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# The Bankruptcy Rush: Rethinking Director Duties in Crisis

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**FINANCIAL POLICY  
& REGULATION**

## Overview

- What are the theoretical justifications for imposing special director duties in financially distressed firms?
- Why special director duties are costly in times of crisis: Introducing bankruptcy congestion costs
- How legislators and market players mitigated bankruptcy congestion costs during the Covid-19 crisis?
- Policy Proposals

## What are the Traditional Justifications for Director Duties in the Zone of Insolvency?

### Continuation Bias

- The Moral Hazard Problem / Option Theory
- Managers Wish to Keep their Position
- Optimistic Cognitive Biases

### Excessive Risk Taking

- The Moral Hazard Problem / Option Theory
- “Gambling” Creditors’ Money
- Inefficient Investments
- Fraudulent Transfers



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# The Case against Director Duties



**Congestion  
Costs**



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## How Bankruptcy Congestion Impacts the Court System and the Market?

### Increased Risk of Error in Judgment

- Crowded Dockets
- High Competence Costs
- Fewer Hearings
- Longer Proceedings

### Excessive Supply of Assets For Sale

- Low Asset Prices Reduce Creditor Recovery
- Less Likely to Have Competitor Buyers
- Collateral Value Declines (LTV Increases)



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## Bankruptcy Floodgates

### Germany: Regulatory Suspensions

- Temporary suspension of the obligation to file for insolvency
- Used before in 2013 and 2016 due to severe flooding
- Extended twice

### Australia: Safe Harbors

- COVID-19 Safe Harbor (2020): temporarily protected directors from personal liability for company debts incurred in the ordinary course of business
- Extended once

## Bankruptcy Floodgates

### US: Contractual Suspensions

- Temporary suspensions of contractual rights and covenant relaxations
- Temporary EBITDA adjustments or resets, changes to MAC (Material Adverse Change) provisions, periodic waivers, no default representations, general standstill or forbearance agreements
- According to S&P data, US leveraged loans have experienced 172 covenant-relief amendments from April 1, 2020, to December 1, 2020



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## Policy

### A Crisis Resilient Bankruptcy Regime

- Regulatory Floodgates v. Market Floodgates
- Reconsidering mandatory rules that force managers to file for bankruptcy
- Avoiding ad-hoc shifts in director duties
- Promoting alternative forums for bankruptcy resolution
- Rethinking trustees' incentives





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# Thank You!

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