Equitable Growth, Finance and Institutions
COVID-19 Notes
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COVID-19 Outbreak: Implications on Corporate and Individual Insolvency[1]

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The COVID-19 pandemic has impacted firms by reducing demand for their products and services, disrupting the supply of inputs and tightening the provision of credit. Individuals are also experiencing a sharp decrease in income as unemployment grows. This is already resulting in shocks to the financial system in the form of increases in non-performing loans, insolvency filings, unnecessary liquidations and asset fire-sales. Government responses so far have been a mix of regulatory forbearance, higher barriers to entry into formal insolvency proceedings and the extension of procedural deadlines. The World Bank – as an FSB standard setter in the field of insolvency – can play a role in mitigating the crisis through supporting rapid actions in the insolvency sphere. The insolvency system can facilitate recovery as a channel for resolving debt-overhang and preserving employment.

1. How is COVID-19 impacting the solvency of firms and individuals?

The COVID-19 pandemic has impacted firms by reducing demand for their products and services, disrupting the supply of inputs and tightening the provision of credit. While the present situation is particularly unique, past crises have shown that sharp increases in corporate and personal insolvency typically follow these shocks.[2] Financial distress is already being reported in numerous sectors, particularly aviation, tourism, hospitality, retail and manufacturing.[3] Emerging markets and developing economies (EMDEs) are particularly vulnerable in light of their shallower financial markets and vulnerability to shocks.

System-wide credit and product market disruptions affect the insolvency system's ability to direct viable firms into reorganization and non-viable ones into liquidation. Insolvency regimes are designed to save viable businesses while disposing of non-viable businesses and returning assets to productive use.[4] In a systemic crisis, the scramble for liquidity increases the risk of pushing viable firms into liquidation, especially vulnerable micro, small and medium enterprises (MSMEs),[5] with the unnecessary accompanying

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[2] See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/780241/Insolvency_Statistics_Commentary-_Q1_2018_domain_update.pdf; http://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy_Statistics/Total-Business-Consumer1980-Present.pdf.

[3] See McKinsey Global "Coronavirus COVID-19: Facts and Insights, "9 March 2020.

[4] See World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (2016), http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes. The World Bank is designated by the Financial Stability Board (together with UNCITRAL) as co-standard setter of the Insolvency and Creditor Rights Standard: ttps://www.fsb.org/2011/01/cos_051201/.

[5] For a detailed discussion of crisis response measures for MSMEs, including MSME insolvency please see World Bank Group FCI Unit "Accessing the impact and policy response in support of private sector firms in the context of the COVID-19 pandemic."

employment losses and widespread fire sale of assets. Without addressing these effects, economic recovery also suffers once the crisis recedes. Ensuring that sound firms are given a fair chance to survive the expected temporary market disruption, is therefore critical, while also ensuring that, as the crisis progresses, there is not a proliferation of 'zombie' firms that could starve healthy firms of credit in the post-crisis environment.[6]

Insolvency-related measures complement the fiscal and regulatory responses being enacted in many countries to increase the likelihood of success of those responses. Several countries are putting short-term insolvency-focused measures (see Phase 1 below) in place to help ensure all firms and consumers have breathing space until the markets have stabilized, and business viability assessments can be made. Insolvency reforms will need to respond to three phases in this crisis, which might be considered sequential or might have significant overlap, depending upon the respective country context. In Phase 1, creditors, who, faced with their own liquidity challenges, will prematurely push viable firms into insolvency, resulting in significant value destruction. In Phase 2, the insolvency system will have to respond to the increase in both the failure of firms and the increase in firms that cannot restructure their debts without an out of court workout or a formal "chapter 11" type process.[7] Finally, Phase 3 will require a focus largely on individuals dealing with the aftermath of personal financial distress resulting from the crisis. The measures described below are extraordinary and are potential responses to the COVID-19 crisis. Therefore, having a "sunset" date is essential, in order to avoid upsetting the balance between different stakeholders' rights.

2. How can policymakers respond to the key challenges?

	Key Challenges	Critical Responses
Phase 1	**Preventing viable firms from prematurely being pushed into insolvency**	**Implementing one or more extraordinary measures for a limited period of time:** • Increasing the barriers to creditor-initiated insolvency filings; • Suspending the director's duty to file and associated liability; • Ensuring complementarities with debt repayment emergency measures.
Phase 2	**Responding to the increased number of firms that will not survive this crisis without going through insolvency**	**Ensuring the smooth functioning of workouts and debt restructuring mechanisms:** • Establishing informal out-of-court or hybrid workout frameworks; • Facilitating business rescue through bridge financing; • Extending procedural deadlines for a limited period of time; • Suspending the requirement to proceed to liquidation if the business activity of the debtor has stopped while undergoing reorganization; • Encouraging e-filings, virtual court hearings and out-of-court solutions in insolvency cases.
Phase 3	**Addressing individual financial distress resulting from the crisis**	• Implementing modern consumer bankruptcy frameworks, which are still non-existent or outdated in many Emerging Markets and Developing Economies; • Ensuring there are flexible options for debt rescheduling and repayment plans; • Enabling a debt forgiveness mechanism or discharge is important for facilitating a fresh start.

[6] Zombies are firms that earn just enough money to continue operating and servicing debt but are unable to pay off their debt, thus diverting resources away from healthy, viable firms. Adalet McGowan et al (2017): "The walking dead: zombie firms and productivity performance in OECD countries," and Ricardo Caballero et al (2008) "Zombie Lending and Depressed Restructuring in Japan."
[7] Chapter 11 of the US Bankruptcy code provides formal debt restructuring under a court supervision. Many EMDEs have processes that, while very different, aim to produce the same outcome.

Phase 1: Preventing viable firms from prematurely being pushed into insolvency

Increasing the barriers to creditor-initiated insolvency filings for a limited period: A relatively simple crisis measure that immediately helps avoid pushing viable firms into insolvency is to raise the threshold requirements for creditors commencing an insolvency process,[8] or introducing such a threshold in countries where one does not exist. The vulnerability of MSMEs in handling shocks makes these measures particularly important.[9] Alternative measures include suspending specific creditors' rights (such as government creditors) or even all creditors' rights to initiate insolvency proceedings for a limited time period, while preserving the debtor's right to voluntarily open proceedings.[10] Additional measures also include increasing response timelines for debtors to give them more breathing room.[11]

Suspending the director's duty to put companies into insolvency and the associated personal liability for a limited period: In most countries, directors have a duty to act in the creditors' interests when a firm is on the edge of insolvency. This is designed to prevent businesses from significantly growing their liabilities when management knows the business is unlikely to be able to repay them.[12] A duty to file for insolvency and the corresponding liability for any damages to creditors arises as the debtor becomes insolvent. Suspending the duty to file – and the corresponding liability – in the current climate is advisable to prevent a flood of insolvencies.[13] Similarly, in some countries, directors that continue to carry on business trading while the enterprise is insolvent, are considered to be personally liable for wrongful trading, and potentially fraudulent trading. Suspending the personal liability of directors for wrongful trading will offer some relief during this crisis, when assessing business solvency is difficult,[14] and restructuring solutions are perhaps being sought. The rules relating to fraudulent trading should not be altered given the criminal behavior they aim to sanction.

Ensuring complementarities with debt repayment emergency measures: Although not directly an insolvency intervention, broader debt repayment measures have been introduced in several countries in an effort to relieve financially distressed businesses. At their core, three types of measures can be identified. First, those led by private initiatives where a group of banks decides -for instance- not to pursue repayments during a period of time (such as in the Netherlands). Second, some countries have introduced emergency legislation to modify contractual terms addressing either the prospects of repayment (e.g. extending the repayment terms of a set of loans in Portugal) or the effects of non-payment (e.g. prohibiting the acceleration of contractual terms in France). Third, some countries have focused their interventions on the judiciary. These interventions have ranged from suspending judicial proceedings (e.g. Italy) to suspending the execution of certain assets owned by individuals (e.g. Bulgaria). Debt repayment interventions carry the risk of being overly broad, as they may provide redress to firms and individuals who may not need it, thereby further affecting financial stability – and should therefore be enacted only with extreme caution. At

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[8] Australia has increased the threshold at which creditors can issue a statutory demand on a company from $2,000 to $20,000, which will be in effect for 6 months as a response to COVID-19. India has increased the default threshold from INR 1 Lakh to INR 1 Crore (approximately USD $150,000) as a response to COVID-19.
[9] India's reform was specifically aimed at assisting MSMEs.
[10] Spain has suspended creditors' rights to file involuntary bankruptcy petitions until the end of the state of emergency.
[11] Australia has provided companies with an increased time-frame of six-months rather than the current 21 days, to respond to statutory demands served on them, which will be in effect for 6 months.
[12] World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (2016): http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes.
[13] Spain has suspended the director's obligation to file for bankruptcy until two months after the end of the state of emergency. In Germany, the federal government has indicated it intends to suspend the directors' obligation to file for bankruptcy until September 30, 2020 if the ground for insolvency is due to the consequences of COVID-19.
[14] The Australian Government has relieved directors from the risk of personal liability for insolvent trading where the debts are incurred in the ordinary course of business.

the same time, these measures tend not to focus on insolvency, so there is a clear opportunity for complementarities. For instance, demand shocks may lead firms into insolvency even if debt repayment is not being pursued. Without urgent insolvency interventions, managers and directors could nonetheless drive these firms into formal insolvency just to avoid personal liabilities despite other debt repayment measures.

Phase 2: Responding to the increased number of firms that will not survive this crisis without going through an insolvency process

(i) Informal Restructuring and Work-outs

Establishing informal or hybrid workout frameworks: The experience from both the 2008 global financial crisis and Asian financial crisis illustrates the importance of having informal workout frameworks[15] setting out the core obligations for informal debt negotiations with financial institutions, such as a standstill agreement preventing debt enforcement.[16] As they are informal tools, these frameworks can be put in place relatively quickly, ideally spear-headed by the country's central bank and bankers' association, and they typically avoid the procedural complexities and timelines of court proceedings. Creditors should be incentivized to restructure debts (for instance, through tax incentives) and use all restructuring tools available in order to save viable businesses while also maximizing their recovery.[17] As a medium-term measure, countries should aim to put preventive restructuring[18] or pre-insolvency frameworks[19] in place to facilitate debt restructuring as early as possible.

Facilitating business rescue through bridge financing: For many firms experiencing financial distress, a successful restructuring can only happen if new financing is obtained at the pre-insolvency stage, when the company can stabilize its position. A number of countries are considering bridging short-term financial distress with specific schemes that would directly lend to distressed borrowers.[20] In some cases, these schemes are being complemented with regulatory forbearance[21] regulating the prudential and accounting treatment of the restructuring measures applied.[22] In case the turn-around efforts do not succeed and formal insolvency proceedings commence, the insolvency law can protect these financing attempts against bankruptcy avoidance actions and prioritize their repayment ahead of other bankruptcy creditors. A similar priority is usually afforded to those creditors that provide interim financing during insolvency proceedings.

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[15] For instance, the South Korean and Indonesian initiatives.
[16] A toolkit for out-of-court workouts (2016). Washington, D.C.: World Bank Group. http://documents.worldbank.org/curated/en/851561511964075432/A-toolkit-for-out-of-court-workouts
[17] In the Netherlands, the largest Dutch banks are now jointly introducing measures to offer corporates that were healthy prior to the corona crisis, a six-month postponement for the repayment of their loans.
[18] For instance, along the lines of the European Union Directive 2019/1023.
[19] Pre-insolvency frameworks refer to a variety of "light-touch" restructuring techniques that debtors can access before they are in a state of insolvency. Increasingly they are being used to address financial distress quickly.
[20] Under the COVID-19 Corporate Financing Facility, the Bank of England will buy short term debt from larger companies to enable corporates to finance short-term liabilities. The People's Bank of China will offer support to MSMEs in certain sectors providing supplies to fight COVID-19.
[21] As experienced during the 2008 financial crisis, regulatory forbearance may have negative effects on financial stability and should therefore be used carefully and as a last resort to respond to temporary issues hampering crisis response only.
[22] An analysis of the different forbearance measures introduced to encourage the restructuring of distressed borrowers is discussed in a separate note prepared by the World Bank's Financial Stability team.

(ii) Formal Restructuring

Extending procedural deadlines for a limited period of time: The insolvency laws in many countries have tight deadlines for restructurings to occur, which is in line with good practice standards.[23] If these deadlines are missed without an approved reorganization plan in place, then debtors may be forced into liquidation procedures. In the current situation, exceptional extensions of deadlines may be needed to facilitate restructurings to occur.[24] Similarly, the automatic stay of creditors is often limited in duration in order to mitigate the losses that such a moratorium may pose on creditors.[25] In the context of COVID-19, exceptional extensions of these deadlines may facilitate restructurings and help preserve business value.[26]

Suspending the requirement to proceed to liquidation if the business activity of the debtor has stopped while undergoing reorganization: Many effective insolvency laws seek to prioritize the reorganization of viable businesses with the expectation that such reorganizations tend to generate better outcomes for all parties involved and the business has the greatest likelihood of continuing as a going concern.[27] In light of COVID-19, some business operations may need to stop, given the difficulty of obtaining inputs from disrupted supply chains or from the labor force facing mobility restrictions. Where business activity has come to a halt during a formal reorganization, some insolvency laws impose a duty to convert the proceedings into liquidation in order to maximize creditor recovery. As a crisis response, governments should consider temporarily suspending the obligation to direct debtors into liquidation if the business has stopped producing as a result of current market conditions.[28]

Countries with sub-optimal reorganization frameworks need to ensure they are reformed for timely, efficient and fair administration of the proceeding with the objective of maximizing stakeholder recovery. The law should grant an immediate, but temporary, protection to the debtor from any creditor enforcement and ensure that reorganization plans can be formulated, voted and approved in a flexible and fair manner with opposing creditors receiving a recovery equal to or greater than they would likely receive in a liquidation. Effective implementation of the plan should be independently supervised and where a debtor fails or is incapable of implementing the plan, this should be grounds for termination and liquidation.

Encouraging e-filings, virtual court hearings and out-of-court solutions in insolvency cases: Court closures and/or procedural suspensions during the emergency period are expected to result in severe overburdening of insolvency courts, once insolvency-related filings and proceedings are resumed, as seen

[23] World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (2016): http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes.

[24] Bulgaria's Law on the State of Emergency passed on March 20, 2020, suspended all procedural deadlines for ongoing court litigations, arbitrations and executions, except under the Penal Code. Spain's Emergency Act provides for the suspension of procedural judicial and administrative terms, suspension of any limitation period before filing a claim, and suspension of judicial proceedings which are not considered urgent. Poland has adopted very similar provisions, suspending statutes of limitations and debt enforcement proceedings, except urgent cases.

[25] World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (2016): http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes.

[26] Some countries have gone further and prevented any debt enforcement or foreclosures by creditors outside of the insolvency process. Bulgaria's Law on the State of Emergency provides that creditors will not be able to enforce debt or to foreclose until the end of the state of emergency.

[27] World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes, (2016) http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes.

[28] They might also consider suspending the duty to recapitalize or liquidate companies where capital drops below certain thresholds. See Aurelio Gurrea-Martinez, "Insolvency law in Times of COVID-19" (2020), https://www.derechoyfinanzas.org/en/insolvency-law-in-times-of-covid-19/.

in other crises.[29] Countries should start planning for equipping insolvency courts with an increased number of sufficiently trained staff,[30] as well as moving towards procedures conducted entirely in writing and promoting digital communication options.[31]

Phase 3: Addressing individual financial distress resulting from the crisis

Ensuring there are flexible options for debt rescheduling and repayment plans will be critical: Improving the breadth of debt repayment options available to individuals would help remove the stigma of personal bankruptcy. Informal, out-of-court and often online tools are increasingly important to allow individuals to get relief in a quick and accessible manner. Given the potential number of personal bankruptcy applications following COVID-19, a simplified administrative process for debt restructuring as an option in the personal bankruptcy framework, involving experts such as debt counsellors or potentially mediators, will provide flexible mechanisms for dealing with individual debt in an expedited manner.

EMDEs that do not have a consumer bankruptcy framework need to adopt it: These frameworks (which include individual entrepreneurs) provide at least partial protection against financial risks, by providing an orderly framework for paying creditors and giving debtors key protections, such as a "fresh start" -access to discharge[32]- from their debt burden and shielding certain assets from seizure by creditors. Although application to the discharge process should be broadly available, discharge itself should be applied under clearly articulated guidelines that do not expose the financial sector to undue systemic risk. Although many advanced economies have modern consumer bankruptcy regimes, many EMDEs are still lacking these laws or they are insufficient.

[29] Cirmizi, Klapper, Uttamchandani, "The Challenges of Bankruptcy Reform" (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1694337.

[30] Germany has already initiated planning for increasing the staff of insolvency courts in particular, and is moving towards predominantly written proceedings, using digital means.

[31] In Canada, Chief Justice Morawetz declared that all urgent matters be conducted either in writing, by teleconference or videoconference unless the court ordered otherwise. In Hong Kong, Justice Russell Coleman of High Court conducted hearings via telephonic conferencing and qualified the use of telephones is an 'obvious' solution during the current crisis when physical hearings are not permissible on health grounds. The U.S. Bankruptcy Court for the District of Delaware, where many of the biggest insolvent companies seek court protection, announced that they will conduct upcoming hearings via telephone or video chat unless the presiding judge orders otherwise.

[32] A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts, so that the debtor is no longer required to pay those discharged debts. Discharges can be calibrated according to country priorities so that certain debts continue, even after the discharge, to avoid either systemic or moral hazard risks.