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12. The value of insolvency law in the COVID-19 crisis

Aurelio Gurrea-Martinez²⁸²

Introduction

The COVID-19 pandemic not only has generated a social, humanitarian and public health crisis but it has also led to the worst recession the world's economy has experienced since the Great Depression.²⁸³ As a response to the economic challenges generated by the COVID-19 crisis, many countries are responding with a variety of legal and economic measures that seek to support businesses, employees, and households.²⁸⁴

The role and limits of insolvency law

An efficient corporate insolvency framework should perform two primary functions.²⁸⁵ First, it should minimise the destruction of value generated in a situation of insolvency. This is done through a variety of tools generally provided by insolvency law,²⁸⁶ including: (i) the existence of a moratorium that stops creditors from enforcing their claims when a debtor is unable to pay its debts; (ii) the inability of lenders and suppliers to terminate their contracts with the debtor upon the initiation of an insolvency proceeding; and (iii) the possibility of having access to new finance, since the court, under certain conditions, may grant a super-priority status to those lenders willing to provide new financial sources to a company subject to a formal insolvency or restructuring procedure.²⁸⁷

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²⁸³ G. Gopinath, 'The Great Lockdown: Worst Economic Downturn Since the Great Depression' (*IMF Blog*, 14 April 2020) <<https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/>>.

²⁸⁴ For a summary of the responses adopted by many countries around the world, see INSOL International and World Bank Group, 'Global Guide: Measures adopted to support distressed businesses through the COVID-19 crisis' (3 July 2020) <<http://insol-techlibrary.s3.amazonaws.com/a8d909e7-532c-489a-b7fb-3a05cc15377a.pdf?AWSAccessKeyId=AKIAJA2C2IGD2CIW7KIA&Expires=1595508582&Signature=94EII R49bKc69Vx0RcKDUgF7b4U%3D>>.

²⁸⁵ See Aurelio Gurrea-Martinez, 'The Role of Corporate Insolvency Law in the Promotion of Economic Growth' (*SGRI Blog*, 1 July 2020) <<https://cebcla.smu.edu.sg/sgri/blog/2020/07/01/role-corporate-insolvency-law-promotion-economic-growth>>.

²⁸⁶ It should be noted, however, that some of these tools might not be found in some jurisdictions. Likewise, other countries with most sophisticated insolvency frameworks, such as Singapore and the United States, even provide more insolvency tools to support debtors.

²⁸⁷ Some authors have pointed out that one of the primary functions of insolvency law is actually serving as a 'liquidity provider' for firms. See Kenneth Ayotte and David Skeel, '*Bankruptcy Law as a Liquidity Provider*' (2013) 80(4) *The University of Chicago Law Review* <http://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/01_Ayotte_Skeel.pdf>.

Second, corporate insolvency law should also make sure that the debtor's assets are efficiently allocated. In the context of *viable* companies (that is, companies that are worth more if the assets are kept together under their current use), that means that a corporate insolvency regime should make sure that the debtor is provided with the necessary tools to emerge from insolvency with a new financial structure. These tools include not only an adequate forum for negotiations, usually led by a reliable third party (e.g., bankruptcy judge), but also certain rules that facilitate the financial reorganisation of the debtor. For example, outside of an insolvency proceeding, debtors generally need consent of all their creditors to modify their debt agreements. In an insolvency proceeding, however, this is no longer needed. A majority or qualified majority of each class of creditors will be sufficient. In fact, in some insolvency jurisdictions such as Singapore and the United States, a reorganisation plan can even be passed without the approval of all the classes of creditors provided that various requirements seeking to protect the interest of the creditors are met.²⁸⁸

However, even in countries with the most sophisticated restructuring frameworks, insolvency law is subject to various limitations during the current pandemic. First, the commencement of insolvency proceedings imposes significant costs that can be particularly prohibitive for micro, small and medium-sized enterprises (MSMEs).²⁸⁹ Second, the current pandemic may lead to a wave of insolvency cases that can be unmanageable for any judicial system.²⁹⁰ For this reason, if the insolvency curve generated by the COVID-19 pandemic is not flattened, the judicial system can become overwhelmed, harming the ability of insolvency law to help viable companies facing financial trouble.

Flattening the insolvency curve generated by the COVID-19 crisis

In my view, the current situation should encourage countries to implement three types of responses to flatten the insolvency course while keeping businesses alive. First, they should provide a breathing space to debtors by enacting emerging legislation that should include not only temporary changes to the insolvency framework but also other changes affecting contracts and creditors' rights.²⁹¹

Second, even if debtors are provided with a breathing space that usually involves protecting them from legal actions initiated by their creditors, they still need to cover many expenses and fixed

²⁸⁸ The ability to impose a plan on dissenting classes of creditors is generally known as 'cross-class cramdown'.

²⁸⁹ E. R. Morrison and A. C. Saavedra, 'Bankruptcy's Role in the COVID-19 Crisis' (2020) Columbia Law and Economics Working Paper No. 624, <www.ssrn.com/abstract=3567127>.

²⁹⁰ Some authors have even estimated the precise number of judges that would be needed to handle the wave of insolvency cases in some countries such as the United States. See B. C. Iverson, J. A. Ellias and M. J. Roe, 'Estimating the Need for Additional Bankruptcy Judges in Light of the COVID-19 Pandemic' (2020) 11 Harvard Business Law Review (forthcoming) <www.ssrn.com/abstract=3624529>.

²⁹¹ E. R. Morrison and A. C. Saavedra (n 289).

costs, including rent and salaries. For this reason, this measure needs to be complemented with financial assistance provided by the Government, perhaps in the form of wage subsidies, cash payouts and loans backed by the State.²⁹²

Finally, countries should promote the use of workouts and pre-insolvency proceedings as debt restructuring tools.²⁹³ On the one hand, the use of these procedures, generally involving a minimal or no intervention of courts will avoid a potential congestion of the judicial system. On the other hand, these procedures will provide companies unable to afford an insolvency proceeding (especially MSMEs) with a valuable tool to achieve a debt restructuring. Moreover, due to the concentrated debt structure generally existing in MSMEs, achieving a workout is much easier.²⁹⁴ Therefore, countries should encourage debtors and creditors to reach out-of-court agreements as a primary mechanism to solve a situation of insolvency generated by COVID-19. And even though promoting workouts can be desirable for any country affected by the COVID-19 pandemic, it will be even more relevant for emerging economies, due to the unattractiveness of their insolvency frameworks.²⁹⁵

Keeping the economy alive in a post-pandemic world

Many companies are currently surviving the COVID-19 pandemic thanks to their reserves of cash and the legal and financial support provided by public authorities. At some point, however, companies will run out of cash, and they will need so survive without Governmental support. It will be then when the role of corporate insolvency law will become even more relevant in the current pandemic. Indeed, since many companies may not have the financial support and temporary protections provided by the Government, they may be exposed to enforcement actions by their creditors. For this reason, the initiation of an insolvency proceeding can help many companies preserve value. More importantly, since these companies will probably need new financing and an adjustment of their debt contracts, corporate insolvency law, at least in countries with efficiently insolvency frameworks such as Singapore, can help them achieve these goals.

²⁹² This was actually the response in Singapore. See Aurelio Gurrea-Martinez, INSOL International and World Bank Group (n 284).

²⁹³ Aurelio Gurrea-Martinez and Samuel Loh, 'Singapore's Legal and Economic Response to the COVID-19 Crisis: The Role of Insolvency Law and Corporate Workouts' (2020) 17(4) International Corporate Rescue <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3653059>.

²⁹⁴ Horst Eidenmüller, Luca Enriques and Kristin Van Zwieten, 'COVID-19: A Global Moratorium for Corporate Bonds?' (*OXFORD BUSINESS LAW BLOG*, 23 March 2020) <<https://www.law.ox.ac.uk/business-law-blog/blog/2020/03/COVID-19-global-moratorium-corporate-bonds>>. See also Aurelio Gurrea-Martinez and Samuel Loh (n 293).

²⁹⁵ Aurelio Gurrea-Martinez, 'Insolvency Law in Emerging Markets' (2020) Ibero-American Institute for Law and Finance, Working Paper 3/2020 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3606395>.

Conclusion

The world is facing the worst economic recession observed in modern times. In this context, corporate insolvency law is expected to play a major role in the current situation. Nonetheless, due to the limitations of insolvency law, out-court-restructurings should be promoted, and other legal and financial measures should be adopted by the Government. Still, the combination of an efficient insolvency framework and the promotion of workouts can keep many businesses alive not only during the worst part of the COVID-19 crisis but also in a post-pandemic world.