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IMPACT OF COVID-19 ON BANKRUPTCY

WHITEPAPER

Introduction.

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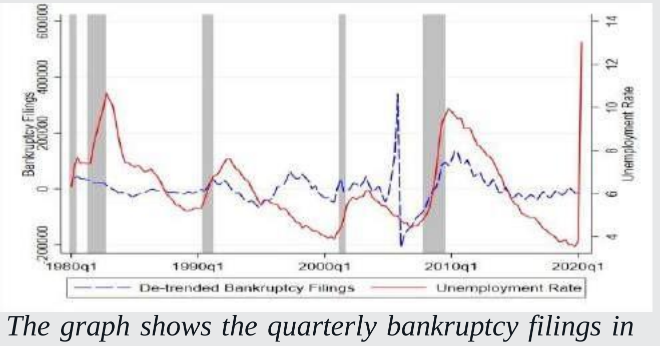
The COVID-19 pandemic has impacted daily life in the US and caused a significant slowdown in the US economy. Also, this has led to lower consumer spending and the worst unemployment rate since the Great Depression. As a result of the crisis, Congress and the Federal Reserve took swift action, including a $600 weekly boost in unemployment benefits, $1,200 stimulus checks, and over $1.2 trillion in lending given to the Paycheck Protection Program (PPP) and Main Street Lending programs. Other measures have been taken by several state and local governments as well as federal agencies and industry partners in an effort to prevent the onset of severe financial hardship for families and businesses (Wang, Yang, Iverson, & Kluender, 2020).



The graph shows the quarterly bankruptcy filings in the United States and the unemployment rate. There has been a level shift in the number of filings following the 2005 bankruptcy reform, as well as a time trend when adjusting bankruptcy filings. NBER recessions are reflected in the shading. The Bureau of Labor Statistics (BLS) compiles data on court filings in the United States (Wang et al.,2020).

Wang et al. (2020) reported that historically, bankruptcy filings have closely tracked economic conditions as businesses and households seek relief from macro-economic shocks.

Wang et al. (2020) shows that the time-series of unemployment rates and bankruptcy filings at the national level, after adjusting the number of bankruptcy filings for a level shift that occurred after the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) and a general time trend.

The correlation between the two series as indicated in the graph above is 0.42, and increases to 0.54 when dropping 2005 due to sharp changes in filing rates around the passage of BAPCPA . While other factors besides the business cycle affect bankruptcy filing rates, distress and bankruptcy generally increase as macroeconomic conditions deteriorate, and this relationship was especially strong during the 2007-2009 recession and subsequent recovery (Wang et al., 2020). Historical increases in unemployment and bankruptcy are largely contemporaneous at the quarterly level, suggesting that bankruptcy rates would have increased by the second quarter of 2020 under more normal circumstances.

Impact of Covid-19 on Bankruptcy

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The COVID-19 recession's specific characteristics raise questions about what we might expect in the bankruptcy courts. The scale of the economic shock means that both individuals and corporations may face severe financial hardship. Between January and April, consumer expenditure, the main component of US GDP, fell by more than 30%. (Chetty, Friedman, Hendren, Stepner et al., 2020). According to the U.S. Census Pulse surveys, over half of all families lost money between March 13th and July 21st, and 74% of smaller firms lost money between April 26th and May 2nd (U.S. Census Bureau, 2020a,b), cited in Wang et al (2020). However, a strong legislative response, increased uncertainty, and difficulties accessing the bankruptcy system may cause bankruptcy filings to be delayed or avoided.

Wang et al. (2020) reported that the massive support implemented by the Families First Coronavirus Act, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, and other policies in response to the dramatic shock to economic activity would be expected to mitigate the potential wave of bankruptcy filings predicted by the rise in unemployment rates.

Consumers have received liquidity in the form of stimulus checks and increased unemployment insurance (Bartik, Bertrand, Cullen, Glaeser, Luca and Stanton, 2020).

The Paycheck Protection Program and the Federal Reserve's Main Street Lending programs and other facilities have helped to support bank and bond credit for both large and small businesses. Large-scale forbearance policies and moratoria on evictions and foreclosures have also aimed to reduce financial distress for businesses and consumers alike.

Wang et al. (2020) assert that despite these large policy responses, evidence suggests that there is still a large amount of financial distress in the economy, with 20–30 percent of households experiencing food insecurity, and only about half of furloughed individuals receiving unemployment insurance benefits as of early June (Bitler, Hoynes and Schanzenbach, 2020). In addition, there is a large amount of uncertainty regarding the amount and length of continued government support and the duration and depth of the ongoing economic slowdown (Ganong, Noel and Vavra, 2020). Many potential bankruptcy filers may be waiting for the fog to clear before filing.

Wang et al. (2020) in their quest to understand this trend, collect real-time information on the universe of bankruptcy filings in the United States and analyze the impact of the COVID-19 crisis on filing rates. They posit several potential forces driving changes in bankruptcy filing rates and the implications of these trends for the bankruptcy system and the financial health of businesses and households.

They went further to compare filing rates from January 1st to August 31st of 2020 to the same period in 2019, and use regression analysis to control for seasonal trends in order to assess the timing and magnitude of changes due to COVID-19.

Wang et al. (2020) discovered that bankruptcies closely tracked contemporaneous unemployment rates during the last business cycle. However, this relationship has reversed during the COVID-19 crisis so far.

They assert that if the historical relationship between the unemployment rate and consumer bankruptcy filings had continued, we would have expected to see over 200,000 additional consumer filings in the second quarter of 2020 relative to the second quarter of 2019. Instead, there were about 81,000 fewer consumer filings year-over-year in the second quarter. Both consumer Chapter 7 and 13 filings dropped dramatically starting in mid-March, before their trends diverged. While consumer Chapter 7 filings initially declined by 34 percent year-over-year from March 15th to April 30th, they began rebounding in mid-April and

have stabilized around a 20 to 30 percent year-over-year decline from May through August. Consumer Chapter 13 filings did not rebound in April and have remained at 55-65 percent below 2019 levels through the end of August.

Business Chapter 11 filings have grown by 35 percent year over year in their sample, while files with more than $50 million in assets have increased by roughly 200 percent, according to media sources.

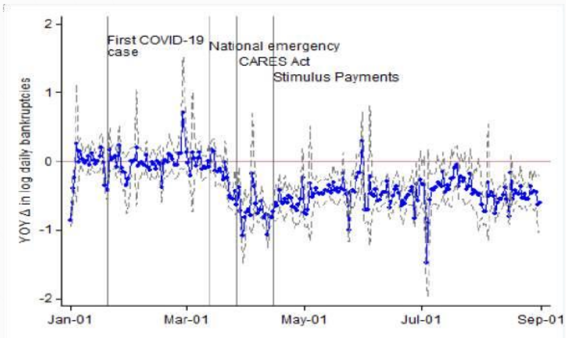
While the mainstream media has concentrated on the rise in bankruptcy filings by major organizations, they present new data suggesting small business bankruptcies have declined during the COVID-19 pandemic thus far. Business Chapter 7 filings (which are dominated by small and medium-sized businesses) have decreased by 20 to 30 percent year-over-year for most of the time from mid-March to the end of August, and are down by 13 percent year-over-year from January to August, similar to consumer Chapter 7 filings.

They discover that the negative association between unemployment and bankruptcy during the COVID-19 crisis is true not only in the time series but also in the cross-section, by evaluating the relationship between year-over-year variations in state unemployment and bankruptcy rates (Wang et al., 2020).

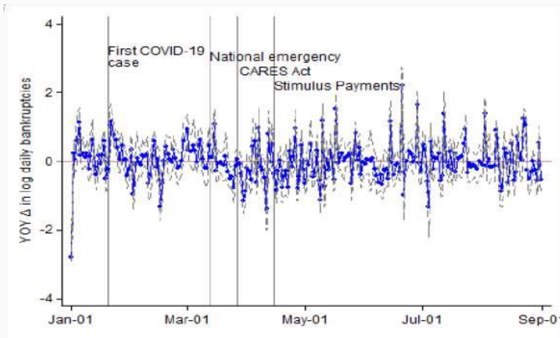
Their findings show that large corporations have a completely different relationship with bankruptcy than small businesses and consumers.

While large corporations may be able to turn to bankruptcy as a source of protection with ease, small businesses and consumers generally see it as a last choice and are more inclined to avoid filing if there isn't a precipitating incident. The COVID-19 pandemic has so far corresponded with a wave of significant business filings, mostly driven by sectors like retail, which were already struggling before the outbreak.

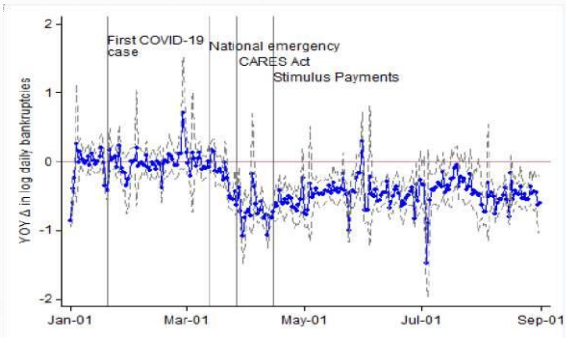
Consumer and small business filings, on the other hand, dropped sharply at the start of the crisis in mid-March, particularly in high-unemployment areas, owing to a combination of financial, physical, and technological barriers to accessing the court system, as well as increased economic uncertainty. Despite the CARES Act's huge stimulus measures, its implementation on March 27 did not significantly alter the downward trend in filing rates that had already begun (Wang et al., 2020).



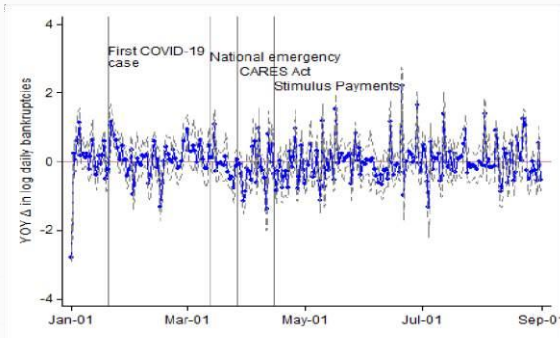
(a) Consumer



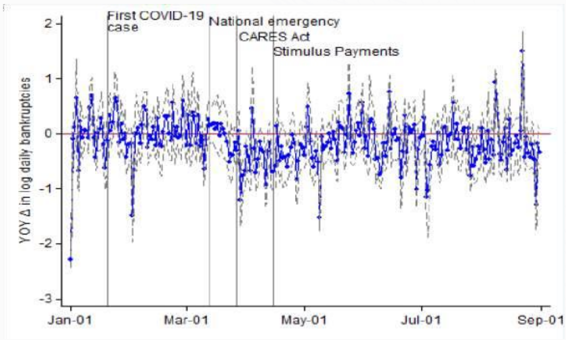
(b) Business



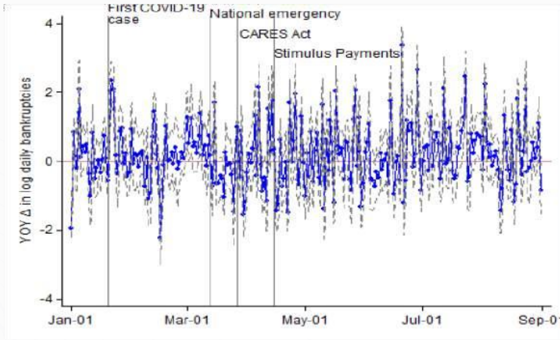
(a) Consumer Chapter 7



(b) Consumer Chapter 13



(a) Business Chapter 7



b) Business Chapter 11

Source*: Wang, J., Yang, J., Iverson, B. C. & Kluender, R. (2020). Bankruptcy and the COVID-19 Crisis.*

Conclusion

Conclusively, Wang et al. (2020) documented five key facts about bankruptcy during the COVID-19 crisis.

- First, corporate Chapter 11 filings have increased year-over-year throughout 2020, a trend that is particularly dramatic for the largest businesses and the retail and restaurant sectors.
- Second, in contrast with business Chapter 11, all other major types of filings – consumer Chapters 7 and 13 and business Chapter 7 – were on trend from 2019 prior to the severe onset of the COVID-19 pandemic and dropped significantly starting in mid-March, a drop that has persisted through the end of August.
- Third, while both consumer and business Chapter 7 filings rebounded from mid-April through mid-July, consumer Chapter 13 filings remained at 55 to 65 percent below 2019 levels through August.
- Fourth, while the rebound in Chapter 7 filings reached close to 2019 levels by mid-July, they declined again between mid-July and the end of August.
- Finally, in the cross section, states that experienced the largest increases in unemployment during the spring and summer saw the greatest declines in bankruptcy. The gap between high and low unemployment states was widest in March and April and closed moderately over time.

They went further to explain that the dramatic decline in consumer and small business bankruptcies following the declaration of a national emergency on March 13th could be driven by a variety of factors. One reason for the initial decline in filings is state and local social distancing policies, which include shutdowns and changes in procedures within the court system. Approximately 55 of 94 United States Bankruptcy Courts moved to telephonic hearings between March 13 and April 1, 2020, with some shutting down physically and/or experiencing outbreaks.

The changes in court operations may have made it even more difficult for vulnerable populations to access the bankruptcy system, as updated filing rules frequently made filing without an attorney and/or internet access more difficult, and wet signatures on printed documents were more difficult to obtain during the pandemic (Skiba, Jim'enez, Miller, Foohey, and Greene, 2020). Foot traffic to bankruptcy attorney offices has almost certainly decreased as well, and this trend may have a disproportionate effect on **"supply-driven"** Chapter 13 filings in comparison to **"demand-driven"** Chapter 7 filings (Lawless, 2013).

Along with physical and technological impediments to filing, the first commencement of the COVID-19 issue was accompanied by substantial increases in unemployment and a sluggish unemployment insurance system, which left many households and companies without financial support for several months. As Gross, Notowidigdo, and Wang (2014) and others have demonstrated, money restrictions are a significant barrier to filing, and this aspect may have contributed to the initial fall.

References

A survey of thousands of small businesses between March 28 and April 4, 2020 found widespread uncertainty about how long the COVID-19 crisis would last, the policy response, and whether their business would survive (Bartik, Bertrand, Cullen, Glaeser, Luca and Stanton, 2020).

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Taking into account the $600 increase in weekly unemployment benefits implemented by the CARES Act, potential replacement rates for lost income are above 100 percent for the median qualifying unemployed worker (Ganong, Noel and Vavra, 2020). According to the Bureau of Economic Statistics, the personal savings rate reached a high of 32 percent in April, and personal income grew by 11 percent from March to April.

U.S. Census Bureau (2019) "Business Dynamics Statistics (BDS)," Technical Report, U.S. Census Bureau. Available at https://www.census.gov/programs-surveys/bds.html.

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Appendix

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Difference between bankruptcy cases filed under chapters 7, 11, and 13

Chapter 7:	Chapter 11:	Chapter 13:
Often called the liquidation chapter, chapter 7 is used by individuals, partnerships, or corporations who are unable to repair their financial situation. In chapter 7 asset cases, the debtor's estate is liquidated under the rules of the bankruptcy code. Liquidation is the process through which the debtor's non-exempt property is sold for cash by a trustee and the proceeds are distributed to creditors.	Often called the reorganization chapter, chapter 11 allows corporations, partnerships, and some individuals to reorganize, without having to liquidate all assets. In filing a chapter 11, the debtor presents a plan to creditors which, if accepted by the creditors and approved by the court, will allow the debtor to reorganize personal, financial or business affairs and again become a financially productive individual or business.	An individual with a regular income who is overcome by debts, but believes such debt can be repaid within a reasonable period of time, may file under chapter 13 of the bankruptcy code. Chapter 13 permits the debtor to file a plan in which the debtor agrees to pay a certain percentage of future income to the bankruptcy court trustee for payment to creditors. If the court approves the plan, the debtor will be under the court's protection while repaying such debts.

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