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Bankruptcy and the coronavirus: Part II

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Introduction

As the pace of extraordinary intervention by regulators and lawmakers to help consumers and businesses stave off economic collapse slows, and the economy begins to open up, the initial fallout of the crisis will become clearer. Many businesses that do not survive may simply stay closed, paying their creditors (either in full, or under renegotiated terms) and shutting down. According to one new study, the number of incorporated business owners has fallen from 5.8 million to 4.7 million,[1] which suggests this has already begun. Bankruptcy filings also are likely to increase dramatically, as consumers and businesses seek either to restructure their debt or to turn over their assets to the court and leave their current obligations behind.

An earlier report, released a few weeks after the start of the coronavirus crisis, considered some of the bankruptcy implications of the crisis.[2] After discussing evidence that bankruptcy courts are less effective when they are congested, the report suggested a variety of strategies regulators and lawmakers might use to adapt the bankruptcy process to the coming wave of cases. The report also advocated measures (such as temporary new bankruptcy judgeships) to expand the capacity of the bankruptcy system, a recommendation also made by other bankruptcy scholars.[3]

This report begins with an update on the question of whether a bankruptcy wave is in fact materializing. The report then takes a closer look at two key features of the bankruptcy process: the standstill that goes into effect when a debtor files for bankruptcy and the debtor's access to financing for the bankruptcy process. In each context, scholars and other commentators have advocated Covid-19 specific adjustments to the ordinary bankruptcy rules. The report will briefly assess the current proposals, concluding that an expanded standstill is not necessary but enhanced access to financing is.

The bankruptcy ripple

From a bankruptcy perspective, the most obvious danger of the current crisis is the risk that the economic shutdown will trigger a bankruptcy wave that overwhelms the bankruptcy system. As discussed in the earlier report, current evidence suggests that congested bankruptcy courts perform more poorly with both small and large corporations.[4] When smaller businesses file for bankruptcy in a congested court, their already high likelihood of shutting down gets even higher. Large corporations remain much more likely to reorganize, even in a congested court, but the process takes longer and is considerably more costly.

It is still too early to tell how big the bankruptcy wave will be. Bankruptcy professionals appear to be gearing up for a major wave. Law firms with a substantial bankruptcy practice have been hiring bankruptcy lawyers

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1. Robert W. Fairlie, "The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey," p. 5, NBER Working Paper Series (June 2020).
2. David Skeel, "Bankruptcy and the coronavirus," Economic Studies at Brookings (April, 2020).
3. For a detailed set of recommendations, including district-by-district assessments of potential congestion, see Letter from Jared A. Ellias, Chair, Large Corporations Committee of Bankruptcy & COVID-19 Working Group to Sens. McConnell and Schumer, and Reps. Pelosi and McCarthy (June 10, 2020)(attaching memorandum authored by Benjamin Iverson, Jared A. Ellias, and Mark Roe).
4. "Bankruptcy and the Coronavirus," p. 5 (discussing Benjamin Iverson, "Get in Line: Chapter 11 Restructuring in Crowded Bankruptcy Courts," Management Science 64 (2018): 5370)).

and enlisting lawyers from other practice areas to join the bankruptcy practice group.[5] Financial advisors are responding similarly.

The actual data on bankruptcy filings are harder to interpret. The number of business bankruptcy filings is higher than it was a year ago, but the increase is not yet especially dramatic. Based on raw filing data, there were roughly fifty percent more business bankruptcy filings in April and May than in 2019.[6] But the numbers are somewhat noisy, because they treat each entity that files as a separate bankruptcy filing, even if the entities are connected. If a company and its 99 subsidiaries each filed for bankruptcy, for instance, this would register as 100 filings, and thus could spike the numbers.[7] Business bankruptcy filings clearly are rising, although perhaps not quite as much as the initial numbers suggest.[8]

Consumer bankruptcy filings have actually gone down during the early months of the crisis. The most obvious explanation for the drop is that Congress's coronavirus aid packages have helped many consumer debtors who might otherwise have filed for bankruptcy. It also is possible that court closures have limited some consumers' ability to file. Given the huge number of recently unemployed workers, the number of bankruptcy filings seems likely to rise significantly as the funding programs come to an end.

So far, the bankruptcy system has not been overtaxed, thanks to the assistance from Congress and regulators. These efforts may have flattened the bankruptcy curve somewhat, but it remains likely that a major wave is coming.[9]

Is a more extensive standstill needed?

One of the biggest benefits of bankruptcy is the "automatic stay"—which is an across-the-board standstill that goes into effect as soon as a debtor files for bankruptcy.[10] Thanks to the automatic stay, a debtor can immediately stop making payments to its creditors, and creditors are required to halt their efforts to collect what they are owed. This is what newspaper reporters have in mind when they say Hertz or J.C. Penney has filed "for relief from its creditors."

From the outset of the economic shutdown, there have been calls for Congress to impose some type of standstill—either of particular obligations such as mortgage or rent payments, or of all obligations—outside

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5. See, for example, Katy Stech Ferek, "Law Firms Gear Up for Expected Jump in Bankruptcies Triggered by Coronavirus," Wall Street Journal, May 6, 2020.

6. See Katy Stech Ferek, "U.S. Business Bankruptcies Rose 48% in May," Wall Street Journal, June 4, 2020.

7. The filing of Pain Quotidian in May, 2020 appears to have had precisely this effect, skewing the May numbers. Bob Lawless, "Chapter 11 Filings in May Are Not Up as Much as Everybody Will Say There Are," Credit Slips (June 3, 2020), available at https://www.creditslips.org/creditslips/lawlessauthor.html. For an analysis of the late May, 2020 filing data that takes account of the effect of affiliate filings, see Ed Flynn, American Law Institute, "Weekly Bankruptcy Analysis May 25-31, 2020," available at https://abi-org.s3.amazonaws.com/Covid19/stats/Weekly_Update_May_25-31-20.pdf.

8. With large business filings (firms with liabilities greater than $50 million), David Smith calculate a 78% increase in March-June 2020 compared to a year earlier. Email from David Smith, Virginia Bankers Association Professor, University of Virginia McIntire School of Commerce, to David Skeel, June 24, 2020.

9. For an article discussing the prediction of Edward Altman, emeritus professor at New York University's Stern School of Business, that there will be record or near record numbers of large business bankruptcies this year, see Mary Williams Walsh, "A Tidal Wave of Bankruptcies is Coming," New York Times, June 18, 2020.

10. 11 U.S.C. section 362(a).

of the ordinary bankruptcy process. In a March 22, 2020 letter to Congress, the National Bankruptcy Conference, a group of bankruptcy judges, lawyers, and scholars, advocated a 90-day stay for individuals and businesses.[11] "These protections [should] not forgive debts or permanently forbid proceedings to collect debts," the group wrote. "Instead, they would grant a temporary pause on evictions, repossessions, foreclosures, and similar proceedings that will follow from the severe dislocations caused by the pandemic." Other bankruptcy experts also called for a standstill for consumers, small businesses or both.[12]

Although Congress has not formally enacted a standstill, federal housing regulators put a moratorium on mortgage foreclosures early in the crisis, and the CARES Act provides for up to a year of forbearance on mortgage payments. In addition, many states put moratoria on mortgage foreclosures or evictions. These measures fit a pattern that goes back to the nineteenth century, and which reemerges in times of crisis.[13] Many lenders and landlords have voluntarily agreed to defer payments; several bankruptcy experts have proposed an interesting framework for coordinating these private efforts.[14]

The question is whether more is needed. The case for a universal, federally enacted standstill is straightforward. While the current patchwork of regulatory, legislative and private standstills has provided substantial relief for many consumers and small businesses, others may fall through the cracks, and many of the moratoria are coming to an end. Moreover, the economy is still largely shut down in some places, and the recent relaxing of restrictions in some states may need to be reversed if a second wave of the virus hits. An across-the-board standstill would fill in these gaps.

Although a universal standstill would have been desirable at the outset of the crisis—providing a temporary halt on payment obligations—it no longer seems desirable. The same standstill that would benefit those who owe mortgage or rent payments and have other obligations would impose a corresponding hardship on those to whom the payments are owed. At this point in the crisis, a more nuanced approach seems more appropriate. Any federal solution should take account not just of the hardship of the crisis for debtors, but also the hardship to the debtor's creditors, many of which are small businesses themselves. To be sure, the parties could renegotiate their obligations during a temporary standstill, but renegotiations also can take place in the absence of a standstill or in bankruptcy.

One recent proposal for a standstill comes closer to achieving an appropriate balance among the interests at stake. In a letter to Congressional leaders, a group of scholars urged lawmakers to "adopt temporary changes to the Bankruptcy Code that allow small business owners to delay proceedings until economic activity has been substantially restored."[15] Under their proposal, small businesses that file for bankruptcy under a new set of reorganization provisions enacted by Congress last year (the Small Business Reorganization Act) would be given an automatic six month suspension during which their case would essentially be frozen. The debtor would not be required to make payments to creditors, and most deadlines would be

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11. Letter from Jane L. Vris, Chair, National Bankruptcy Conference, to Speaker Pelosi, Rep. McCarthy and Sens. McConnell and Schumer (March 22, 2020). The quotes in the text are from p. 3.

12. See, for example, Edward R. Morrison & Andrea C. Saavedra, "Bankruptcy's Role in the COVID-19 Crisis," p. 11 (April 7, 2020); Aurelio Gurrea-Martinez, "Insolvency Law in Times of COVID-19," p. 9 (April 3, 2020); Kenneth Ayotte & David Skeel, "Bankruptcy Law Needs a Boost for Coronavirus," Wall Street Journal, March 30, 2020.

13. The classic discussion of nineteenth century relief measures is Charles Warren, Bankruptcy in United States History, Cambridge: Harvard University Press, 1935, pp. 146-59.

14. Jonathan C. Lipson & Norman M. Powell, "Don't Just Do Something—Stand There! A Modest Proposal for a Model Standstill/Tolling Agreement" (April 14, 2020).

15. Letter from Brook Gotberg, Chair, Small Business Committee of the Bankruptcy & COVID-19 Working Group to Sens. McConnell and Schumer, and Reps. Pelosi and McCarthy (May 26, 2020).

pushed off for six months, including the requirement that the debtor file a propose a reorganization plan within 90 days.

The proposal is intended to address the very real concern that small businesses filing for bankruptcy in the next few months may not be able to negotiate a reorganization within ninety days, given the uncertainty caused by the current pandemic. Because the proposal would only apply to businesses that file for bankruptcy, it would not be nearly as overinclusive as a universal non-bankruptcy stay. The principal beneficiaries would be the companies most likely to need relief. The proposal also includes several attractive ancillary features, such as a proposal that interest be deemed to have stopped accruing during the crisis.

The key question is whether the proposal takes sufficient account of the effect of the standstill on a debtor's creditors. Unlike most other standstill proposals, the scholars' proposal does not ignore creditors altogether. A secured creditor whose collateral is deteriorating in value would be permitted to to invoke its right under ordinary bankruptcy law to ask for "adequate protection." But creditors would be forced to forgo any meaningful payments from the debtor for six months and potentially longer. Although this proposal would be preferable to a blanket standstill, it does not seem desirable at this point in the crisis. Small business debtors already are permitted to request an extension of the ninety-day deadline for proposing a reorganization, for instance, "if the need for the extension is not attributable to circumstances for which the debtor should not justly be held accountable." This provision should provide sufficient flexibility to respond to the uncertainties created by the crisis.

The more general point is this: a simple standstill could cause more harm than good, by further delaying the restoration of revenues to landlords, suppliers and others to whom the debtor owes money. Any temporary bankruptcy or bankruptcy-like regime needs to take full account both of debtors' and of their creditors' vulnerability.[16]

Federal support for debtor-in-possession financing

When a company files for Chapter 11—bankruptcy's provisions for corporate reorganization—it invariably is starved for cash. As a result, obtaining a loan to fund its operations during the bankruptcy case may be essential to achieving a successful reorganization. Roughly three-fourths of large debtors that receive debtor-in-possession (DIP) financing get it from their principal pre-bankruptcy lenders: the old lenders supplement their original loan with new financing.[17] The other one-fourth of debtors obtain new loans from other creditors or from third parties.

It is far from clear whether sufficient DIP financing will be available if a major bankruptcy wave materializes. The prior report proposed that the Federal Reserve or Treasury could help unfreeze the DIP financing market if needed by lending directly or by taking a 20 or 25% interest in DIP loans provided by private

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16. Robin Greenwood and David Thesmar outline one possibly strategy for balancing the needs of small businesses and their creditors. Robin Greenwood & David Thesmar, "Sharing the economic pain of the coronavirus," unpublished manuscript, April 2020. Under their proposal, landlords would be given a 30% tax credit if they forgive all post-coronavirus rent. See also Peter Diamond, Howell Jackson & David Skeel, "A Temporary Bankruptcy Regime for Small Business," work-in-progress, June 2020.

17. Frederick Tung, "Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis," Yale Journal on Regulation 37 (2020): 651, 655 n.13.

lenders.[18] Several other scholars also have advocated Fed or Treasury involvement in the DIP financing market.[19]

The CARES Act strongly discourages the Federal Reserve and Treasury from playing this role. The $500 billion lending program intended for large businesses (as well as states and municipalities) is linked to the Fed's use of its emergency lending powers, which explicitly preclude lending to a company in bankruptcy. The Paycheck Protection Program—which authorizes up to $660 billion in potentially forgivable loans to small businesses—does not explicitly prohibit loans to companies in bankruptcy. But the loans are handled by the Small Business Administration, which requires companies to affirm they are not in bankruptcy on the loan application.

How serious a concern are these obstacles—or to put the question differently, how badly is government support for DIP financing needed? Two months ago, the need for government assistance seemed obvious. Sanchez Energy had announced that it would not be able to pay its DIP financer in full. This almost unprecedented default triggered grave concerns about the availability of funding. Since then, the private DIP financing market has proven more resilient than the early report predicted. J.C. Penney, Neiman Marcus and Pain Quotidian, among others, have been able to obtain DIP financing.

The most obvious explanation for the ready availability of bankruptcy financing is that many funds had a substantial amount of investible resources when the crisis hit, due to the relative dearth of attractive lending opportunities at the time. In a recent column, two bankruptcy experts estimated that distressed investors have access "to nearly $150 billion that can be deployed as DIP loans."[20] Because DIP loans carry a high interest rate (and/or fees), they are attractive investments, even in the current environment.[21] Bank deposits have grown considerably during the crisis, which may enhance their ability to make bankruptcy loans as well.[22]

Although the private market for bankruptcy financing is still functioning, government support is nevertheless essential. Even under ordinary circumstances, the availability of DIP financing is skewed toward the largest firms. The available funding may be sufficient to cover the DIP financing needs of large (more than $50 million in assets) corporate debtors, which one scholar currently estimates to be $33-101 billion in the next eighteen months.[23] The prospects are far more precarious for smaller firms. Prior to the crisis, the dearth of funding for small and medium-sized companies was less alarming, since small and medium-sized firms often are not viable by the time they file for bankruptcy. ("Small" and "medium-sized" lack a standard definition, but one rough dividing line is than $10 million in assets for small businesses, $10-$50 million

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18. Skeel, "Bankruptcy and the coronavirus," pp. 9-10.

19. The earliest proposal, predating the current crisis, appears to be Jonathan C. Gordon, "Government Guaranties for Corporate Bankruptcies, Vermont Law Review 43 (2018): 215. Other crisis proposals include Peter DeMarzo, Arvind Krishnamurthy, & Joshua Rauh, "Debtor-in-Possession Financing Facility (DIPFF) Proposal, March 29, 2020, who advocate direct lending by the Fed and Treasury; and George Selgin, "Catch-11," Cato at Liberty, May 13, 2020.

20. Elliot Ganz & David Smith, "It's Not Time for a Government Bankruptcy Facility," RealClear Markets, June 15, 2020.

21. For evidence that DIP loans provide supracompetitive profits, see B. Espen Eckbo, Kai Li, & Wei Wang, "Rent extraction by super-priority lenders," working paper, March 13, 2020.

22. Thanks to David Smith for this observation about the growth of bank deposits (and to Greg Nini, who suggested it to him).

23. Email from Wei Wang, Professor of Finance, Smith School of Business, Queens University, to David Skeel, June 19, 2020.

for medium-sized.)[24] During the current crisis, by contrast, many otherwise viable firms may default. As a result, it will be much more of a problem if even these firms do not have access to DIP financing, as seems likely to be the case for many of them.

In addition, and of relevance even for large debtors, private DIP financing agreements often include potentially onerous terms. Current agreements routinely include “milestones” setting strict deadlines requiring, for instance, sale of the company’s assets if the debtor does not propose a restructuring plan within a few months of filing for bankruptcy. Although this practice dates back several decades,[25] it has become increasingly prevalent—86% of DIP financing agreements now include milestones, according to a new study.[26] Milestones can be beneficial—they may encourage the company to restructure more quickly than it might otherwise, for instance. But they also can have pernicious effects. One scholar found that the use of milestones and other “extraordinary” provisions is not a response to market conditions such as the availability of credit.[27] Several other bankruptcy scholars have warned that DIP financers may use the tight deadlines to force fire sales of companies that would be worth more if they continued.[28]

The risk that DIP financing agreements could have problematic effects might be alleviated somewhat if there were more flexibility in the lending process. Under current law, a new lender cannot be given priority (a “priming lien”) unless the debtor provides “adequate protection” of any pre-bankruptcy lenders’ interests in the same collateral.[29] Because most or all of the debtor’s assets have usually been pledged to earlier lenders as collateral, it is very difficult to demonstrate that the old lenders will be fully protected if a new lender is given priority. As a result, the debtor’s pre-bankruptcy lenders often are the only realistic source of new funding, which gives them significant leverage in their negotiations with the debtor. As noted earlier, 75% of DIP financing loans are made by pre-bankruptcy lenders.[30] If the priming requirement were eased—by allowing priming for a short period of time, such as two or three months, for instance, as several scholars have proposed—there might be more competition to provide bankruptcy financing.[31] No new legislation would be required. By simply construing the “adequate protection” requirement more flexibly, a bankruptcy judge might loosen the stranglehold debtors’ pre-bankruptcy lenders have over bankruptcy financing.

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24. A different, employee-based dividing line might be less than 100 employees for small, 100-10,000 employees for medium-sized. By way of comparison, the Paycheck Protection Program, which is aimed primarily at small businesses, is available for firms with up to 500 employees.

25. Early articles highlighting the strict constraints in DIP financing agreements include Douglas G. Baird & Robert K. Rasmussen, “The End of Bankruptcy,” Stanford Law Review 455 (2002): 751; David A. Skeel, Jr., “Creditors’ Ball: The ‘New’ New Corporate Governance in Chapter 11,” University of Pennsylvania Law Review 152 (2003): 917.

26. The 86% finding comes from Kenneth Ayotte & Jared A. Ellias, “Bankruptcy Process for Sale” (unpublished manuscript, May 26, 2020), p. 15. More than 90% of the DIP loans in Eckbo, Li, and Wang’s sample included milestones. Eckbo, Li & Wang, ibid. at 11.

27. Frederick Tung, “Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis,” Yale Journal on Regulation 37 (2020): 651.

28. Ayotte & Ellias, “Bankruptcy Process for Sale.” A key earlier article suggesting that DIP financers may induce fire sales is Kenneth M. Ayotte & Edward R. Morrison, “Creditor Control and Conflict in Chapter 11 Bankruptcy,” Journal of Legal Analysis 1 (2009): 511. For a more optimistic view see Mark Jenkins & David C. Smith, “Creditor Conflict and the Efficiency of Corporate Reorganization” (unpublished manuscript, June 2017).

29. 11 U.S.C. section 364(d).

30. Tung, “Financing Failure,” p. 655 n.13. See also Eckbo, Li & Wang, ibid. at p. 4 (same).

31. Ayotte & Ellias, ibid. at pp. 54-56.

Although this adjustment would be an improvement, it is not enough. In many cases, even a more flexible adequate protection standard will not dislodge the inside lenders, either because other creditors are not able to provide funding or because they doubt they will prevail if they attempt to underbid the inside lenders. Moreover, even more flexible financing rules may not ensure an adequate flow of financing to smaller companies in bankruptcy. At least in the short run, while the crisis lasts, government support is needed.

The simplest solution would be removing the current barriers to use of CARES Act funding for companies in bankruptcy as part of its next coronavirus aid package. Absent a legislative fix or shift in Small Business Administration policy, it might be possible for the Federal Reserve and Treasury to maneuver around the restrictions by lending to companies prior to their bankruptcy filing, or after the company emerged, as discussed in the earlier report. In other current work, Peter Conti-Brown and I argue that the Federal Reserve could use its discount window to facilitate bankruptcy financing.[32]

From the government's perspective, any government support needs to be structured in a way that minimizes the perception the Federal Reserve is picking winners and losers in determining which firms are given funding. This concern is diminished if the Federal Reserve supports loans made by private lenders, rather the initiating the loans itself. It can be further reduced by establishing clear, objective rules for eligibility. The Fed's new Main Street Lending Facility under the CARES Act has both of these features, although some of the terms of the program have dampened banks' interest in participating thus far.[33] A Federal Reserve program aimed at facilitating bankruptcy financing for medium-sized companies could significantly reduce the risk that viable medium-sized businesses will be unable to reorganize during the current crisis. A debtor's pre-bankruptcy lenders should be excluded, to facilitate loans from new lenders rather than further entrench existing lenders.

Some fear governmental support could "crowd out" private financing, contending that the DIP market is sufficiently robust for the current crisis.[34] This is a legitimate concern. But given the existing shortcomings of the market, and the dearth of DIP financing for medium-sized firms even under ordinary conditions, government assistance is essential. Just as the Federal Reserve and Treasury have sought to provide the funding needed to keep businesses out of bankruptcy, they should put support in place for viable firms that need to restructure their debt in Chapter 11.

The coronavirus crisis has prompted a wave of proposed crisis-oriented bankruptcy reforms from scholars and other commentators, but only a limited response from Congress thus far. This report has focused on potential reforms aimed at two of the most important features of bankruptcy, the standstill and the bankruptcy financing.

Proposals for a standstill call either for a general pause of debt obligations, even in the absence of bankruptcy, or a six-month halt on debt payments conditioned on a bankruptcy filing. At the outset of the crisis, a pause was desirable, and in fact was achieved for many individuals and businesses for major obligations

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32. Peter Conti-Brown & David Skeel, "Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the Covid-19 Bankruptcy Crisis" (unpublished manuscript, June, 2020).

33. For an excellent discussion of the problems and suggestions for adjusting the program, see William B. English & J. Nellie Liang, "Designing the Main Street Lending Program: Challenges and Options," Brookings Institution, Hutchins Center Working Paper #64, June 18, 2020.

34. See, for example, Ganz & Smith, ibid.

such as rent and mortgage payments through ad hoc legislative, regulatory and private action. At this point in the crisis, a standstill is no longer desirable. The ordinary stay for consumers and businesses that file for bankruptcy should be sufficient.

With bankruptcy financing, by contrast, the need for intervention is much greater. The private market for bankruptcy financing is remarkably strong, despite the crisis. But the crisis is likely to force many medium-sized businesses that are viable and would not have filed for bankruptcy absent the crisis to seek bankruptcy relief. These businesses are less likely to have access to bankruptcy financing. By partnering with private lenders, the Federal Reserve and Treasury could expand the scope of the current DIP financing market. The expansion could also diminish debtors' need to agree to the use of extraordinary provisions in DIP financing agreements.

The earlier report addressed several other issues, including strategies regulators might use to facilitate pre-packaged bankruptcies and other creative uses of existing bankruptcy restructuring tools, and the need to expand the capacity of the bankruptcy system. Unless lawmakers' and regulators' interventions have dramatically reduced the coming bankruptcy wave, each of these features will significantly increase in importance in the coming weeks.