Countering COVID-19 with Countercyclical Bankruptcy Policy

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Original post here.

Governments are temporarily tilting their bankruptcy laws in favor of debtors to help businesses survive the crisis. Some have taken advantage of the crisis to propose permanent pro-debtor bankruptcy reforms.

Many countries have found that their current bankruptcy laws do not offer enough relief to debtors in these difficult times. This even applies to countries with pro-debtor systems, like Chapter 11 in the United States, that aim to avoid liquidations and restructure all companies that are viable as going concerns. Due to COVID-19, many otherwise viable businesses see themselves without a strategy for recovery until social-distancing measures end. Policymakers fear that this will force countless businesses to liquidate, leaving even more workers unemployed. So many bankruptcies could overwhelm bankruptcy courts, drawing out an already painful process.

In response, countries with creditor-friendly bankruptcy systems--those that focus on the orderly liquidation of insolvent firms for the benefit of creditors--are taking on more of the characteristics of debtor-friendly systems--which favor restructuring for the benefit of debtors. Creditor-friendly UK and Germany focus on equitably compensating all creditors through liquidation and typically discourage or forbid debtor-friendly practices. The more debtor-friendly US system makes it difficult for creditors to execute an involuntary bankruptcy and allows companies to continue to conduct transactions after a company has become insolvent, a practice known as "insolvent trading." Italy and France have restructuring procedures that are arguably more debtor-friendly than Chapter 11.

This blog focuses on the temporary measures that governments are taking to save businesses from liquidation and help bankrupt businesses restructure more easily. We survey the following nine tools:

- Moratoria
- Changing the definition of insolvency
- Extended notice periods for debtors
- Changes to preferential transfer rules
- Relaxed rules mandating that managers file for bankruptcy
- Relaxed rules against "wrongful trading"
- Expanded access to simplified bankruptcy procedures

- Modification of existing bankruptcy payment plans
- Preferred status (payment seniority) for lenders to troubled businesses

Moratoria

Governments can impose moratoria on bankruptcy applications to close bankruptcy courts to new cases. They can also put a stop to bankruptcy proceedings for existing cases. Another alternative would be to delay deadlines for creditors and debtors to take certain actions in bankruptcy courts, similar to the automatic stay in US bankruptcy law.

Some moratoria appear to be tied to other lockdowns of non-essential government services and are thus more about public health policy than macroprudential policy. (We define "macroprudential" as policies that seek to promote financial stability). For example, on March 18, Switzerland ordered a moratorium on debt collection and bankruptcy proceedings through April 4. Similarly, the Government of India declared a 21-day lockdown on March 25. The Insolvency and Bankruptcy Board of India (IBBI) responded on March 29 with a statement that the remaining days of the lockdown would not count toward the various timelines imposed by India's bankruptcy code.

Turkey has implemented what is close to a blanket moratorium on bankruptcy. Beginning March 22, Turkey suspended nearly all access to creditor-debtor law through April 30. The "Decree to Suspend Enforcement and Bankruptcy Proceedings" halted all new and current bankruptcy proceedings. The only proceedings exempted from Turkey's moratorium are those related to the enforcement of child support.

An alternative to a moratorium is to make it more difficult for creditors to impose bankruptcy on debtors. This approach leaves open the possibility of debtors voluntarily filing for bankruptcy because they need relief during a crisis.

Russia recently passed a six-month moratorium during which creditors can take no bankruptcy actions against companies impacted by COVID-19. The law grants the government discretion over who will benefit from the moratorium. After May 1, government creditors will be exempt from the rule and will be allowed to file against debtors. The moratorium also halts the enforcement of debts and any financial sanctions that might be imposed as part of bankruptcy proceedings. The moratorium law imposes behavioral expectations on debtors who benefit; it forbids debtors from distributing dividends or buying back their shares during the moratorium. On the other hand, it also allows creditors to maintain existing attachments on a debtor's assets and imposes other restrictions on the disposal of assets.

Similarly, creditors in Czechia will not be able to file bankruptcy petitions against debtors until the state of emergency ends or August 31, whichever comes first. Czechia also proposed what it called extraordinary moratoria for companies that are still solvent. These are temporary moratoria on payments that can be obtained with fewer administrative barriers, can last up to six months, and do not require the consent of creditors to be approved. Businesses can apply for these moratoria until August 31. Czechia also will change its bankruptcy code to offer moratoria to debtors who are not yet insolvent, but will probably become insolvent if not helped soon.

Germany has implemented a version of this policy. Debtors can file for bankruptcy, but creditors are not allowed to file against a debtor between March 1 and June 30 unless the debtor's insolvency or over-indebtedness had occurred before March 1. Similarly, France has stopped creditors from filing insolvency proceedings against a debtor who is unable to meet its outstanding liabilities with its available assets until three months after the end of the country's health emergency period. This protection is only available for debtors who became cash-flow insolvent after March 12.

Changing the definition of insolvency

Some countries are trying to stem the flow of bankruptcies by temporarily increasing the amount of defaulted debt at which a company is deemed insolvent. Australia increased the threshold for insolvency from AU$5,000 to AU$20,000 (from $2,998 to $11,992), India increased from Rs 100,000 to Rs 10,000,000 (from $1,308.56 to $130,855.80), and Singapore plans to increase from S$10,000 to S$100,000 ($5,996 to $59,960).

Extended notice periods for debtors

Government can also give debtors more time to stave off a liquidation by simply increasing the amount of time debtors have to respond to a bankruptcy notice. This can slow down the bankruptcy process at its earliest stages and relieve some of the administrative burden on the courts. For example, Australia gave debtors six months, rather than 21 days, to respond to a creditor's bankruptcy notice.

Changes to preferential transfer rules

Governments can also use temporary changes to their bankruptcy laws to incentivize creditors to do business with or lend to companies rendered temporarily insolvent by COVID-19. During normal times, many bankruptcy codes (including the US Bankruptcy Code) allow the estate of the debtor to void or "claw-back" certain transactions executed in the period leading up to the bankruptcy. These transactions are known as preferential transfers. These rules ensure that similar kinds of creditors are treated equitably. However, they also can discourage banks from lending to or helping rescue a troubled company. A number of countries have made these rules less stringent or provided even larger incentives for creditors to aid a company that may be insolvent.

Germany implemented two policies attempting to reduce disincentives for new lending to and payments by these businesses. First, all loans granted to companies between March and September cannot count as "an illegal delay of insolvency" and be voided until September 30, 2023. Second, agreements between an insolvent business and its creditors are insolvency-proof until September 30.

Relaxed rules mandating that managers file for bankruptcy

A number of European countries have temporarily modified laws that oblige a company's management to file for bankruptcy within a certain period after the company has become cash-flow insolvent, that is, when it cannot pay its debts as they come due. These efforts also aim to prevent the court system from being flooded with bankruptcy petitions from managers of only temporarily insolvent firms that would ordinarily be forced to file.

Luxembourg usually mandates that management file for bankruptcy within one month of having missed a payment to a creditor. On March 25, Luxembourg suspended this requirement until June 25.

Other countries have taken an approach that is more generous to debtors. For example, Germany has suspended management's obligation to file within three weeks after the company has become over-indebted or cash-flow insolvent, through September 30. However, the policy does not protect businesses that became cash-flow insolvent for reasons not related to COVID-19 and businesses where there is "no prospect of eliminating the insolvency." The government also built a statutory assumption that expands the number of debtors who can benefit from the policy. The law assumes that any company that became insolvent in 2020 can blame COVID-19. Usually, company managers are liable under both criminal and civil law for failing to file for bankruptcy within three weeks of becoming over-indebted or cash-flow insolvent.

Similarly, Czechia has proposed a law that, among other things, abolishes the management's obligation to file for insolvency until six months after the country's emergency measures lapse. Only insolvencies that occured because of COVID-19 are eligible for this relief and the government will have to pass a law to extend this policy if the emergency measures are still in effect at the end of 2020. Usually, Czechia takes a discretionary approach to punishing those who fail to file after knowing they are insolvent. The law normally specifies that insolvent debtors have to file without undue delay after learning of the insolvency or "after it should have learned of its insolvency if it had exercised due care."