Bail-outs and Bail-ins are better than Bankruptcy: A Comparative Assessment of Public Policy Responses to COVID-19 Distress

Law Working Paper N° 535/2020
August 2020

Kristin van Zwieten
University of Oxford and ECGI

Horst Eidenmueller
University of Oxford and ECGI

Oren Sussman
University of Oxford and ECGI

ECGI Working Paper Series in Law

Bail-outs and Bail-ins are better than Bankruptcy: A Comparative Assessment of Public Policy Responses to COVID-19 Distress

Working Paper N° 535/2020
August 2020

Kristin van Zwieten
Horst Eidenmueller
Oren Sussman

Abstract

COVID-19 has severely disrupted the conduct of business around the globe. In jurisdictions that impose one or more 'lockdowns', multiple sectors of the real economy must endure prolonged periods of reduced trading or even total shutdowns. The associated revenue losses will push many businesses into bankruptcy. No public policy response can recover these losses. States can, however, act to reduce the amplification of the shock by the way in which they treat the cohort of newly bankrupt businesses. In jurisdictions where a well-functioning reorganisation procedure is capable of producing value-maximising outcomes in normal conditions, the temptation may be to subject this cohort to treatment by such procedures. This temptation should be resisted, not only because of the (significant) costs of these procedures, or because of concerns about institutional capacity to treat a high volume of cases, but also because such procedures are likely to be a poor 'fit' for the treatment of COVID-19 distress. In our view, the more attractive routes to relief are bail-ins (one-time orders to creditors or counterparties, or some class thereof, to forgive), bail-outs (offers to assume the debtor's liabilities, or a class thereof), or some combination of the two. In this paper, we explain why a public policy response is necessary to mitigate the amplification of the shock caused by trading shut-downs, and compare treatment by the prevailing bankruptcy law with treatment by bail-ins or bail-outs along a range of dimensions. We conclude by tentatively suggesting some principles to help guide the choice between bail-ins and bail-outs, and the design of either form of intervention

Keywords: Bankruptcy, Bail-out, Bail-in, Reorganisation, COVID-19 Distress, Public Policy

JEL Classifications: D61, E62, G33, K22

Kristin van Zwieten
Clifford Chance Associate Professor of Law and Finance
University of Oxford, Faculty of Law
St Cross Building, St Cross Road
Oxford OX1 3UL, United Kingdom
e-mail: kristin.van-zwieten@law.ox.ac.uk

Horst Eidenmueller*
Statutory Professor for Commercial Law
University of Oxford, Faculty of Law
St Hugh's College, St Margaret's Road
Oxford, OX2 6LE, United Kingdom
phone: +44 1865 284 472
e-mail: horst.eidenmueller@law.ox.ac.uk

Oren Sussman
Reader in Finance
Said Business School, University of Oxford
Park End Street
Oxford,OX1 1HP, United Kingdom
phone: +44 18 6528 8926
e-mail: Oren.Sussman@sbs.ox.ac.uk

*Corresponding Author

Bail-outs and Bail-ins are better than Bankruptcy:
A Comparative Assessment of Public Policy Responses to COVID-19 Distress

Kristin van Zwieten, Horst Eidenmüller and Oren Sussman*

Abstract

COVID-19 has severely disrupted the conduct of business around the globe. In jurisdictions that impose one or more 'lockdowns', multiple sectors of the real economy must endure prolonged periods of reduced trading or even total shutdowns. The associated revenue losses will push many businesses into bankruptcy. No public policy response can recover these losses. States can, however, act to reduce the amplification of the shock by the way in which they treat the cohort of newly bankrupt businesses. In jurisdictions where a well-functioning reorganisation procedure is capable of producing value-maximising outcomes in normal conditions, the temptation may be to subject this cohort to treatment by such procedures. This temptation should be resisted, not only because of the (significant) costs of these procedures, or because of concerns about institutional capacity to treat a high volume of cases, but also because such procedures are likely to be a poor 'fit' for the treatment of COVID-19 distress. In our view, the more attractive routes to relief are bail-ins (one-time orders to creditors or counterparties, or some class thereof, to forgive), bail-outs (offers to assume the debtor's liabilities, or a class thereof), or some combination of the two. In this paper, we explain why a public policy response is necessary to mitigate the amplification of the shock caused by trading shut-downs, and compare treatment by the prevailing bankruptcy law with treatment by bail-ins or bail-outs along a range of dimensions. We conclude by tentatively suggesting some principles to help guide the choice between bail-ins and bail-outs, and the design of either form of intervention.

Contents

Introduction

COVID-19 has significantly upset the conduct of business in multiple jurisdictions simultaneously. Since no economy is entirely closed, even jurisdictions with few cases of the virus will experience some level of disruption to the real economy.[1] In many jurisdictions, this disruption has already been, or can reasonably be expected to be, severe. Where rates of local virus transmission necessitate the imposition of one or more periods of 'lockdown', businesses in some sectors may not be able to trade at all, and others will confront significantly reduced demand and/or significantly costlier supply. Businesses may also be severely affected by the progress of the virus in neighbouring jurisdictions, which again may reduce demand for domestically produced goods or services, or inhibit supply.

As a consequence, many businesses in many jurisdictions have or will experience significant reductions in revenue. These revenue losses will generally be an unexpected loss that managers have not hedged against, directly or indirectly, *ex ante*. If these losses are left to lie where they fall, some businesses will rapidly move from a pre-pandemic state of solvency to a post-pandemic state of insolvency, at least in the cash-flow sense.[2] In some cases, the business may no longer be considered economically viable (i.e. no longer capable of achieving a turnover that exceeds operating costs), but in many cases this will not be so. In the case of a jurisdiction in 'lockdown', many businesses that suffer a loss of revenue may reasonably be expected to again achieve a turnover that

---

* Kristin van Zwieten is Clifford Chance Associate Professor of Law and Finance in the Law Faculty at the University of Oxford, Gullifer Fellow at Harris Manchester College, and Research Member of ECGI. Horst Eidenmüller is Statutory Professor of Commercial Law in the Law Faculty at the University of Oxford, Fellow of St Hugh's College and Research Member of ECGI. Oren Sussman is Reader in Finance at the Said Business School at the University of Oxford, Fellow of Wadham College, and Research Member of ECGI. We are grateful to Aurelio Gurrea Martinez, Simon Gleeson, Thom Wetzer, Reinhard Bork, John Armour, and participants at a Business Law Workshop in Oxford for helpful comments on this project.

[1] For example, because of disruptions in import/export supply chains, or because of changes in demand for domestic goods or services.

[2] Insolvency in the cash-flow sense means inability to pay debts as and when they fall due. *See* further KRISTIN VAN ZWIETEN, GOODE ON PRINCIPLES OF CORPORATE INSOLVENCY LAW [4-15] et seq. (5th ed. 2018).

exceeds costs when the lockdown is lifted.[3] In the meantime, however, they may default on debts as they fall due. Importantly, such default is not premised on the business having external debt finance: since businesses typically have fixed costs under executory contracts (for example, periodically accruing wage or lease liabilities, which once accrued constitute a debt), they are at risk of default even in the absence of financial creditors.

In this paper, we consider how states might respond to the emergence of a large cohort of newly defaulting business debtors, and suggest principles to guide the design of such responses. We take as our paradigm case a jurisdiction in which some form of 'lockdown' is imposed, which will almost inevitably result in a significant loss of revenue for multiple sectors of the real economy, simultaneously. We begin in Part I by identifying what we consider to be the problem for policymakers, namely that if revenue losses from a shutdown or reduced trading period are left to lie where they fall, the shock will be amplified (or, to put it another way, the adverse impact on the value of affected businesses will be increased), because of the costs of financial distress. Among these costs, we focus particularly on the risk that the assets of defaulting businesses will be sold at a 'fire-sale'[4] price. Where such sales occur, losses to creditors and counterparties will be exacerbated, and, depending on the subsequent use of the assets, unemployment may increase.[5] We explain[6] how the risk of such 'fire sales' may arise even where assets can be shielded from uncoordinated 'grabs' by creditors, with a view to enabling a viable business to be sold as a going concern. Such sales may not be achievable in current conditions.

We acknowledge that many jurisdictions have introduced procedures designed to enable a distressed debtor to retain a viable business, rather than be subject to a forced sale ('reorganisation' procedures). About two-thirds of the world's economies have

---

[3] Of course, a firm that is viable on the easing of a lockdown may nevertheless still be unable to pay all accrued liabilities: its margins may be too slight to accommodate trading losses from the lockdown period. See further below, text to note 59.

[4] A fire-sale price is a price lower than fundamental value: B. Espen Eckbo and Karin S. Thorburn, *Automatic bankruptcy auctions and fire-sales*, 89 JOURNAL OF FINANCIAL ECONOMICS 404, 405 (2008. See further below, text to note 21.

[5] See below, text to note 42.

[6] See below, text to note 39.

such a procedure.[7] These may or may not function to produce value-maximising outcomes (many do not), but even where they generally do so, we do not think they will be appropriate for use by all debtors that have become distressed as a result of COVID-19 revenue losses. Some such debtors will be distressed only because they cannot meet (fixed) operating costs. These debtors will not be well-served by a procedure that is geared towards restructuring financial debt (of which there may be none), and which assumes the debtor will be able to continue to pay rent and other liabilities periodically accruing during the procedure (it cannot, because it cannot presently generate sales). Others may have pre-pandemic debt, but expect to be able to service it[8] on the relaxation of lockdown restrictions, and to discharge rent and analogous liabilities that accrued during lockdown. It is plainly undesirable to inflict the (significant) costs of a formal reorganisation[9] on such debtors. But even in the case of a debtor that, absent some relief from the state, will need to restructure some of its debts, we are doubtful about subjecting such a debtor to immediate treatment by the prevailing reorganisation law.[10] There is an argument for postponing the restructuring until the lockdown is relaxed, if workout prospects can reasonably be expected to be better then.

---

[7] World Bank, Doing Business Report 2020: Resolving Insolvency, 'Good Practices', available at https://www.doingbusiness.org/en/data/exploretopics/resolving-insolvency/good-practices (last accessed August 6, 2020).

[8] This assumes, of course, that the loan has not been accelerated by an event of default, as to which see further below, section II.B.

[9] On these direct and indirect costs, see further below, text to note 55.

[10] Hence, we disagree with scholars in the US who advocate the use of bankruptcy (more specifically: Chapter 11 of the US Bankruptcy Code) to address the crisis. See, for example, Jared Ellias and George Triantis, *Congress is ignoring the best solution for troubled companies: bankruptcy*, FORTUNE, May 15, 2020, https://fortune.com/2020/05/14/bankruptcy-cares-act-aid-coronavirus/ (last visited August 6, 2020); Edward R. Morrison and Andrea C. Saavedra, *Bankruptcy's Role in the COVID-19 Crisis*, Working Paper June 26, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3567127 (last visited August 6, 2020), although these authors recommend use by the bankruptcy system only by larger businesses, and assume at least some of these businesses will obtain liquidity support from the state. Skeel's position appears similar: David Skeel, *Bankruptcy and the coronavirus*, ECONOMIC STUDIES AT BROOKINGS, April 21, 2020, https://www.brookings.edu/research/bankruptcy-and-the-coronavirus/ (last visited August 6, 2020). In contrast, Joseph Stiglitz reportedly favours the introduction of a special procedure to the Bankruptcy Code to deal with systemic bankruptcy, albeit for reasons somewhat different to ours. *See* Peter Coy, *Stiglitz Calls for 'Super Chapter 11' to Avoid Systemic Collapse*, BLOOMBERG BUSINESSWEEK, April 9, 2020, https://www.bloomberg.com/news/articles/2020-04-09/could-super-chapter-11-help-an-economy-avoid-systemic-collapse (last visited August 6, 2020); see further below, text to note 43.

Reorganisation law is, of course, not fixed, and so some of our objections to its use could be dealt with by changes to the law or its interpretation. Such changes, however, may result in a procedure that works far less well in normal times, including an occasional cyclical downturn, when it may be perfectly reasonable to assume that debtors who need to 'buy time' due to temporary business disruption will generally be able to do so informally[11], and to assume that liabilities that accrue during a reorganisation will generally be paid as an expense of that process. We are wary, then, about proposals to amend reorganisation laws to accommodate the features of COVID-19 distress.

If relief is not to be delivered through reorganisation law, how are debtors to be insulated from the costs of financial distress, including the immediate risk of fire-sale outcomes? In Part II of the paper, we identify two additional ways to deliver relief to newly defaulting debtors outside of the existing bankruptcy law framework. By comparison with this framework, these forms of relief require fewer legal resources (courts, etc.), are more readily tailored to the peculiar features of COVID-19 distress (i.e. pan-industry distress of exceptional magnitude prompted by unhedged business disruption), and are less likely to produce an unduly 'debtor-friendly' reorganisation law that persists into good times, compromising access to finance for all business debtors.

The first mode of relief is for the state to offer to assume some or all of the debtor's liabilities. The state's offer could be expressed to be limited to a particular category of debt or liability (e.g. wages[12]), or more general (as where the state facilitates access to a zero interest / no fee loan or provides a cash grant to compensate for turnover

---

[11] Outside of a pan-industry crisis, creditors and counterparties will generally be much better positioned to accede to such a request.

[12] Such 'furlough' schemes have been implemented in a number of EU Member States. See FitchRatings, Furlough Schemes Limit Coronavirus Unemployment Shock in Europe, May 18, 2020, https://www.fitchratings.com/research/sovereigns/furlough-schemes-limit-coronavirus-unemployment-shock-in-europe-18-05-2020 (last visited July 28, 2020).

losses[13]). Such relief could be termed a 'bail-out'.[14] The costs of delivering this relief will be borne by taxpayers over time.

The other route to relief is for the state to mandate some forgiveness by creditors and counterparties. The state may mandate a partial write-down (e.g. of interest accruing during a lockdown), or more modestly provide a mandatory extension in maturity.[15] Again, such relief may be specific to particular classes of obligation (e.g. rent[16]), or more general, as where the state introduces a temporary moratorium (which is in functional terms an extension of maturity[17]) on the exercise of all debt enforcement rights against debtors that were not distressed prior to the pandemic. Relief of this kind may appear similar to that which can be obtained by filing for an insolvency procedure, but, crucially, can be tailored to the particular characteristics of pandemic distress and need not be subject to all the restrictions otherwise found in bankruptcy laws.[18] The costs of delivering this relief are borne, in the first instance, by creditors and counterparties who are ordered to forgive, or (to put it another way) by current savers

---

[13] Two examples of this are the UK scheme for retail, hospitality and leisure grants for small and medium-sized businesses in these sectors (*see* Department for Business, Energy and Industrial Strategy, Grant Funding Schemes – Frequently Asked Questions: Small Business Grant Fund and Retail, Hospitality and Leisure Grant Fund Guidance, 2020, https://www.gov.uk/government/publications/coronavirus-covid-19-guidance-on-business-support-grant-funding (last visited August 6, 2020)) or the US scheme for 'economic injury disaster loans' for small business owners and non-profits, which includes an up-front advance that does not have to be repaid: *see* https://www.coronavirus.gov/smallbusiness/ (last visited August 6, 2020).

[14] See below, text to note 66.

[15] A mandatory conversion of debt to equity is also possible, but usually not practicable for smaller businesses that, although incorporated, are in substance a 'quasi-partnership' where "incorporation is a device for personifying the business and, normally, divorcing its liability from that of its members despite the fact that the members retain control and share the profits": PAUL L. DAVIES AND SARAH WORTHINGTON, GOWER PRINCIPLES OF MODERN COMPANY LAW [1-15] (10th ed. 2016).

[16] In one version, the state restrains the exercise of a landlord's right of re-entry, buying the tenant time to pay rent accruing during lockdown (*see*, for example, the UK *Coronavirus Act 2020*, s.82). Similarly, the state might restrict the ability of a secured creditor to appoint a receiver, i.e. to exercise a foreclosure remedy: *see*, for example, the Singaporean *Covid-19 (Temporary Measures) Act 2020* s.5.

[17] Robert Gertner and David Scharfstein, *A Theory of Workouts and the Effects of Reorganisation Law*, 46(4) JOURNAL OF FINANCE 1189, 1210 (1991).

[18] Relief may be given to a subset of debtors that expect to be neither economically nor financially distressed on the relaxation of lockdown restrictions: see above, text to note 8, and below, text following note 58.

who have provided funds or assets to businesses. Such relief can be termed a 'bail-in', provided that the differences with bail-ins in bank resolution are appreciated.[19]

In theory, states could relieve debtors from the risk of fire-sales by offering to assume debts (a bail-out), ordering a one-time forgiveness of debts (a bail-in), or by some combination of the two. How should states decide which route to take? Plainly, this will be highly context-specific: some states will have greater capacity to assume private liabilities than others; some creditors and counterparties will be better positioned than others to take on the loss under a mandatory forgiveness scheme. It is, however, possible to articulate some principles that appear likely to be of general relevance, and we do so in Part III of the paper.

Our starting point is that relief should be proportionate, in the sense that it should not go beyond that reasonably thought necessary to minimise the amplification of the economic shock caused by periods of trading shutdowns (Principle 1). In choosing between forms of relief, and in designing the terms of relief, states should seek to minimise distortions to efficient private bargains and private law rules, especially the prevailing debtor-creditor law (Principle 2). Transfers should be from the less financially constrained to the more financially constrained companies and individuals, taking loss absorbing and risk bearing capacity into account (Principle 3). Policies should attempt to achieve a good 'fit' with the existing institutional infrastructure in a particular jurisdiction (Principle 4). Finally, a transparent process for determining the allocation of pandemic-induced costs should be established, to minimise the risks of damage to the legitimacy of the state in the post-crisis period (Principle 5).

I. COVID-19 Distress and Bankruptcy

A. The Nature of the Problem

In a perfect world, market participants would be able to trade claims contingent on all conceivable eventualities, including a novel coronavirus pandemic. Through trade in such contingent claims, companies and individuals less exposed to pandemic risk would

[19] See below, text to note 67.

be able to sell insurance to businesses more exposed to such risk. In theory, the outcome of such trade would be an efficient allocation of the risk. Had such trade occurred, governments would not presently have a problem to solve, as COVID-19 losses would have been more evenly distributed. It is important to emphasize that COVID-19 losses are the inevitable, unavoidable consequence of parts of the economy being shut down for a considerable length of time. All that a well-functioning capital market can do is to allocate the aggregate loss more evenly, to each company according to its exposure to the pandemic. (Needless to say, some companies – Zoom is an extreme example[20] – have reaped big gains from the pandemic; in a perfect world, Zoom could have absorbed, at a premium, some of the losses of the more exposed industries.) We refer to that hypothetical benchmark distribution as the 'unavoidable minimum' loss. As it is, in the absence of such trade, governments must confront a disproportionate concentration of losses in certain sectors of the economy, which amplifies the effect of the pandemic over and above that which would have been implied had the risk been insured and properly allocated against *ex ante.* All that the government can do in such circumstances is to use transfers in order to bring the economy as close as possible to the hypothetical unavoidable minimum.

The root cause of the amplification effect is the non-linear relationship between a business owner's net worth and the value of her company, which implies that extreme equity losses cannot be netted out against equivalent equity gains in another sector. As we explain below, this is because the unavoidable losses can push the business into financial distress, and this distress is costly. Thus, a company owner who suffers a lost revenue of 100 during the pandemic shutdown, is likely to be driven into financial distress and, as a result, see his post-shutdown cash flow drop by an additional $\Delta>0$, so that the total economic damage to himself is $100+\Delta$. Crucially, an owner who had a windfall of 100 is likely to experience a much smaller increase in future cash flow – or even no change to future cash flow. As a result, losses and windfall (over and above the unavoidable minimum) *do not* net out to zero. Or, to put it differently, the *total* amount of economic value that is destroyed by this amplification effect is higher the more disproportionate the distribution of equity losses across sectors. In addition, there is the obvious distributional problem that the pandemic pain will be borne unevenly (or

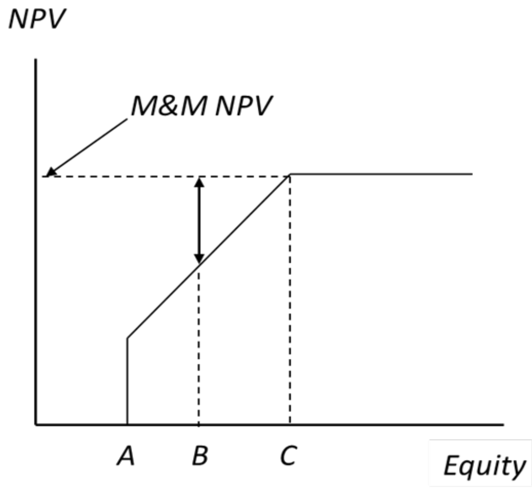
[20] Between January and July 2020, Zoom's share price increased by some 300%.

‘unfairly’) by individuals in society, with those in the sectors most affected by the shutdown bearing the losses as well as the amplification of these losses where financial distress ensues.

To illustrate, the figure below plots the relationship between a business owner’s net worth, her equity, and her company’s value, that is the net present value of the company’s future cash flow. To the left of point A, equity is so low that the business cannot access any external funding or working capital (including trade credit), so it cannot operate. It is credit-rationed and its value is down to zero. To the right of point C, the business is emancipated from any dependency on external finance, and therefore bears no associated loss of value (including bankruptcy risk). Increasing the owner’s equity will make her (personally) richer but will not increase the value of the business, which will stay at the Modigliani-Miller, frictionless level. In between, at a point like B, the value of the business falls short of the M&M value, due to the costs associated with external finance, including bankruptcy risk with all its attendant costs, such as the risk that assets will be subject to a forced sale at a price that does not reflect fundamental value (a fire-sale).[21]

[21] “A fire-sale discount results when the observed auction price is lower than an estimate of the assets’ fundamental value (taken to represent the value in best alternative use)”: B. Espen Eckbo and Karin S. Thorburn, *Automatic bankruptcy auctions and fire-sales*, 89 JOURNAL OF FINANCIAL ECONOMICS 404, 405 (2008). *See* also Andrei Shleifer and Robert Vishny, *Fire Sales in Finance and Macroeconomics*, JOURNAL OF ECONOMIC PERSPECTIVES 29, 30 (2011): “a fire sale is essentially a forced sale of an asset at a dislocated price. The asset sale is forced in the sense that the seller cannot pay creditors without selling assets… Assets sold in fire sales can trade at prices far below value in best use, causing severe losses to sellers”.

Figure 1: Relationship between a Business Owner's Equity and the Company's NPV



The essential point for present purposes is that a business can be pushed back from the right of point C into a point like B by unhedged business disruption, *even if they have no external debt finance*, so that they become subject to the same loss of value associated with the presence of debt. This occurs because even a business with no financial creditors will typically have fixed costs that accrue periodically under executory contracts.[22] Simple examples of such operating costs are the obligation to pay wages under a contract of service[23], or to pay rent under a lease. Obligations of this kind will typically be met out of turnover (perhaps with some form of line-of-credit facility to smooth cash-flow month-to-month). But in the absence of turnover, the obligations will (unless susceptible to unilateral adjustment by the business[24]) continue to accrue, and once accrued they are a debt that exposes the business to default risk. This point is missed in literature that focuses on external borrowings as the source of financial distress. That is the proper focal point where the business is capable of

[22] *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINNESOTA LAW REVIEW 440, 460 (1973) (defining an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other").

[23] Wage liabilities may not be fixed, because the applicable law may permit temporary lay-offs where provided for in the contract of employment, but other types of liabilities periodically accruing under executory contracts, such as the obligation to pay rent, will not typically be susceptible to such unilateral adjustment.

[24] Wage liabilities may be so susceptible: *ibid.* A debtor may also be relieved of future obligations if the executory contract can be said to have been frustrated. The scope of the common law doctrine of frustration is, however, narrow.

generating revenue (which should, if the business is viable, exceed operating costs), but not if it is suddenly paralysed from doing so for a non-trivial period, as in a lockdown. A sudden loss of revenue also places non-borrowing businesses at risk of bankruptcy, with all its attendant costs, including the risk of fire-sales.

Consistent with this analysis, there is an established market for business disruption insurance which is turnover-based. At least in the UK, however, it seems that some policies were limited to disruption from damage to business property, and that other broader policies are contended by insurers not to cover COVID-19 related losses, for various reasons.[25] The result is that, unless businesses have hedged against the risk of business disruption of the kind and scale currently faced in some other way, and in the absence of state intervention, they will be required to absorb the revenue losses associated with COVID-19. Some may be able to do so without defaulting: they may have few fixed costs, and little or no external finance, or they may have cash reserves, i.e. equity beyond point C, sufficient to enable them to pay fixed operating costs and service debts for the duration of the period of trading losses. Clearly, however, many businesses will not have such reserves. Surveys of small and medium sized businesses in the UK and Canada at the beginning of 'lockdown' periods indicate that the majority of those surveyed had less than three months of cash reserves[26], even after allowing for a reduction in wage liabilities either unilaterally (through temporary layoffs) or through a governmental assumption of such liabilities (as in a furlough scheme).[27] The picture

---

[25] See the skeleton argument for the test case brought by the UK Financial Conduct Authority here: https://www.fca.org.uk/publication/corporate/bi-insurance-test-case-fca-skeleton-argument.pdf (last visited August 6, 2020). Survey evidence by McKinsey suggests that small businesses are now less likely to purchase business interruption insurance: https://www.ft.com/content/ba7b8321-73a0-442d-ac85-74ad09019223 (last visited July 28, 2020).

[26] UK: a survey of over 600 businesses by the British Chambers of Commerce ('BCC Coronavirus Business Tracker') found that 62% of those surveyed had less than three months' cash reserves https://www.britishchambers.org.uk/page/bcc-coronavirus-business-impact-tracker (last visited August 6, 2020); Canada: survey of 8,730 small businesses by Canadian Federation of Independent Business, Your Business and COVID-19 Survey – Part 2, Preliminary Results as of March 23, 2020, 9, https://www.cfib-fcei.ca/en/research/survey-results/investigating-the-impact-of-covid-19-on-independent-business (last visited August 6, 2020).

[27] For further survey evidence for other jurisdictions, *see* OECD, OECD Policy Responses to Coronavirus (COVID-19): SME policy responses, Table 1, http://www.oecd.org/coronavirus/policy-responses/coronavirus-covid-19-sme-policy-responses-04440101/ (last visited August 6, 2020).

that emerges is that any state whose economy is seriously affected by COVID-19 must expect the emergence of a sizeable cohort of newly defaulting business debtors.

Upon default by a business operator, the unpaid creditors will become entitled to exercise whatever enforcement rights are available to them under the applicable law. These enforcement mechanisms may require recourse to a court, but this will not necessarily be so: depending on the nature of the creditor's claim (including whether it is unsecured or secured), and the applicable law, some modes of out-of-court enforcement (self-help) may be available. A secured creditor, for example, might have the ability to appoint a third party 'receiver and manager' to take control of the asset(s) which are the subject of security, receiving income generated by the assets and managing (including through sale) them for the benefit of the creditor. Landlords may have a right of peaceable re-entry on a tenant's default, which, where exercised, results in the forfeiture of the lease. Where formal enforcement mechanisms offer creditors only weak protection – for example, because rights of self-help are limited and court-controlled processes are procedurally complex or otherwise slow[28] – informal enforcement institutions will be developed to substitute.[29] Whether the creditor relies on formal or informal enforcement mechanisms, the objective will be the same, *viz.* to liquidate (or, convert to cash) the debtor's assets to the extent necessary to satisfy the creditor's claim.

Plainly, uncoordinated attempts by creditors to liquidate the debtor's assets could be value-destructive: assets that are worth most together may be broken up and sold piecemeal. This coordination problem can be solved *ex ante* by the allocation of liquidation rights through contract. The simplest example of this is the grant of security over the whole or substantially the whole of the debtor's assets to a single creditor or class of creditors:[30] enforcement action by such a creditor or class will encompass the

---

[28] *See* the ground-breaking cross-country study by Simeon Djankov, Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Schleifer, *Courts*, 118 QUARTERLY JOURNAL OF ECONOMICS 453 (2003).

[29] Curtis J Milhaupt and Mark D West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 UNIVERSITY OF CHICAGO LAW REVIEW 41 (2000).

[30] *See* Julian Franks and Oren Sussman, *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, 9(1) REVIEW OF FINANCE 65 (2005); John Armour and Sandra Frisby, *Rethinking Receivership*, 21(1) OXFORD JOURNAL OF LEGAL STUDIES 73 (2001).

whole of the debtor's estate, producing a *de facto* moratorium on asset "grabs" by unsecured creditors.[31] Alternatively, the problem can be solved *ex post* by the imposition of a procedure in which control of the debtor's estate passes to some third party (an insolvency practitioner, trustee or judge), charged with exercising their powers of management and sale in the interests of the general body of creditors, and during which individual enforcement action is stayed *de jure*. The former solution will not, at least in its simplest form, be available in every jurisdiction.[32] The latter, however, is a familiar form of collective insolvency procedure that is widely available across all legal systems.

B. Preventing Forced Sales

Either of these forms of procedure – a secured-creditor controlled realisation, or a third-party (insolvency practitioner, trustee, or judge) controlled realisation – enable assets worth more together to be kept together. The starting point then, is that a sale on a going concern basis – that is, at a price that reflects the fact that "the whole is worth more than the sum of its parts"[33] – is in principle possible[34], provided the process is fast and cheap enough to enable the inputs that generate going concern value[35] to be held together.[36] Such a sale may not, however, be achievable. This may be because the inputs that generate going concern value are not in fact readily transferable to a third party, as

[31] Kristin van Zwieten, *supra* note 2, at [10-69]. Unsecured creditors' ability to do so may also deter them from racing to place the debtor into a collective insolvency procedure: Franks and Sussman, *supra* note 30, section 6.2.

[32] As Djankov et al. explain, the simple example of concentrating control rights in the hands of a single creditor by the grant of global security is premised on the debtor being able to grant non-possessory security over all of its assets, including circulating assets, and on the secured creditor being able to quickly exercise its control rights: Simeon Djankov, Oliver Hart, Caralee McLiesh and Andre Schleifer, *Debt Enforcement Around the World*, 116(6) Journal of Political Economy 1105, 1108 (2008).

[33] Patrick Bolton and David S Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104(1) Journal of Political Economy 1, 2 (1996).

[34] Djankov et al., *supra* note 32, at 1107.

[35] "The combination of inputs of land, labour and capital each employed at their highest and best use results in an enterprise that has a greater value than the mere sum of its parts… [this] is often referred to as going concern value": Merle F Dimbath, *The Theory and Practical Determination of Going Concern Value*, 7(2) Journal of Forensic Economics 171, 171 (1994).

[36] Andrea Polo, *Secured Creditor Control in Bankruptcy: Costs and Conflict*, Working Paper, June 16, 2012, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2084881 (last visited August 6, 2020).

in the case of a micro business the value of which is primarily tied up in the vision, skills and relationships of the entrepreneur founder[37]. But it may also be because, although the business is in principle transferable on a going concern basis, a price that reflects fundamental value is not obtainable at the time of sale, for example because of information asymmetries.

Obtaining a sale price that reflects fundamental value requires an environment in which "raising cash for bids is easy and there is plenty of competition among several well-informed bidders"[38]. If the debtor's distress is idiosyncratic, there may be such an environment[39], but there may not be such an environment where the debtor's distress has been prompted by an economy-wide or even industry-wide shock. Industry players are most likely (given their informational advantages) to value the business most highly, but if they are also cash-constrained, any bid by them for the business will not reflect this value.[40] The result of a forced sale in such conditions will be a sale at a fire-sale price, increasing losses to creditors.[41] Where the winning bidder is an "industry outsider", the result may be the cessation of the business altogether, with associated unemployment losses that may not be compensated for by new employment (if the assets are put to a lower value use by the purchaser[42]). Even worse, depressed prices in the secondary asset markets will increase loan-to-value ratios in otherwise unaffected firms, potentially pushing them into the pool of financially distressed operators as well.[43]

---

[37] The connected party sales examined by Polo, *supra* note 36, appear to be an example of this.

[38] Philippe Aghion, Oliver Hart and John Moore, *The Economics of Bankruptcy Reform*, 8(3) JOURNAL OF LAW, ECONOMICS AND ORGANISATION 523, 527 (1992).

[39] Andrei Shleifer and Robert Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47(4) THE JOURNAL OF FINANCE 1343 (1992).

[40] *Ibid.* at 1344-1346.

[41] *Ibid.* at 1344.

[42] *Ibid.* at 1344. See also Aghion, Hart and Moore, *supra* note 38, at fn. 8: "in the absence of a competitive auction, the winning bidder may not be the highest value user of the firm's assets". For empirical evidence consistent with this, *see* Shai Bernstein, Emanuele Colonnelli and Benjamin Iverson, *Asset Allocation in Bankruptcy*, 74 JOURNAL OF FINANCE 5 (2019).

[43] This is the problem with which Marcus Miller and Joseph Stiglitz are concerned in *Bankruptcy protection against macroeconomic shocks: the case for a 'super Chapter 11'*, December 1998, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.617.8478&rep=rep1&type=pdf (last visited August 7, 2020). *See* also Stiglitz's suggestion of a special bankruptcy procedure to be embedded within

This analysis suggests that it would be highly undesirable to subject businesses that have become temporarily distressed as a result of pandemic-related losses in revenue to an immediate forced sale. Since the debtor's distress will very likely be shared by others in the same industry, as well as by debtors in other industries, subjecting the business to a forced sale will be unlikely to yield a price that comes close to approximating fundamental value, exacerbating losses to creditors and (depending on subsequent use of the assets) potentially increase unemployment. It follows from this that any rule that requires a debtor that has become cash-flow insolvent because of COVID-19 to file for the commencement of a collective insolvency procedure in which control passes to a third party with a view to a sale is undesirable: if all that can reasonably be expected is a fire-sale outcome, the debtor should be spared the costs of entry into such a process.[44]

C. THE SHORTCOMINGS OF FORMAL REORGANISATIONS

An obvious objection to this analysis is that the applicable law may provide an alternative form of procedure for debtors with a viable business – one geared not towards realisation through a forced sale, but to enabling the business to remain with the debtor itself. In such a 'reorganisation' procedure, assets are not converted to cash in a bid to (partly) satisfy creditor claims; instead, the debtor's distress is resolved by a renegotiation of these claims, given the debtor cannot satisfy them in full. Such procedures characteristically permit managers to retain some or all control rights during

---

bankruptcy legislation to deal with circumstances of 'systemic bankruptcy': Joseph Stiglitz, *Bankruptcy Laws: Basic Economic Principles*, *in* RESOLUTION OF FINANCIAL DISTRESS: AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS Chapter 1 (Stijn Claessens, Simeon Djankov, and Ashoka Mody eds., 2001). That proposal, however, was formulated with a different kind of macroeconomic shock in mind, and as such it was assumed that once in the procedure, the debtor would have little or no need for additional funding. The position is of course otherwise where the debtor cannot generate revenue due to a lockdown.

[44] In fact, many jurisdictions with 'mandatory filing' rules or 'recapitalise or liquidate' rules moved quickly to suspend them on the onset of the pandemic: see Aurelio Gurrea Martinez, *Directors' Duties of Financially Distressed Companies in the Time of COVID-19*, Oxford Business Law Blog, March 24, 2020, https://www.law.ox.ac.uk/business-law-blog/blog/2020/03/directors-duties-financially-distressed-companies-time-covid-19 (last visited August 7, 2020).

the renegotiation, so that the business can be carried on throughout[45], provided that the costs of doing so can be met by the debtor (typically, by treating such costs as an expense that is payable in priority to any distribution to pre-commencement claim holders).[46] Such procedures also typically provide some priority for new finance extended to the business during this period, which might otherwise be unavailable given the debtor's existing, unsatisfied obligations.[47] The renegotiation itself is facilitated by a rule that a majority of claimholders can bind a minority of similarly situated claimholders to a reduction of their entitlements (so that the negotiation is not defeated by the refusal of some claimholders to participate[48]).

As others have explained, the "standard case" for these procedures is that they may avoid the value destruction associated with a forced sale.[49] In recognition of this, and following experience of value-destructive forced sales in recent crises and (related) nudges by international development banks, many jurisdictions have introduced one or

---

[45] Another motive for leaving managers in control ('debtor in possession') is to induce entry sooner rather than later, which may reduce the costs of financial distress: Horst Eidenmüller, *Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 239 (2006); Barry E. Adler, Vedran Capkun and Lawrence A. Weiss, *Theory and Evidence on the Bankruptcy Initiation Problem*, Working Paper, September 1, 2005, available at https://www.researchgate.net/profile/Lawrence_Weiss4/publication/228979933_Theory_and_Evidence_on_the_Bankruptcy_Initiation_Problem/links/541054030cf2df04e75d1826/Theory-and-Evidence-on-the-Bankruptcy-Initiation-Problem.pdf (last visited August 7, 2020).

[46] *See*, e.g., German Insolvency Code § 55. For analysis of the treatment of executory contracts in insolvency in 34 jurisdictions, *see* JASON CHUAH AND EUOGENIO VACCARI, EXECUTORY CONTRACTS IN INSOLVENCY LAW 273 (2019) (discussing 'permanent' executory contracts under Greek insolvency law at 273, Danish law at [10-51], Japanese law at [16.11]-[16-12]). The position under English law has historically been rather complicated, but at present is that an administrator who adopts a pre-administration contract for the benefit of the administration will render post-commencement liabilities an expense of the process: see Kristin van Zwieten, *supra* note 2, at [111].

[47] On the so-called 'debt overhang problem' *see* K. Ayotte and David A. Skeel, *Bankruptcy Law as Liquidity Provider*, 80 UNIVERSITY OF CHICAGO LAW REVIEW 1557 (2013).

[48] Such refusal is rational because creditors find themselves in a multi-party prisoners' dilemma in which not cooperating is the dominant strategy.

[49] *See* Shleifer and Vishny, *supra* note 21, at 34: "the standard case for Chapter 11 reorganisation, while not focusing specifically on fire sales, warns about the risk of lost value arising through piecemeal liquidation of firms for prices substantially below the value in best use".

more reorganisation procedures.[50] Where such procedures exist, why not use them to treat COVID-19 distress? One may query whether there is institutional capacity to deal with a large influx of cases: there may not yet be much practice with applying the law, such that outcomes are not yet predictable, and significant judicial resources are required to settle outstanding questions of interpretation[51]. Even where there is a settled reorganisation practice, there may not be the resources – courts, trustees, supervisors, etc. – to deal with such an influx.[52] But even assuming there is such capacity, we are deeply sceptical about the desirability of using reorganisation procedures to treat distress caused by COVID-19 related revenue losses.

Our starting point is to remind ourselves that some members of the newly distressed cohort may have little or no external finance. These businesses are in difficulty not because they cannot service debt, but because they cannot meet operating costs that continue to accrue periodically under executory contracts (wage liabilities, rental liabilities, etc.). It seems to us that reorganisation procedures are likely to be singularly ill-suited to dealing with distress of this kind. Such procedures are typically premised on the business being viable – that is, enjoying a turnover that exceeds costs – but having too much debt.[53] Consistent with this, such procedures provide tools to facilitate a renegotiation of pre-commencement claims, but typically assume post-commencement operating costs will be paid in full, as an expense (if the business is not viable, why should managers be permitted to remain in possession and liquidation rights stayed?). This approach is at once too broad and too narrow for treating a debtor that is

---

[50] *See* (in relation to developments in the EU) Horst Eidenmüller and Kristin van Zwieten, *Restructuring the European business enterprise: the European Commission's Recommendation on a new approach to business failure and insolvency*, 16 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 625 (2015).

[51] Research by Benjamin Iverson, Joshua Madsen, Wei Wang and Qiping Xu suggests that judges take time to develop the skills necessary to manage restructuring cases: *Financial Costs of Judicial Inexperience*, Working Paper, April 10, 2020, available at http://www.beniverson.org/papers/IMWX_LearningDoing.pdf (last visited July 28, 2020).

[52] See Benjamin Iverson, Jared A Elias, and Mark Roe, *Estimating the Need for Additional Bankruptcy Judges in Light of the COVID-19 pandemic*, 10 HARVARD BUSINESS LAW REVIEW ONLINE (2020) (forthcoming); Skeel, *supra* note 10, at 11; Stiglitz, *supra* note 43, at 19.

[53] See, for example, Frederick Tung's description of a "traditional Chapter 11 reorganisation" as one in which "The general goal is to reduce the debt burden on the company such that its operations can generate sufficient cash flow to service the remaining debt": *Financing failure: bankruptcy lending, credit market conditions, and the financial crisis*, 37 YALE JOURNAL ON REGULATION 651, 656 (2020).

distressed because it cannot trade during a lockdown: it is too broad, because it provides tools for a renegotiation that it is not necessary to conduct (there may be little or no pre-commencement debt outstanding), and applying these tools is costly; it is too narrow, because it assumes the debtor can 'pay its way' while the stay applies. One implication of this is that it may also be harder for a case of COVID-19 'operating cost distress' to be resolved informally in the shadows of a formal reorganisation law, since the law assumes that debt, not operating costs, is the problem.

What about debtors that *do* have financial creditors? Here, too, we are sceptical about mass treatment by the prevailing reorganisation law, although for different reasons. Our starting point for this analysis is an acknowledgment of the significant costs – direct, and indirect – associated with the use of formal reorganisation procedures. Since reorganisation procedures involve the adjustment of legal entitlements, they are much more complex to administer than auction procedures.[54] Each of their characteristic features – the interim protection of management, priority for new finance, and the ability of dissenters to be bound by a majority – introduces risks of expropriation that must be safeguarded against, and these safeguards add direct costs.[55] Additionally, the announcement of entry into a reorganisation procedure may be associated with significant indirect costs, including a reduction in customer base and loss of counterparties flowing from reduced confidence in the viability of the business.[56] In a crisis of COVID-19 scale, one might query how acute these indirect costs might be – perhaps the context will mean customers and counterparties regard the announcement

---

[54] No such adjustment is necessary in an auction. If there is power to sell assets free and clear of security interests, then assets can be exchanged for cash, which can then be distributed to claim-holders in accordance with the priority rules prescribed by law: Douglas Baird, *The Uneasy Case for Corporate Reorganisation*, 15(1) JOURNAL OF LEGAL STUDIES 127 (1986).

[55] The extent of these direct costs will of course depend on who is charged with applying these safeguards, and their fee/cost structures.

[56] The intensity of this effect will of course depend on the nature of the goods or services supplied. Ali Hortacsu, Gregor Matvos, Chad Syverson and Sriram Venkataraman document a significant effect in relation to cars that are bundled with warranties and other services: *Indirect Costs of Financial Distress in Durable Goods Industries: The Case of Auto Manufacturers*, 26(5) REVIEW OF FINANCIAL STUDIES 1248 (2013).

as less troubling than they otherwise would.[57] Yet anecdotal evidence suggests debtors remain concerned about these indirect costs in the crisis.[58]

We remind ourselves that at least some members of the newly distressed cohort will have a reasonable expectation of being able to service their debt, even allowing for lockdown losses and the accrual of interest, on the relaxation of lockdown restrictions. It is plainly highly undesirable for such debtors to be required to bear the direct and indirect costs of a formal reorganisation. We acknowledge, however, that – at least where disruption to trading is prolonged, and in the absence of any other intervention to relieve debtors (see Part II below) – many debtors may well need to have their obligations partially written down or otherwise compromised. This will not, though, be knowable at the beginning of a lockdown, the duration of which is uncertain *ex ante*. Moreover, creditors and counterparties may be more willing to support a workout on the lifting of the lockdown, when trading is resumed, than they are during a lockdown: it may be easier to distinguish "strategic" from non-strategic defaults[59] when there is better information on the effect of the lockdown on the debtor's business. The latter point suggests there is a good reason to enable the business to survive outside a reorganisation procedure for at least the duration of a lockdown even when it is already reasonably clear that some restructuring will be required. A key argument for early restructuring – that managers will be distracted during circumstances of financial distress, increasing the indirect costs of that distress – seems to us to have little salience in a lockdown scenario, when managers are already distracted and at least to some extent already prevented from pursuing new projects. In our view, early entry into a

---

[57] *See* Stiglitz and Miller, *supra* note 43, at 2: "In normal times, bankruptcy conveys a lot of information about the quality of a firm's management. But, in the context of a system-wide failure, little information is conveyed either about the manager or even the firm's long run viability".

[58] In the UK, for example, there has reportedly been reluctance to use the rescue-oriented administration procedure in Sch.B1 of the Insolvency Act 1986 despite the emergence of 'light-touch' applications of that procedure that enable debtors to remain in possession. One well-known practitioner, Chris Laughton, has described a (mistaken) perception that businesses that enter the procedure must be "worthless". *See* ICAEW Insights, Insolvency: what are the options for troubled businesses?, July 19, 2020, https://www.icaew.com/insights/interviews-and-profiles/2020/july-2020/insolvency-what-are-the-options-for-troubled-businesses (last visited August 7, 2020).

[59] Bolton and Scharfstein, *supra* note 33, at 2, defining a strategic default as one "in which a firm defaults because managers want to divert cash to themselves", and contrasting this with a "liquidity" default ("in which a firm does not have the cash to make debt payments").

reorganisation procedure should be the preferred route only for debtors that do not seem to be good candidates for a workout even after lockdown restrictions are relaxed. An ancillary benefit of our suggested approach is that some institutional capacity will be preserved for the treatment of cases already in reorganisation prior to a lockdown, as well as for other kinds of cases the system routinely treats.[60]

Some of our objections to the use of formal reorganisation procedures to treat COVID-19 distress could be addressed by a change in the law, or to its interpretation. The requirement that operating costs be paid as expenses could be relaxed, allowing a debtor to shelter from enforcement from both pre- and post-commencement creditors; alternatively, normal rules on when new finance can be given priority over existing claims could be relaxed with a view to inducing lending to cover operating costs.[61] More generally, direct costs could be reduced by relaxing safeguards against expropriation risk (for example, by reducing the need for court oversight to the minimum level required by public law). Such changes will not, however, deal with all of our objections: indirect costs will remain, and prospects of a lower cost workout could plausibly be expected to improve post-lockdown. More fundamentally, such changes could do significant harm to debtors in the future: if the concessions extracted from creditors and counterparties to deal with the particular features of COVID-19 distress become a permanent feature of the law (for example, through the operation of rules of precedent), the costs of these concessions will ultimately be borne by debtors, in the form of increased borrowing costs and/or reduced availability of debt finance, and increased contracting costs. Leaving COVID-19 distress to be dealt with by the prevailing reorganisation law seems to us to generate a very high risk of such distortive effects. There is evidence of such effects from reorganisation rule-making in previous

[60] This includes the liquidation of unviable businesses under court oversight with a view to ensuring antecedent transactions and the conduct of managers are properly scrutinised.

[61] For an example of this from the global financial crisis, see Tung, *supra* note 53. For a proposal for super-priority lending to cover operating costs in the COVID-19 crisis, but outside the auspices of the existing reorganisation law, see the proposal for Indian businesses in Vidhi Centre for Legal Policy, Toward a Post-Covid India, June 2020, at 43, https://vidhilegalpolicy.in/research/towards-a-post-covid-india-25-governance-challenges-and-legal-reforms/ (last visited August 7, 2020).

crises,[62] and already some evidence of potentially distortive effects in the current crisis.[63]

Given all this, we conclude that reorganisation law ought to be a 'last resort' for the treatment of distress caused by COVID-19 losses in revenue. Our argument is strengthened by the fact that one third of economies do not have such a procedure,[64] and by the fact that even where such procedures exist, they may not necessarily, even in good times, function well to preserve going concern value.[65] This means, however,

---

[62] *See* Tung, *supra* note 53, reporting how changes in credit availability were relied on to justify inducements given for DIP finance to debtors in US reorganisation proceedings during the global financial crisis. The empirical evidence reported in the paper casts doubt on this justification, suggesting that the practice was too generous to senior claimants, risking expropriation of junior claimants. The extent to which this effect persists will depend, as Tung notes, on how the precedents from this period are dealt with in the future.

[63] *See*, e.g., a reported push in the US to change the position on administrative expenses: WilmerHale, *COVID-19: Rethinking Administrative Expenses in Chapter 11: How Vendors and Landlords Will Be Affected by "Mothballed" Cases, Partial Freezes, and Critical Expenses in the COVID-19 Crisis*, April 14, 2020, https://www.wilmerhale.com/en/insights/client-alerts/20200414-rethinking-administrative-expenses-in-chapter-11-how-vendors-and-landlords-will-be-affected-by-mothballed-cases-partial-freezes-and-critical-expenses-in-the-covid19-crisis (last visited August 7, 2020). A similar development in Australian law (a decision of the Federal Court of Australia in *Strawbridge (Administrator), in the matter of CBCH Group Pty Ltd (Administrators Appointed) (No 2)* [2020] FCA 472) is commented on from an English law perspective here: Steven Cottee, *Is rent an 'administration expense' during coronavirus lockdown?*, April 22, 2020, https://www.pinsentmasons.com/out-law/analysis/rent-administration-expense-coronavirus-lockdown (last visited August 8, 2020). The guidance issued by the Chinese Supreme People's Court on the handling of cases involving COVID-19 (China's Supreme People's Court (SPC), *Guidance on the Proper Handling of Civil Cases Involving the Novel Coronavirus Outbreak in Accordance with the Law (No.1)*, April 20, 2020, http://www.court.gov.cn/fabu-xiangqing-226241.html (last visited August 8, 2020)) may be a further example, if the effects of the guidance persist beyond the pandemic.

[64] World Bank, *Doing Business Report* (2020), 'Resolving insolvency', https://www.doingbusiness.org/en/data/exploretopics/resolving-insolvency/good-practices (last visited August 8, 2020).

[65] There is ample evidence at country-level of reorganisation procedures that do not or did not, prior to reform, function to preserve value. For one such example, see Xavier Gine and Inessa Love, *Do Reorganisation Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Columbia*, World Bank Policy Research Working Paper 3970, July 1, 2006, https://documents.worldbank.org/en/publication/documents-reports/documentdetail/334481468243249486/do-reorganization-costs-matter-for-efficiency-evidence-from-a-bankruptcy-reform-in-colombia (last visited August 8, 2020). More generally, the World Bank's current *Doing Business* (*supra* note 64) data suggests that piecemeal sales are still the dominant outcome

that relief from the risk of fire-sales, and the other costs of financial distress caused by COVID-19 trading losses, must be given some other way. In the next part, we identify two paths to the provision of such relief outside reorganisation law, and identify some of the advantages of these forms of relief relative to relief through reorganisation law.

II. Bankruptcy v. Bail-outs and Bail-ins

A. Responses Available to Policymakers

We see two routes to relief outside of formal reorganisation law for debtors distressed by COVID-related losses in revenue. First, the state might intervene to assume some or all of a business debtor's liabilities. We term this a 'bail-out', using the phrase in the same way as suggested in the literature, namely "government … payments (including loans, loan guarantees, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors or counterparties". [66] Secondly, the state might intervene to mandate – in a 'one time' way, outside of formal reorganisation law – some degree of forgiveness by creditors or counterparties. We term this a 'bail-in', but this should be caveated with an acknowledgment of the differences with bail-in powers in bank resolution. A bail-in power given to a bank resolution authority will typically be concerned only with certain classes of financial debt, and the trigger for, and scope of, the bail-in power will be set *ex ante*.[67] To the extent that the claimholder has already adjusted to the possibility of the bail-in, it is the debtor that 'pays' for this. In contrast, the kind of bail-in we have in mind is a mandatory one-off transfer imposed *ex post*.[68] Unlike relief through reorganisation law, bail-ins

---

around the world when a financially distressed but viable business is subject to treatment by the prevailing domestic insolvency law (the 2020 data indicates that practitioners in only 46 of 166 jurisdictions, excluding those with no evidence of practice, and excluding sub-national data, expect such a business to emerge as a going concern).

[66] Eric A. Posner and Anthony Casey, *A framework for Bailout Regulation*, 91(2) NOTRE DAME LAW REVIEW 479 (2015).

[67] See generally Jianping Zhou et al., *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions*, IMF Staff Discussion Note, April 24, 2012, https://www.imf.org/external/pubs/ft/sdn/2012/sdn1203.pdf (last visited August 8, 2020).

[68] Like the nullification of 'gold clauses' in debt contracts during the Great Depression, the impact of which was explored by Randall S. Kroszner in *Is it Better to Forgive than to Receive? Repudiation of*

and bail-outs require little or no legal resources (courts etc.) to implement, and pose little or no risk of producing long-term distortions in the prevailing debtor-creditor law.

B. Comparative Assessment

We begin with a brief discussion of the bail-in option for an economy in 'lockdown'. A full implementation of this option would involve the state mandating the write-down of all interest and lease and license payments that accrue during a lockdown period. In theory, a state could also require that wage liabilities are written off during the period, even where the employer would not otherwise have an entitlement to reduce these liabilities through temporary lay-offs. However, such a strategy would threaten basic household security (so much so that workers may be unable to abide by 'lockdown' rules, with associated feedback effects on attempts to contain the pandemic), and as such is highly undesirable. If wage liabilities were covered by a furlough scheme in which the state covered labour expenses (a partial bail-out), then a write-down of interest, lease and license payments accruing over the shutdown could cover all business expenses, effectively "stopping the economic clock" for the duration of the lockdown. Such a policy would enable a business that was prevented from trading during lockdown to emerge from it in the same financial shape that it was on entry, without accumulating any additional debt, with the same net worth (see Figure 1 above) but, also, without compromising any of its pre COVID-19 debt. In case of a V-shaped recovery (i.e. a quick recovery to pre-pandemic levels of economic activity), such a business can resume normal operations once or soon after the lockdown is lifted. In the case of a more prolonged recovery, businesses may not be able to return to pre-pandemic revenue levels for some time, which may imply the need for some financial and/or operational restructuring.

---

the Gold Indexation Clause in Long-Term Debt During the Great Depression, October 1988, http://commission.abi.org/sites/default/files/10.1.1.72.381.pdf (last visited August 8, 2020), or the experiments with debt relief in the 'Panic of 1819' as charted by MURRAY N. ROTHBARD IN THE PANIC OF 1819: REACTIONS AND POLICIES Chapter II (2007), https://cdn.mises.org/The%20Panic%20of%201819%20Reactions%20and%20Policies_2.pdf (last visited August 8, 2020), though Rothbard reports that many of these were struck down as unconstitutional (*ibid.* at 66).

Note that in a bail-in of this kind, no moratorium on enforcement by creditors or counterparties should generally be necessary to prevent the risk of fire-sales, assuming that the debtor was not in default prior to the imposition of the lockdown. The effect of the bail-in (when coupled with a furlough scheme to cover labour expenses) is to prevent (by mandating a write-down) default during the lockdown period. One qualification should, however, be placed on this analysis: the state may have to intervene to prevent the operation of contractual clauses that would have the effect of accelerating a debtor's liability on specified 'events of default', if the latter are defined broadly enough to encompass the one-off mandatory write-down imposed by the state. This qualification would not be needed if the state chose to assume liabilities accruing during the lockdown (the bail-out), rather than mandate their write-down (the bail-in).

For the reasons set out in Part I, a bail-in of this kind would apply regardless of whether the business has any external debt finance. A business with no bank debt or other financial creditors may nevertheless default (exposing it to fire-sale risk and the other costs of financial distress) because of fixed obligations arising under executory contracts. A bail-in of liabilities accruing during the period when the business cannot trade, or during which trade is substantially diminished, would prevent such default. For businesses that do have debt, their ability to again service this on the lifting of the lockdown will depend on the effect of the pandemic on their sector, as well as on the broader shape of economic recovery (as noted above). For some businesses, some restructuring will be required; for others, this will not be necessary (that is, they will be able to again achieve a turnover that exceeds costs, including liabilities that accrue after lockdown under pre-lockdown contracts). This may not be knowable at the time the lockdown is imposed. Applying a bail-in at the outset has the effect of 'stopping the economic clock', preventing default and associated fire-sale risk, until there is better information.

A bail-out targeting interest, lease and licence payments (as well as wages) that accrue during a lockdown would have the same 'stopping the economic clock' effect on the debtor. The impact on creditors and counterparties would, of course, be radically different. A bail-in in the form of a write-down of liabilities that would otherwise accrue in favour of creditors and counterparties (landlords etc.), will place these institutions under stress[69]. The problem can be solved by pausing their operational expenses as well. Under this approach, the business-sector payment holiday would be passed through the banking industry (formal and shadow alike) to the ultimate creditors, namely pension funds and saving households. The loss of net worth on that side is unavoidable: someone has to bear the cost of the economic shutdown.

Table 1: A Comparison of the Three Policy Options

	Existing debtor-creditor law, including reorganisation procedures	*State offers to assume debt (bail-out)*	*State mandates forgiveness of debt (bail-in)*
Use of legal resources	Intense, more so where the applicable law does not facilitate out-of-court settlements or where the court system is chronically slow and ineffective	Zero	Minimal; confined to challenges to the very legality of the scheme
Effect on borrowing company	Depends on the applicable insolvency law. In theory, a Chapter 11 like reorganisation procedure is intended to facilitate and coordinate debt restructuring to the mutual benefit of all parties; in practice, such procedure may function differently. Will typically be directed primarily to restructuring pre-commencement liabilities, with assumption that post-commencement expenses (rent etc.) will be paid while stay applies.	Depends on the generosity of the bailout or emergency funding schemes. If structured as a loan rather than as a grant, may leave companies with massive debts that will have to be treated later on, either by write-downs or via the insolvency system.	Depends on the scope of the direction. Could require debt and lease write-downs to which the creditors would not agree voluntarily. If accompanied by a furlough scheme that pays workers wages (i.e. wage bail-out: column 2), and a moratorium on enforcement of debts accrued in immediate run-up to lockdown, will 'stop the clock' during lockdown, resetting the company to its pre-COVID financial position.
Who will pay?	Depending on the applicable insolvency law, would split the cost between current debtors and creditors.	Massive effect on the national debt, borne by taxpayers. If rolled over, the burden is likely to fall on those currently young.	Cost borne by current savers who supply funding or assets to borrowing firms. No effect on the national debt.

[69] A point also made by Skeel, *supra* note 10, at 7.

Transparency in decision-making process	Depends on who oversees the procedure (court, insolvency practitioner or trustee?) and their duties to disclose deliberations and reasons for decisions	Depends on type of intervention, but clear risk of opacity in the process of designing and delivering relief	Depends on type of intervention, but clear risk of opacity in the process of designing and delivering relief
Long-term effect on insolvency law	Likely to be significant, either because formal changes to legislation are made to accommodate features of COVID-19 distress, or because judicial interpretation and practice and procedure changes to accommodate COVID-19 debtors, risking a tsunami of new debtors-friendly precedents that would affect the system for years.	Zero	Zero
Cross-border effects	Governed by existing rules on the recognition of insolvency proceedings and their effects, including (in the EU) the European Insolvency Regulation, and the UNCITRAL Model Law on Cross-Border Insolvency Law where adopted.	No difficulty: liabilities are assumed, rather than ordered forgiven, so no concern about securing recognition abroad with a view to restraining enforcement.	Potential difficulty: depends on the reception of the debt forgiveness order by the courts of the place(s) where the debtor has assets.

Table 1 summarizes the differences between use of existing debtor-creditor law (including any available reorganisation procedures), bail-ins, and bail-outs along several dimensions. Obviously, the first option is the most intensive in its use of legal resources: any borrower who can argue that his/her financial position is undermined by COVID-19 can file for court-supervised reorganisation wherever such a procedure exists, or be placed into some other form of collective insolvency procedure. Such applications have to be processed on a case-by-case basis, which would put the entire court system under enormous pressure. In theory, cases can be settled out of court through a bargaining process that takes the court's stipulated decision as a 'threat point' for the negotiations. In practice, stipulating the court's decision in such unprecedented circumstances will be extremely difficult (not least because even where a reorganisation procedure exists it will not typically be designed to deal with operating cost distress of the kind experienced by some businesses in the COVID-19 crisis[70]), which may undermine the prospects of such settlements. The great advantage of the other policy options is that they avoid the court system almost entirely: bail-outs should not require courts at all; bail-ins only to the extent necessary to adjudicate the validity of the order to forgive.[71]

There are substantial differences between the three policy options with respect to their effect on the borrowing company. Unlike the first option (the prevailing debtor-creditor law, including any reorganisation procedure), bail-ins make a very clear distinction between pre-lockdown and in-lockdown liabilities. The bail-in option is considerably more generous with respect to in-lockdown liabilities, but leaves any pre-lockdown debt intact. In contrast, a distinction of that sort is likely to be irrelevant for a reorganisation procedure commenced at some point after the imposition of a lockdown, although it is of course relevant to any assessment of the company's future viability. Moreover, once commenced, the reorganisation procedure is unlikely to bring relief from liabilities that continue to accrue under executory contracts for the remainder of the lockdown, since (as we have already explained) such procedures are typically premised on the payment of such liabilities as an expense of the procedure. Both bail-outs and bail-ins can focus specifically on such costs (together with, where relevant, interest on pre-pandemic debt). In the case of bail-out, however, if it is structured as a loan rather than a cash grant, businesses will incur much extra debt that may inhibit growth post crisis (and may have to be written off, eventually). In the UK, it has been estimated some £32-36 billion extended in state-backed COVID-19 loans will prove unsustainable by the end of March 2021.[72]

Unlike bail-outs, bail-ins allocate the cost of the intervention up front, at least in their full "write-down" form (a more modest bail-in, for example one that merely mandates

---

[70] See *supra*, text to notes 46 and 53.

[71] The more intense or full the bail-in, the more work will need to be done to defend the proportionality of the intervention.

[72] TheCityUK, *Supporting UK Economic Recovery: Recapitalising Businesses Post Covid-19*, July 2020, at 13, https://www.thecityuk.com/assets/2020/Reports/2d5179dbfb/Supporting-UK-economic-recovery-recapitalising-businesses-post-Covid-19-v2.pdf (last visited August 8, 2020).

an extension in maturity, does not do so). Bail-outs, in contrast, are often structured as cash-for-debt swaps (i.e. loans rather than grants), with an expectation that some of that debt would be forgiven in the future. The incidence of the future tax to be levied, eventually, in order to pay for the subsidy component of the bail-out is not known at the time of implementation. This problem is amplified by the fact that the public finances of most developed economies were already weak pre COVID-19, so changes in taxation are highly likely.

A key advantage of bail-ins and bail-outs relative to use of the prevailing debtor-creditor law is that processing COVID-19 distress through the existing legal framework is highly likely to require changes to that framework (either via precedent or via emergency legislation) so that it is suitable for treating the exceptional scale and nature of COVID-distress. This is undesirable. If the applicable law is already optimized to deal with financial distress in normal times, including periodic downturns, such change cannot be for the better. If the applicable law is not so optimized, then it should change in the direction of normal-times optimum rather than the exceptional circumstances of COVID-19.

We can see only one clear advantage with use of the prevailing debtor-creditor law for the treatment of COVID-19 distress, and that is in relation to cross-border effects. Existing procedures will be eligible for recognition and assistance under existing rules designed to give primacy to insolvency proceedings taking place in the place of the debtor's "home".[73] It is unclear whether a one-time mandatory order for debt forgiveness (i.e. a bail-in), even in the place of the debtor's home, would be respected in the same way by foreign courts.[74] Note, however, that there is no such problem with

[73] As defined by the applicable legal regime. The dominant concept used for this purpose is COMI, or 'centre of main interests' (used in the European Insolvency Regulation, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, OJ L 141, 5 June 2015, and the UNCITRAL Model Law on Cross-Border Insolvency), but some regimes for assistance in cross-border cases use other concepts of 'home', such as the place of incorporation (*see*, e.g., the decision of the Privy Council in *Singularis Holdings Limited v PricewaterhouseCoopers* [2014] UKPC 36 on assistance at common law).

[74] See the discussion in Simon Gleeson, *Legal Aspects of Bank Bail-in*, LSE Financial Markets Group Paper Series, Special Paper 205, January 2012, at 17, https://www.lse.ac.uk/fmg/assets/documents/papers/special-papers/SP205.pdf (last visited August 8, 2020).

a bail-out, because the liabilities are assumed by the state, rather than ordered forgiven by the state. This may suggest that a difference of approach to large debtors with cross-border activities (compared with SMEs whose activities are concentrated in a single market) is warranted.

A second possible advantage of bankruptcy relative to bail-ins or bail-outs is transparency in the treatment of distressed debtor. It may not be clear why some classes of debtor are eligible for a bail-out while others are not, or why some classes of creditors and constituencies have been mandated to forgive while others have not, or have had their claims taken on by the state. It should not, however, be assumed that a reorganisation procedure (if adapted to accommodate the features of COVID-19 distress, with all the associated costs we anticipate above) will necessarily be transparent. Some well-known reorganisation procedures are notorious for their opacity[75]; indeed, this is sometimes argued to be a virtue[76].

III. Principles to Guide Policymaker Responses

The main thrust of our argument so far was to put up a warning sign: It is not advisable to use general insolvency or reorganisation laws to help firms weather the economic storm caused by the COVID-19 pandemic, nor is it advisable to reform these laws such that they appear more suited to deal with the exceptional scale and nature of COVID-19 distress. We argued that policies we called 'bail-in' (a state-ordered one-time forgiveness of private debts) or 'bail-out' (with states offering to assume private debts) are to be preferred. But we did not attempt to make a case for either of these policies, nor did we articulate any principles that states should follow when implementing them. This is the task to which we now turn.

---

[75] For a historical example, *see* the discussion of access to tribunal decisions under India's notorious Sick Industrial Companies (Special Provisions) Act 1985 in Kristin van Zwieten, *Corporate Rescue in India: The Influence of the Courts*, 15 JOURNAL OF CORPORATE LAW STUDIES 1, 15 (2015). The administration procedure presently provided by English law is highly opaque because of the widespread use of the procedure in 'pre-packaged' form, in which there is no judicial involvement, though requirements for *ex post* disclosure by the administrator have increased in recent years: Kristin van Zwieten, *supra* note 2, at 496.

[76] See Polo, *supra* note 36, on the potential advantages of pre-packaged sales under English law.

Bail-outs are tempting politically because they shift COVID-induced losses/burdens to future generations (taxpayers), largely avoiding the need to make hard choices now, as in a bail-in.[77] Further, bail-outs appeal to widely shared considerations of fairness regarding loss-allocation in cases involving risks which affect us all, albeit to a different degree. In a bail-out, it is not specific stakeholders or groups of stakeholders which are supposed to shoulder the economic burden. Rather, everybody (all taxpayers) contribute to the common good. Finally, bail-outs may also allow for policing of moral hazard by recipients more easily than bail-ins. This is because the state can use its administrative apparatus to review grant- or loan-giving decisions and utilisation of funds. By contrast, in a bail-in this task typically has to be performed by stakeholders from the private sector.

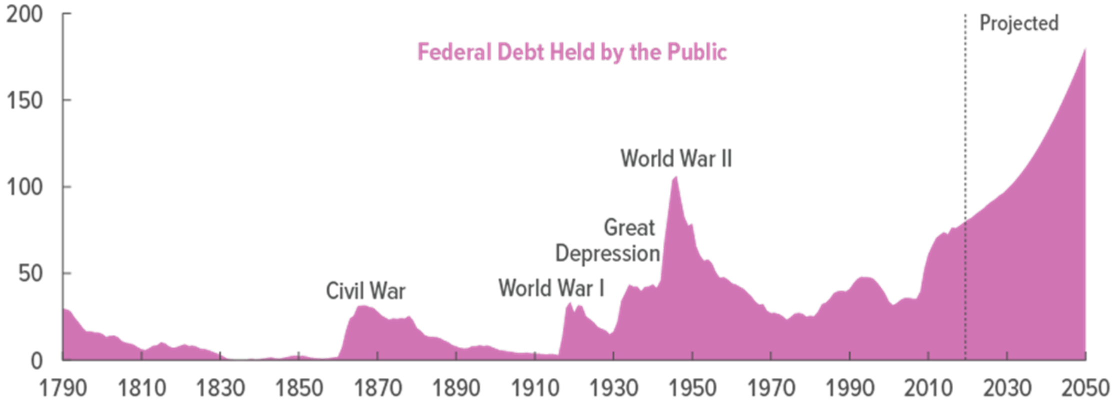
At the same time, significant bail-outs have a massive effect on the national debt, borne by taxpayers, as already discussed in Part II above. For example, federal debt held by the public in the United States was forecasted to reach unprecedented levels already before the pandemic (see Figure 2). This raises difficult questions of inter-generational fairness. Why should the current generation be allowed to significantly compromise the prospects of the next? "The significance of our lives cannot be put into the little box of our own living standards, or our need-fulfilment."[78]

---

[77] The issue cannot be avoided completely to the extent that budget cuts have to be made elsewhere to 'finance' a massive bail-out. This has become a significant issue in the European Union, for example. After the compromise in the European Council (17-21 July 2020), the European Parliament stated: "The multiannual financial framework must be able to address the main challenges facing Europe in the medium term, such as the Green Deal, digitalisation, economic resilience, and the fight against inequalities. … New own resources are needed immediately. We also need measures to ensure the effective defence of the rule of law. Furthermore, Parliament has repeatedly called for the end of rebates. If these conditions are not sufficiently met, the European Parliament will not give its consent." *See* European Parliament, *Future EU Financing and Recovery: MEPs to assess summit outcome*, July 22, 2020, https://www.europarl.europa.eu/news/en/press-room/20200722IPR83801/future-eu-financing-and-recovery-meps-to-assess-summit-outcome (last visited August 8, 2020).

[78] AMARTYA SEN, THE IDEA OF JUSTICE 252 (2009),

Figure 2: Federal Debt Held by the Public in the United States[79]



Source: Congressional Budget Office, 2020

Further, in a perfect world, market participants would be able to trade claims contingent on all conceivable eventualities, including a novel coronavirus pandemic (see Part I above). Hence, it is helpful to think about economic policy responses to the pandemic in terms of re-conceptualising the contours of a hypothetical private arrangement, had affected parties contemplated the pandemic-induced risk in advance and tried to come up with a private solution. That brings the efficiency of the contemplated responses into focus (see *infra*).[80]

We return to efficiency below, but note as a preliminary matter that policymakers must also be sure that the mode of relief adopted is capable of reaching its intended beneficiary (that is, that the relief is *effective*). Superficially appealing modes of intervening to reduce the amplification of the COVID-19 economic shock may not function as intended, so that the policy goal is not achieved. Our intuition is that this may be particularly an issue for bail-ins. Bail-outs can be calibrated to benefit a specific target group. With bail-ins this is more difficult. Private actors usually find themselves in a web of complex commercial and contractual relationships. Interventions at one point will often ripple up and down supply or investment chains. For example, and as

---

[79] Congressional Budget Office, *Federal Debt: A Primer*, March 2020, https://www.cbo.gov/system/files/2020-03/56165-CBO-debt-primer.pdf (last visited July 30, 2020).

[80] From an efficiency perspective, it does not matter whether the 'losers' under the policy actually compensate the 'winners', if the Kaldor/Hicks test for efficiency is used. (It would matter under the Pareto test.) The Kaldor/Hicks test is the standard test used in normative Law & Economics. *See*, for example, HORST EIDENMÜLLER, EFFIZIENZ ALS RECHTSPRINZIP 41-57 (4th ed. 2015).

acknowledged in Part II above, a write-down of (certain) claims directed against a UK company would affect not only the company's creditors but also those who finance those creditors (the 'creditors' creditors'), both domestic and foreign, and so on until some endpoint in the investment chain is reached. Further, the application of contracts or other private law rules is often tied to particular roles/situations in which private actors find themselves, for example that of lessor/lessee. These roles do necessarily match well with the intended group of beneficiaries of the government policy, making systematic transfers difficult to achieve.

Whatever type of policy is adopted to mitigate the economic fallout from the COVID-19 pandemic, it seems clear to us that the policy should not go beyond what is necessary to achieve the stipulated goal. As between equally effective measures from an *ex post* perspective, the one that is least intrusive regarding existing contractual and commercial relations should be chosen. Proportionality in this sense is an almost universally accepted constitutional standard to judge the legitimacy of law-making which involves interference with constitutionally protected rights or interests.[81] With respect to bail-outs, proportionality is also a standard of prudence in the sense of limiting the use of government funds. That leads us to suggest the first principle to guide policymakers in devising responses to the economic damage caused by the COVID-19 pandemic:

> Principle 1: Relief should be proportionate, in that it should not go beyond that reasonably thought necessary to minimise the amplification of the economic shock, including by fire-sales, caused by periods of trading shutdowns.

Applying this principle to specific contemplated bail-in or bail-out measures will often yield helpful guidance for policymakers. For example, maximising the effectiveness of a bail-in measure suggests that a global moratorium on the enforcement of creditors' claims is better than contract-specific 'solutions' such as the freezing of rental payments. A global moratorium provides the more wide-ranging 'solution'. At the same

---

[81] *See*, for example, Article 5(4) of the 'Treaty on European Union' in the EU: "Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties."

time, not going beyond what is necessary, as required under the principle of proportionality, suggests that facilitating private (re-)negotiations is better than imposing a specific outcome, such as a (partial) write-down. Hence, if a global moratorium/stay suffices to deal with the cash flow problems of pandemic-stricken firms, it is to be preferred compared to more intrusive measures, such as mandated write-downs. This is of course a 'big if'. Given that in a lockdown jurisdiction multiple sectors will sustain significant losses in revenue which cannot be recovered, some assumption of their liabilities (as in a furlough scheme for employees' claims) or write down will usually be the relevant choice. If debt overhang problems are to be avoided, bail-out assistance that is structured as a loan, rather than as a grant, may have to be written down, and quickly.

A key issue with respect to bail-in measures will be the efficiency losses associated with such measures. As is well-known, achieving distributive goals such as, for example, re-allocating losses suffered by some economic actors to others, by intervening in private bargains (contracts) may be less efficient than using the tax/transfer system (bail-outs) to achieve the same goal.[82] Both mechanisms distort the work/leisure trade-off ('inefficiency 1'). But interventions in contracts usually create an additional inefficiency by substituting an efficient contractual risk allocation with an inefficient one ('inefficiency 2'). For example, during the pandemic, many flights have been or are cancelled due to border controls. Refunding pre-payments to customers is the efficient solution as the airlines clearly are the superior risk bearer in this contractual relationship. Nevertheless, cancelling refund rights or giving vouchers to customers instead of such rights were measures contemplated in Europe and elsewhere to ease cash-flow problems of airlines, in a clear deviation of (otherwise) applicable legal rules.[83] Implementing such a policy would come at a significant cost as it undermines efficient existing legal stipulations. Against the background of this discussion, the following second principle to guide policymakers in devising responses to the economic damage caused by the COVID-19 pandemic can be derived:

---

[82] Louis Kaplow and Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23(2) THE JOURNAL OF LEGAL STUDIES 667 (1994).

[83] See, for example, 'EU Commission to Take Legal Action Over Airline 'Vouchers'', July 7, 2020, https://www.schengenvisainfo.com/news/eu-commission-to-take-legal-action-over-airline-vouchers/ (last visited August 8, 2020).

Principle 2: Measures should aim to protect against amplification of the shock at minimum cost, including the costs associated with long-term distortions to efficient private bargains and private law rules, especially in the context of the prevailing debtor-creditor law.

A corollary of this principle is that temporarily suspending private rights is better than cancelling them altogether. Again, a moratorium fares better under this standard than write-downs. If write-downs or other forms of cancellation of private rights are contemplated, such measures should be time-limited from the outset, i.e. they should cease to apply after a pre-specified period. Thereby, the risk of long-term distortions to debtor-creditor and contract law can be reduced.

Shifting losses from one private actor to another does not eliminate such losses. All it can do is to reduce the 'pain' for some actors – at the cost of 'pain' for others. However, that 'pain' may not be the same. Given decreasing marginal utility of income, the 'loss absorbing capacity' of private parties may well differ significantly. Redistributing losses from those with little means to those who face little (if any) financial constraints appears to be a smart move on both fairness and efficiency grounds.[84] Further, as already mentioned, some parties may be much better positioned to anticipate and deal with low probability/high impact events because of industry knowledge, repeated dealings etc. Such parties usually assume or – if the parties fail to stipulate rules to govern the issue – would have assumed such risks as the 'superior risk bearer' had a 'fully specified contract' been possible. These considerations lead us to the following principle:

Principle 3: Transfers should be from the less financially constrained to the more financially constrained companies and individuals, taking loss absorbing and risk bearing capacity into account.

[84] Even if individual utility functions differ, such transfers should produce an *expected* increase in utility if such differences are random. *See*, for example, Eidenmüller, *supra* note 80, at 276-277 with further references in note 6.

An implication of this principle is that consumers or involuntary creditors (for example tort creditors) should usually not be on the 'giving end' of a bail-in. [85] Neither group voluntarily has assumed pandemic-induced default risks, nor should they: their loss absorbing and risk bearing capacity will usually be extremely limited. On the other hand, parties who actually engage in the business of trading in and assuming risks can rightfully be targeted as transferees.

Bail-ins or bail-outs do not happen in a legal and political vacuum. Rather, they are always embedded in a specific legal and political infrastructure existing in the state in which the measures are implemented. This existing institutional infrastructure is crucially important when evaluating such measures. Bail-out measures such as grants or loans to businesses require a functioning administration which is capable of handing out these grants/loans, policing opportunistic misappropriations of funds etc. Bail-ins which involve interference with contractual rights will give rise to legal disputes that must be handled by the courts. Different jurisdictions will be positioned differently when it comes to their institutional infrastructure which is necessary to manage bail-in or bail-out policies.

> Principle 4: Policies should attempt to achieve a good 'fit' with the existing institutional infrastructure in a particular jurisdiction.

Finally, the COVID-19 pandemic puts extreme stress on our societies. Lives and livelihoods are threatened in an unprecedented way. Extremely difficult decisions must be taken, involving live and death of millions of people worldwide. In such an extreme situation it is all the more important that crucial information is readily available or at least accessible to everybody, that relevant normative criteria are debated openly, and that decision-making processes are as transparent and inclusive as possible. The acceptance and implementation of whatever measures are taken depends on the perceived quality and fairness of the decision-making process. What is more, the legitimacy of the state and its action in the post-crisis period depends on this as well.

---

[85] In fact, Principle 3 is a more general argument for bail-outs and against bail-ins. Bail-outs suspend 'current suffering' altogether to the extent that more state debt is not financed by other budget cuts.

A transparent process for determining the allocation of pandemic-induced costs should be established, so as to minimise the risks of damage to legitimacy of the state in the post-crisis period (Principle 5).

Conclusion

Revenue losses incurred as a result of COVID-19 related trading restrictions cannot be recovered. Bail-outs and bail-ins do not eliminate these losses; rather, they allocate them to future taxpayers (bail-out) or current savers (bail-in). Relative to use of the formal reorganisation law, however, such strategies may work better to reduce the *amplification* of the COVID-19 shock, by tailoring relief to the particular features of COVID-distress while preserving the integrity of existing reorganisation procedures. Distorting such procedures to accommodate the features of COVID-19 distress (or, in jurisdictions where there is not a reorganisation procedure, introducing one designed with COVID-19 distress in mind) risks inhibiting the availability of credit for new projects in future, slowing the path to economic recovery. Bail-outs or bail-ins are then, in our view, better than bankruptcy for the treatment of COVID-19 distress, even where there is reorganisation procedure that functions well in normal conditions.

How should states choose between bail-outs and bail-ins, and settle on the design of either form of intervention? We have suggested that policymakers should intervene in ways that are proportionate, in the sense that they ought to confine themselves to that which is thought necessary to minimise the amplification of the economic shock caused by periods of trading shutdowns; that interventions should be designed to minimise distortions to efficient private bargains and private law rules; that transfers should be from the less financially constrained to the more financially constrained; that interventions should 'fit' with the institutional apparatus responsible for administering them; and that the process of designing and delivering relief should be transparent. We suggest these principles tentatively, mindful of the fact that policymakers may or may not be working with common conceptions of fairness and responsibility, and of the fact that some of our principles may only be able to be fully pursued at the partial expense of others. But we nevertheless hope that they offer a useful starting point for thinking about the design and delivery of novel forms of relief to debtors distressed by COVID-19 related revenue losses.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (https://ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html