Corporate Insights: Ten Reasons to Expect an Increase in Financial Restructurings in 2025

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1. Commercial Chapter 11 Bankruptcy Filings Have Increased Significantly Year-Over-Year: There has been a significant increase in the number of commercial Chapter 11 cases (larger company filings) in 2024. By way of example, there were 1,894 commercial Chapter 11 filings (including subchapter V filings) during the first quarter of 2024, up 43% from the 1,325 total commercial chapter 11 filings during the first calendar quarter of 2023 according to data provided by Epiq Bankruptcy, the leading provider of U.S. bankruptcy filing data. Given current higher interest rates, expect company bankruptcy filings to continue at this more elevated level for the next 12-18 months.

2. The Federal Reserve's Tighter Monetary Policy Is Starting to Slow the Economy: The Federal Reserve hiked interest rates 11 times between March 2022 and January 2024 to curb inflation. The tightening cycle started in March 2022 when the Federal Reserve raised the federal funds rate from 0% by 0.25% to a level of 0.25–0.50%. In July 2023, the Fed made its final 0.25% increase, bringing the federal funds rate to a range of 5.25–5.50%. Higher rates make borrowing more expensive for banks, businesses, and consumers. Tighter monetary policy is only recently starting to slow the economy because changes in monetary policy operate with a lag. Federal Reserve Chair Jerome Powell discussed the idea that monetary policy involves "long and variable lags" during his press conference following the November 2022 Federal Open Market Committee meeting. The cumulative effect of these rate hikes is now starting to slow the economy.

3. Interest Rates Will Likely Stay Higher for Longer: On May 1, 2024, Federal Reserve Chair Jerome Powell said that inflation has remained stubbornly high and that the Federal Reserve does not plan to cut interest rates until it has "greater confidence" that price increases are slowing sustainably to the Federal Reserve's 2% inflation target. The Fed issued its decision in a statement after its May meeting at which it kept the federal funds rate at a two-decade high of roughly 5.3%. Several recent reports on prices and economic growth have recently undercut the Fed's belief that inflation is steadily easing.

4. Higher Interest Rates Are Squeezing Marginal Borrowers: Higher interest rates have caused marginal borrowers to default on their payment obligations and loan covenants. This trend is likely to continue as more loans mature or reset in 2025. Some of these borrowers will no longer be "bankable" and will instead have to try to access working capital through private lenders at substantially higher rates. This problem will grow worse if interest rates stay higher for longer.

5. Banks Are Making Fewer Loans: Several factors are causing banks to make fewer loans. First, higher interest rates have caused many banks to tighten lending standards. Second, many banks, even those otherwise well capitalized, have less liquidity as customers have taken advantage of higher rates by moving their bank deposits from lower yielding bank savings accounts to higher yielding brokerage accounts. Third, many local and regional banks already

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have a relatively high concentration of loans in the commercial real estate sector, and they are less inclined to lend more into this sector absent a compelling opportunity.

6. Expect Congressional Action to Reinstate Increased Eligibility Limits for Small Businesses Under Subchapter V of the United States Bankruptcy Code: While the debt eligibility limit of $7.5 million (in aggregate noncontingent, liquidated debt) for small businesses looking to elect subchapter V reorganization under Chapter 11 of the United States Bankruptcy Code did sunset back to $2,725,625 on June 22, 2024, Congress is expected to pass legislation to reinstate the higher debt eligibility limit of $7.5 million. In December 2023, the American Bankruptcy Institute's Subchapter V Task Force prepared a report to Congress that advocated for permanently maintaining the debt eligibility limit of $7.5 million for small businesses looking to reorganize under Subchapter V of the Code. A higher debt eligibility limit for Subchapter V makes it a more attractive reorganization option for smaller businesses.

7. The Commercial Real Estate Sector Is Likely to Experience Continued Distress: The commercial real estate sector is being squeezed by the twin forces of higher interest rates and lower demand. Higher interest rates increase borrowing costs and lower valuations for commercial real estate owners. Lower valuations, in turn, may trigger loan covenant defaults. Lower demand for commercial office space due to the persistence of remote work is contributing to lower valuations. Some recent examples of lower valuations in Boston's commercial real estate market are telling:

- The property at 281 Franklin Street was valued at $6.1 million in 2017 and sold for only $3.8 million in February 2023, a 38% decline. Two blocks north, 186 Lincoln Street was sold for $20.7 million in 2015 but for only $11 million in the fall of 2023, a 47% decline.
- The office building at 125 Broad Street was bought for $14 million in 2018 and sold for only $3.9 million in December 2023, a 72% decrease.
- The property at 33–41 West Street across from Boston Common was bought for $16 million in 2016 and sold in September 2023 for $4.1 million, a 74% decline.

According to investment-data provider MSCI, property sale prices in Boston's central business district declined in the fourth quarter of 2023 by more than 30% year over year, a decline steeper than any other city MSCI tracked, including Chicago, Manhattan, San Francisco, and Washington, DC.

8. The Healthcare Industry Faces Continued Headwinds: Last year was the busiest in recent years for Chapter 11 bankruptcy cases involving healthcare businesses with assets greater than $10 million. While the first quarter of 2024 did not break any records for healthcare Chapter 11 cases, 2024 still may prove to be another busy year for distressed healthcare businesses seeking relief under Chapter 11, including hospitals, nursing homes, and other businesses that provide patient care. Healthcare companies have pointed to high interest rates, inflationary pressures, the failure of Medicare and Medicaid reimbursements to keep up with rising costs, and the rollout of the No Surprises Act as contributing factors to their Chapter 11 bankruptcy filings. Healthcare companies, especially nonprofit hospitals, have increasingly received credit rating downgrades, and rating agencies have signaled more trouble to come in this sector.

9. The Cannabis Industry Confronts Challenges: While more states are expected to legalize recreational marijuana, in Massachusetts there is currently an oversupply of cannabis retailers. Retail prices have softened. Manufacturers and suppliers are experiencing delays in payment. These trends may result in industry consolidation and restructurings in 2025.

10. The Presidential Election Raises Uncertainty: There is a reasonable likelihood that the 2024 presidential election will be contested. If the outcome remains contested into 2025, expect an adverse impact on economic activity and financial markets.

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