Intelligence MEMOS

From: James A. Haley

To: Canada's Policymakers

Date: June 23, 2020

Re: **SECURING THE RECOVERY**

COVID-19 threatens the economic security of all Canadians. It has already led to massive unemployment; it could yet unleash a wave of business failures. Existing bankruptcy frameworks resolve creditor coordination problems and promote orderly restructurings. They are not designed to deal with an economy-wide shock that pushes a wide swath of firms into distress and overwhelms the bankruptcy system. The disruption from such an outcome could impede the robust supply response needed to restore growth and return to full employment.

But risks remain even if the courts are not congested by a wave of business failures. In particular, heightened uncertainty may impair a key element of efficient bankruptcy frameworks—access to debtor-in-possession (DIP) financing.

Bankruptcy disciplines poor management and promotes the efficient utilization of assets. In some cases, this requires liquidation, the sale of assets to pay the firm's creditors. Liquidation entails the destruction of firm-specific "relationship capital," however, and imposes losses on other stakeholders. An alternative approach, the orderly restructuring of failing firms, is preferable because it promotes the efficient utilization of a firm's assets while preserving firm-specific relationship capital.

DIP financing is used to keep the firm viable as a going concern during the restructuring process, enhancing the security of creditors' collective claims. If DIP financing is unavailable or prohibitively expensive—a possibility under current conditions of extreme uncertainty—restructurings may not be an option.

Unfortunately, two factors may limit the availability of DIP financing. The first factor is the *willingness* of lenders to finance troubled firms. DIP financing typically provides a financial bridge to more stable financial conditions for the firm. In the current environment, lenders may be unable to assess the soundness of the financial footings on the other side of the crisis. Recoveries are a function of asset values, which are ultimately driven by liquidity or "cash in the market." If investors are wary of future prospects, they could exercise an abundance of caution and limit such funds.

The second factor limiting the availability of DIP financing is the ability of lenders to increase exposure to firms in financial distress. Lenders mindful of their fiduciary obligations and wary of regulatory and accounting requirements may conclude that they are unable to balance the risk against the expected return from DIP financing.

Recovery of DIP financing must be the first priority. And while DIP financing enjoys senior status should a restructuring prove unsuccessful and the firm is subsequently liquidated, pervasive uncertainty may require lenders to record such high expected losses that scarce regulatory capital is better utilized in support of other business lines. Recent court decisions that elevate some legacy liabilities (e.g., environmental liabilities) and HST claims ahead of DIP financing may increase uncertainty.

At the same time, the role of other creditors in the restructuring process is critical. Even if a lender is prepared to provide DIP financing, other creditors may oppose the restructuring. This opposition can delay and/or increase the costs of restructuring, reducing the likelihood of a successful workout and limiting the availability of DIP financing.

Two measures could help ease these constraints:

First, a DIP financing facility to support restructurings that preserve firm-specific investments. The large banks would need to be involved given their expertise in credit risk analysis and the balance sheet capacity that may be needed to address the potential needs. But bank managers cannot ignore their fiduciary responsibilities to depositors, shareholders, and other stakeholders.

In the current exigent circumstances, some form of public sector backstop in the form of guarantee or stop-loss provision would likely be needed to allow the banks to strike a felicitous balance between risk and return. Since each restructuring entails its own unique circumstances, those negotiating restructurings must have the flexibility to respond quickly and nimbly to secure agreement. Modalities for the facility would need to be clearly specified in advance.

Second, a review of possible distortions that impair DIP financing or create incentives for creditors to seek liquidation rather than orderly restructurings. For example, greater clarity with respect to the priority of pre-existing liabilities could create a more favourable environment for DIP financing. Similarly, past amendments to the Bankruptcy and Insolvency Act regarding the absolute priority of tax arrears may have the unintended consequence of favouring liquidation to restructuring.

The objective of these measures is not to shield firms from the discipline of the market. They are intended to prevent economic scarring—lasting damage to the sinews that bind workers to firms and firms to suppliers—that could weaken supply responses and delay recovery. Such effects are possible if firm-specific investments are destroyed by the liquidation of firms that would be viable if not for the pandemic.

In this respect, the goal is to secure the recovery.

James A. Haley is Special Advisor, Scotiabank Economics. *He gratefully acknowledges helpful comments from and discussions with Ken Thorlakson and Gale Rubenstein.*