***Beyond “Unprecedented”: The Post-Pandemic Economy***

**Episode 3: “A New Chapter for Bankruptcy?”**

[00:00:02] **Kate Waldock:** In a situation like this, you want everyone to just get by.

[00:00:06] **Edward Morrison:** For every hundred small businesses that fail, at most 20 will file for bankruptcy.

[00:00:10] **Waldock:** There’s no point in coming up with a plan when the future is, like, totally uncertain.

[00:00:14] **Morrison:** Bankruptcy doesn’t have such value add for many small businesses, which is why it’s not being used.

[00:00:21] **[Media clips of journalists saying “unprecedented”]:** The coronavirus pandemic has tanked the global economy with unprecedented speed. The steepness of the decline here is unprecedented. This is a crisis that is unprecedented. It is unprecedented. And we just don’t know.

[00:00:35] **Eric Talley:** This is *Beyond “Unprecedented”: The Post-Pandemic Economy* from Columbia Law School and the Millstein Center for Global Markets and Corporate Ownership. I’m your host, Eric Talley, Sulzbacher Professor at Columbia Law School and a co-director of the Millstein Center.

[00:00:56] **Talley:** In the first half of 2020, more than 3,600 businesses filed for bankruptcy protection in the United States. In this group are familiar brand names like J.Crew, JCPenney, Virgin Atlantic, and Hertz. But this list also includes countless small businesses in small towns across America. We often think of bankruptcy as the end of the road, a graveyard where failing businesses go to die. But is it? And does it have to be? As more or more business owners face tough decisions due to the pandemic, what role, if any, can bankruptcy play in helping businesses and individuals weather economic shocks outside of their control? And if bankruptcy is to play any role, how will it do so across different individuals, small businesses, and large corporations? Today, I’m excited to welcome my guests, Ed Morrison and Kate Waldock—two incredibly talented bankruptcy scholars, who are anything but intellectually bankrupt—to help us understand when and how bankruptcy can be used as a tool for economic recovery.

[00:01:55] **Talley:** Ed Morrison is an expert in bankruptcy law and law and economics and is the Charles Evans Gerber Professor of Law at Columbia Law School and co-director of Columbia University’s Richard Paul Richman Center for Business, Law, and Public Policy. Welcome, Ed.

[00:02:10] **Morrison:** Thank you, Eric. It’s great to be with you.

[00:02:12] **Talley:** And Kate Waldock is an expert in bankruptcy, corporations, and banking and was an assistant professor of finance at Georgetown’s McDonough School of Business. She’s pursuing her J.D. at Columbia and is a research fellow at Columbia’s Millstein Center. Welcome, Kate.

[00:02:27] **Waldock:** Thanks for having me on the show.

[00:02:29] **Talley:** Kate, let me start with you. Bankruptcy is often thought to be a really technical field—even amongst our law students and quite frankly, amongst many of the faculty. So in very, very general, broad strokes, what is it exactly that the bankruptcy process and bankruptcy law is attempting to do?

[00:02:47] **Waldock:** Bankruptcy is confusing, for good reason, to a lot of people. And I think the reason it’s confusing is because it’s fundamentally just a set of laws. And so those laws can mean one thing in one country and another thing in another country. In history, and still in a lot of countries today, bankruptcy has been super unfriendly to the debtor. And by debtor, I mean whether it’s a person or a business, whoever is in bankruptcy. And so by unfriendly that can look like forcing a company to liquidate and shut down or even forcing an individual to go to jail for not paying back their debts. But if we’re talking about bankruptcy in the United States, it’s very different. The United States has a reputation for being super friendly towards debtors and bankruptcy. And so what that friendliness might look like could be having managers sit down with creditors and shareholders and having everyone negotiate so that the company can emerge—it can continue operating, continue producing goods. And similarly for a consumer or an individual, bankruptcy can be friendly because it can allow you to come up with a payment plan based on your income that allows you to keep stuff like your house and your car.

[00:03:56] **Talley:** Well, I think a lot of people think that bankruptcy is where unhealthy companies or people behind on their payments sort of go to die, at least financially. Is that true ,or is bankruptcy something more like Kate suggests, at least in the United States?

[00:04:11] **Morrison:** Yeah, the classic line that the Supreme Court has used is that bankruptcy is for the honest but unfortunate debtor. For consumers, it allows individuals to eliminate a lot of their debts, keep the basics of life, and start over again. And for that reason, it’s commonly called the fresh start. For businesses, it’s very similar. And honestly, a lot of businesses do use bankruptcy to litigate, liquidate, not litigate—Freudian slip. The fundamental goal of bankruptcy is to save businesses that are worth more alive than dead. And that’s really the difficult challenge that our bankruptcy system faces. You know, for every hundred firms that come in, which ones are worth more alive than dead? But for those that are, there is a complicated process, as Kate mentioned, for keeping them alive. But the goal is to preserve the productive capacity of our economy through the bankruptcy system.

[00:05:04] **Talley:** Let’s take this into sort of current day, and let me just take a poster child example. Hertz, for example, which filed for bankruptcy I think probably sometime in May. You know, it was under a crushing almost $20 billion worth of debt load, creditors breathing down its neck, and, you know, its market effectively disappeared: People stopped traveling, they largely stopped renting cars. So for a company like Hertz that goes into bankruptcy, you know, Ed, what’s the basic process? How is it gonna unfold? What’s supposed to come out the other end?

[00:05:37] **Morrison:** It really depends upon what’s coming in the front end. Though, as complicated as the process is, there are some simple cases and those typically are firms that just took on too much debt. That maybe there was some overexpansion or it went through a leveraged buyout, and it’s really not much different than it was before. It just has a lot of debt. And all we really need to do is rejigger the capital structure and maybe jettison some assets. But if you have a simple case where just a financial restructuring, what’s typically going to happen, and it can take just a few months, the firm’s going to come in filing a case that’s going to automatically commence what’s called an automatic stay. That stops all creditors, shareholders from doing anything. It’s a state of suspended animation that allows the judge to orchestrate a negotiation process. This negotiation process, as is articulated in the bankruptcy code, it is not just complicated, it’s byzantine. But it basically asks the firm to separate its creditors into classes, propose a plan of payment to these creditors, and have creditors vote. And if there are enough votes and there’s a supermajority rule, the plan will be confirmed. The plan basically says, hey, I used to owe you 100, I’m now only going to pay you 60, because frankly, based on the financials I’m showing you right now, that is all I can possibly pay. More than that, typically, there’s going to be some junior class of debt where the plan will say, you know, I’m not going to pay you anything. I’m actually going to give you all the equity of the firm. You’re going to own the firm going forward. And so one of the rules of bankruptcy, too, and that’s what makes it painful for shareholders is they’re typically wiped out. Ownership has shifted to the creditors. But once that’s done, you’ve converted a lot of debt to equity, brought the face value of some debts down, the firm now has a capital structure that’s consistent with his ability to pay, and it leaves happy. Those are the simpler cases. Hertz, I don’t think is a simple case.

[00:07:25] **Talley:** Right.

[00:07:26] **Morrison:** You can have bankruptcies that have financial problems—just too much debt but the rest of business, totally fine. Then there’s firms like Hertz where it’s like, ah there’s some operational problems, too.

[00:07:34] **Talley:** Are there any meaningful alternatives to bankruptcy? Is bankruptcy kind of the only route if you’re trying to find your road to redemption as a debtor who is in financial distress, or are there other ways to go about doing it?

[00:07:43] **Morrison:** Oh, yeah. If you look at data from Moody’s for every 100 firms, and they’re looking at firms with publicly traded bonds, but for every 100 firms that default, about half of them will go into bankruptcy. The other half will do something else. And the common thing you do instead is you talk to your creditors and you reach a deal because frankly, bankruptcy is costly. It’s byzantine. It takes time. And it’s costly to everybody, not just the shareholders who are going to get wiped out, but the creditors who are defending their rights in bankruptcy court because, frankly, they’re worried the judge is going to make a decision that hurts them. So it’s kind of in everybody’s best interest to settle things out of court, much the way it is in law generally that you save a lot of money in clean legal fees if you settle out of court. So with respect to bonds, for example, there’s a common device called the distressed debt exchange. And you see that a lot of defaults are resolved that way.

[00:08:29] **Talley:** In some ways, it’s almost like the road to bankruptcy is the sword of Damocles that’s hanging over people’s heads that might or might not induce them to try to figure out some way to not go into bankruptcy court and rework the nature of the capital structure and the debt obligations of the company.

[00:08:46] **Morrison:** That’s right. You could, some people say that our bankruptcy system might be debtor-friendly, creditor-friendly. In general, it kind of sucks for everybody. You kind of don’t want to go.

[00:08:54] **Talley:** Interesting. All right, so I want to bring you into sort of the current crisis and what seems, at least to me, to my untrained eye, to be a bankruptcy riddle wrapped in an insolvency mystery, cloaked in a COVID quandary, all right? [Laughter.] Back in March, you know, I talked to Kate, I talked to Ed, I talked to others, and I kind of feel like people were predicting this avalanche of bankruptcy filings—small businesses, large businesses, consumer bankruptcies. Thus far, we’re kind of still waiting for the avalanche, aren’t we, Kate?

[00:09:28] **Waldock:** So we were actually wrong about it because there was a dip in bankruptcies for consumers that fell off I’d say around like March or April. Chapter 7s have kind of come back, but Chapter 13 bankruptcies are still lower than trend.

[00:09:43] **Talley:** And just to clarify, Chapter 13 is a consumer bankruptcy. That’s kind of like a workout of a business, right?

[00:09:49] **Waldock:** Exactly. For small businesses, same thing kind of happened. There was you know, they fell off a ledge. There were not that many bankruptcies in April. And then they kind of returned. But they’re still, you know, about where they should have been had it not been for the pandemic. We didn’t see a big rush of bankruptcies in the small business space. And then if we’re talking about large corporations, that’s where maybe we were sort of right, but not really. There was a blip. More large corporations filed for bankruptcy in May, June, July than we would have expected. But it still wasn’t the avalanche that we were expecting.

[00:10:22] **Talley:** Why not? What’s the common wisdom now about why we haven’t seen this influx of new filings?

[00:10:27] **Waldock:** There are a few competing theories. One is probably just that the government gave people a lot of cash, right? It gave people $1,200. It upped the unemployment assistance. And so that was certainly helpful. There was the PPP to businesses. There was a similar program for large businesses. There was also a lot of forbearance. So that means that people could delay paying their interest payments for a little while, which helped. Similarly, you know, there were a lot of programs kind of at the state and local level, but now also at the federal level, to prevent people from being evicted. And then there’s also this theory that courts were shut down so people couldn’t physically go. But I think kind of one of the most underappreciated theories for why there hasn’t been a big surge in bankruptcy is just that there’s so much uncertainty. Right? There’s no point in coming up with a plan that depends on evaluation, which is just a number that represents how much a business is worth or how much money you can make through income in the future, when the future is, like, totally uncertain. Right? Are we gonna have an eighth wave in two years? Is the vaccine coming out soon? Nobody knows. And so there’s no real point in going through this rigid judicial process when there’s so much uncertainty out there.

[00:11:34] **Morrison:** I think there’s a lot to that. I think that if we go by category, for consumers, there is a cost to filing in the sense that you can’t file a lot. That might lead you to wait as long as possible. The economic environment has made it possible to wait with dramatic increases in unemployment insurance. And you can’t really discount the importance of the forbearance Kate mentioned, because many landlords are sitting there thinking, yeah, you haven’t paid your rent. I could kick you out, but who’s going to move in instead?

[00:12:03] **Talley:** So one possibility here. Let me just, I think this is what you guys are saying, is that the economists may only be momentarily wrong and that this is, in fact, a perfect storm. It’s a perfect storm that’s essentially like stalled off of the Florida coast. And at some point it’s going to come, it’s going to come ashore. Is that something that you see happening? I’ll start with you, Ed.

[00:12:25] **Morrison:** Well, in some sense, I think the economists were right, it’s just we were looking in the wrong place. We have seen many, many small businesses fail. Thousands. There’s a very large percentage of small businesses that no longer exist, just they’re not filing for bankruptcy. On one level, that’s not necessarily surprising, because we know from the data that for every 100 small businesses that fail, at most 20 will file for bankruptcy. What is interesting over the past summer is that it seems like almost none of the small businesses are filing for bankruptcy. They’re all just shutting down. Reflecting, I think what Kate is talking about, the uncertainty about the future, that why bear the costs of trying to reorganize a business when you probably won’t be able to prove to your creditors or your judge what you will be able to pay going forward because it’s just sort of completely hard to know. Many of those businesses that have died are organized around a person, and that person is still around. And I spoke to some of these entrepreneurs, and they plan to come back. They may not come back with that business, but they will come back with a different business. And so, in some sense, the death of these businesses is not the death of the productive capacity of the individuals who run those businesses. And so what’s interesting about noting that is that it suggests that bankruptcy doesn’t have as much value add for many small businesses, which is why it’s not being used. Entrepreneurs can just shut a business down and start another one later. Bankruptcy is only useful if the current configuration of assets is something that’s really important to keep together. And that could be true for a lot of businesses. But it turns out not to be true for many, many small-business entrepreneurs.

[00:13:55] **Waldock:** Just to put some numbers on what Ed was saying, as of the end of August, almost 164,000 businesses on the Yelp platform closed permanently. And then there’s this website that’s really cool—I urge you to go to it—it’s called tracktherecovery dot O R G. There, it looks like about a quarter of all small businesses have closed. I think there definitely is still potential for a surge. And if it happens, it’ll probably be after December because there’s a whole lot of good stuff that’s in place right now, but that expires like immediately as of the end of December. So, right? So we got like the pandemic unemployment assistance, federal foreclosure moratoria, student loan forbearance, that’s supposed to end. And then also, you know, even though this is not as set in stone, the PPP, originally eight weeks, it was extended to 24 weeks. And most of the businesses that received PPP money took it around May. Right? So May plus 24 weeks puts us at around kind of mid-November and December. And so it looks like all of this good stuff could run out at the end of December. And unfortunately, it’s not really great timing from an election perspective.

[00:15:04] **Talley:** One of the things that’s pretty unique about, you know, say, comparing the current economic situation to, say, the financial crisis 12 years ago was that this is a crisis of the real economy. Right? That if you’re someone who’s running a restaurant or a travel-oriented industry or a small hotel, there is a reasonable chance that your business is going to stay close to nonexistent for a long period of time. Is this the type of thing that bankruptcy can do anything about?

[00:15:32] **Waldock:** That’s a pretty complicated question. I think if you wanted to build an ideal system, I’m going to introduce what I like to call the hierarchy of forbearance. Take it or leave it. What that looks like to me is that you have businesses at the bottom that pay employees and also kind of make stuff. And then above them, they have landlords and banks and above the landlords. And the banks are the federal government. And so what you want is, in a situation like this where there is this huge negative shock to the real economy, you want everything to kind of be frozen in place and you want everyone to just get by, like just survive this period. You know, we don’t want people out in the streets. We don’t want people starving. Let’s just all, like, do whatever we can to hang on. And so that means everyone needs to be really transparent about how much money they have, how much money they’re making, and just pay whatever they can, which is probably not going to be everything that they owe. Now, bankruptcy in the United States gives us an opportunity to do that. Right? As we’ve discussed, it allows businesses to not pay back all their debts and still survive. Same for consumers. I’m not convinced that bankruptcy is really the right setting. It’s not like we should have forced everyone into bankruptcy to undergo negotiations when we could have just had this happen naturally. And actually, that’s what did happen. A lot of people only paid, let’s say, 80% of their rent or a lot of businesses decided not to pay interest for a year. And that’s been OK with a lot of landlords. It’s been OK with a lot of banks because of the system of incentives that the government put in place at the very top. That was just like, you know, we’re going to be nice to the banks, in exchange, the banks should be nice to the landlords, in exchange, the landlords should be nice to the businesses. So everyone just be nice and try to renegotiate privately. And I think that’s kind of what happened for the most part.

[00:17:16] **Morrison:** There’s a great line that I heard back in the 2008 financial crisis, and it goes like this: When the tide goes out, you see who’s not wearing pants, and the tide has gone out big time in this crisis. I woke up this morning and saw that in the news that the holding company for Ruby Tuesday restaurants has filed for bankruptcy. Now, I haven’t eaten at a Ruby Tuesday in a longtime...

[00:17:35] **Talley:** Come on admit it, Ed, you have.

[00:17:38] [laughter] But so then I thought, oh, that’s kind of interesting. I wonder what story is there? Because, of course, the story is, oh, the pandemic killed us. Well, you type in Ruby Tuesdays, and first article I got was “The Pandemic Hastens Ruby Tuesday’s Decline.” That’s true for Hertz, that’s true for J.Crew. In fact, almost every company you mentioned at the start of this podcast, Eric, has a very troubled history. And that decline was hastened by the current pandemic much of the same way that the so-called profligacy of the various municipalities and states is being revealed in a stark way by the current pandemic.

[00:18:14] **Talley:** And just to be fair, I mean, I think there is this old aphorism that has a kernel of truth: Why waste a good crisis? Right? That crises are moments to rethink, in almost a global way, what you’re doing. And so, you know, on some level, you want these companies to think, how did we get to where we are now, and are there different things that we can do going forward? All right. So now I am going to pivot. You study the bankruptcy system pervasively, and there are certain things that it probably does well and certain things that it doesn’t do well. If I were to ask you, can you give me sort of one idea, how could this bankruptcy system work better both for the operation of companies that file bankruptcy and maybe even for companies that don’t file bankruptcy? What would it look like?

[00:18:57] **Morrison:** To start with, simplification. We began today talking about how complex the process is and we didn’t even scratch the surface. A simpler bankruptcy system could be very useful. We’ve seen in the past few decades the rise of what are called prepackaged bankruptcies that are really quick. You get in, you get out. And judges have been very happy to oversee quick financial restructurings that take a month or two. And various policy groups have thought about ways, how can we simplify the bankruptcy process and say—at least for the simple cases where you just have a leveraged buyout, you just need to reduce the debt load—how can we have a very quick, hopefully painless process that gets us through really quickly if we could have a more mechanical in and out bankruptcy process. I think that would reduce costs, reduce uncertainty, and might even make bankruptcy a more attractive venue.

[00:19:44] **Talley:** Interesting. Kate, monarch for a day: What’s your reform? What’s your fix to the bankruptcy system?

[00:19:51] **Waldock:** I actually totally agree with what Ed’s saying. I think that those are, like, the big picture fixes that we need for the overall system. The ones that I’m going to propose are really, like, born out of this particular crisis. And one of the issues with this pandemic is that there were lockdowns, people were stuck in their homes, they weren’t allowed to go out and shop. And so that made it really tough between landlords and commercial tenants as to what they were going to do about paying that rent. Right? Is it fair for a landlord to force a business to pay rent if people couldn’t leave their houses? And the bankruptcy code is very inflexible when it comes to the treatment of leases. And so I would introduce a little bit more flexibility there that could let judges say, look, if there’s a nationwide lockdown, then it’s OK for a commercial tenant, a business, not to pay rent for the pendency of that lockdown. Another change, this isn’t so much to do with the bankruptcy system, but kind of negotiation in distress and outside of bankruptcy, which has to do with mortgage-backed securities. They make it very hard for you to renegotiate. Because what a mortgage-backed security is, is fundamentally like, you know, it’s a loan to a commercial real estate holder. That’s then, like, combined with a bunch of other loans and then sold to many, many people. And they task one special servicer or one master servicer to kind of like take care of all the loans. A special servicer steps in if any of those loans default and then they kind of handle the negotiation process. But it’s very, very messy. If we could make it easier for securitized loans to be renegotiated in periods of crisis, that would help everybody. We should waive some of the rules of special servicers in periods like pandemics.

[00:21:35] **Morrison:** if you look at statutes and practice, we find that credit markets and corporations take a bunch of decisions that create an absolute mess in bankruptcy and would appear to create lots of costs—huge deadweight losses in bankruptcy. And yet, these practices continue. And so it’s got to be the case that there are first-order benefits of these complicated capital structures and these suicide pacts written into mortgage-backed securitizations that loom so large, these first-order benefits, that those who create these structures think that, well, yeah, it’s going to create a hash in bankruptcy, but we think the probability is sufficiently low that we don’t care about it or we’re overly optimistic. So that’s what makes me think that it would be great to do the things Kate is talking about. I just think that’s never gonna happen. The best we can imagine is that we’re just gonna have, excuse me, a lot of shit shows in bankruptcy. So we’re just gonna have to kind of make that process as simple as possible.

[00:22:37] **Talley:** Both of you use the term complicated process. And I think a lot of people think, man, is bankruptcy complicated. And quite frankly, I think a lot of people off the bat think and bankruptcy is kind of boring, too. And I think a lot of our students think that, too.

[00:22:51] **Morrison:** That’s because the professor might be boring! Me! Not the subject! [Laughter.]

[00:22:56] **Talley:** This is actually part of the reason I want to ask this question, because I think even when I was a law student, I thought, oh, man, this is boring. I don’t even want to take bankruptcy. And only after, you know, I started teaching did I start to think that may be more interesting than I figured it was. So how did you guys get sucked into this? And what is your elevator pitch for someone who might think, oh, this is boring and too technical for me?

[00:23:18] **Morrison:** I like to start with the Anna Karenina principle of Tolstoy, which is that, how does it go: Happy families are all alike. Every unhappy family is unhappy in its own way. And bankruptcy is like that. It’s just a bunch of unhappy families. They’re all radically different. When you talk about businesses, it could be a failing retailer, a failing chemical company. And all the problems are different. Environmental disaster, tort problems. It’s a kind of field that also changes with the economy. The kind of businesses that we see in bankruptcy today are very different than we saw in the last recession of 2008. And what I do notice, and this is the best pitch to law students, is that I’ve never met a bankruptcy lawyer who got bored, and many bankruptcy practices in New York and around the country do not separate between litigation and transactional work because very often the work you’re doing on a bankruptcy case is a lot of documenting deals, but you go into court to advocate for those deals all the time. So it’s a really exciting practice and in both the subject matter and in methodology.

[00:24:22] **Talley:** Now, Kate, you came into this through the business school route, though you’re now sort of joining forces with the bankruptcy lawyer types. What got you into this field initially? And why have you stayed in? Why have you continued to find it interesting?

[00:24:36] **Waldock:** I don’t have any Tolstoy to quote off the top of my head, unfortunately.

[00:24:40] **Talley:** He was reaching on that anyway. [Laughter.]

[00:24:44] **Waldock:** No, you’re right. I did come at this from a slightly different angle. My background in economics and finance had me learning about a lot of cool concepts that businesses and individuals used to strategize. But you never actually get to see that implemented. Right? There is data on corporations, but you can’t see them fighting. Whereas in bankruptcy, if you look at a bankruptcy docket—and especially if you get into the hearings and stuff—it’s so messy and it’s like so raw. And you can actually see all of those economic forces playing out in the bankruptcy docket as well as in the courtroom. And that’s just really fun to watch.

[00:25:17] **Talley:** Ed and Kate, thanks so much for joining us on what was like a completely unenergetic and boring session. It was absolutely terrific. My guests today were Ed Morrison and Kate Waldock.

[00:25:32] **Talley:** Join me next time for another episode of *Beyond “Unprecedented.”* Make sure to subscribe wherever you get your podcasts. Thanks so much for listening.

[00:25:41] **Talley:** *Beyond “Unprecedented”* is brought to you by Columbia Law School

and the Ira M. Millstein Center for Global Markets and Corporate Ownership. This podcast is produced by the Office of Communications, Marketing, and Public Affairs at Columbia Law School. Our executive producer is Michael Patullo. Julie Godsoe, Nancy Goldfarb, and Cary Midland, producers. Editing and engineering by Jake Rosati. Writing by Martha Moore and Dan Shaw. Production coordination by Zoë Attridge. Special thanks to Erica Klein and Brea Hinricks at the Millstein Center. If you like what you hear, please leave us a review on your podcast platform. If you’re interested in learning more about law, the economy, and society, visit us at [law.columbia.edu](https://www.law.columbia.edu/), or follow us on Facebook, Twitter, and Instagram.