. That loan was later forgiven for Gissing and most others.

Business investment plummeted in the U.S. to almost zero in the second quarter of 2020 as everyone hunkered down, but immediately shot back up in the third quarter of that year and climbed to a record high by the first quarter of this year thanks to stimulus.

And thanks to boosted unemployment benefits, stimulus checks and more government spending, consumer spending in Michigan recovered by June 2020 and remains higher than pre-pandemic spending by 21 percent, largely led by entertainment, recreation and retail, according to data from Opportunity Insights Economic Tracker.

One only has to look to before the pandemic to realize how well the stimulus worked.

There were 124 commercial bankruptcies filed in the Eastern District in Detroit in 2019, when the economy was booming with an unemployment rate of 3.7 percent and gross domestic product growth for the year at 2.3 percent. That's a more than 95 percent decline in cases from 2019 to 2020.

But that's not to say there aren't economic headwinds now and in the near future, as the financial advisors say. While easing, inflation over the past 12 months remains a problem and so does the ever-present bullwhip that continues to reverberate through supply chains.

Laura Marcero, managing director of turnaround firm Huron Consulting Group, said all roads lead back to federal stimulus money ending.

"There was the COVID relief money and lots of liquidity for refinancing; that was all part of the solution to get through the pandemic," Marcero said. "But COVID relief expired and now the interest rates are driving up and the water is dropping on liquidity. So some of the problems that have been there for years are starting to surface again."

Todd Sable, partner and of the leader of commercial transactions practice group at Detroit-based law firm Honigman LLP, called the rise of bankruptcies, particularly auto supplier bankruptcies, a return to normal.

"Whether all this means there is going to be a huge uptick in bankruptcies remains to be seen," Sable said. "Yes, we are seeing a rise in bankruptcy activity we haven't seen in the last few years, but I think there should be expected some normal rate of suppliers having financial trouble under the extraordinary circumstances we've seen in the past year coupled with the pandemic. Clearly there is stress in the system that needs to be dealt with, but it could be called a return to stress."

So while the Eastern District court has seen 17 cases this year and likely will land many more bankruptcy filings between now and the end of the year, it's hardly a doomsday scenario.

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