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Towards a Principled Approach for Bailouts of COVID-distressed Critical/Systemic Firms

Law Working Paper N° 571/2021
March 2021

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Abstract

In this essay, we propose a principled approach for government bailouts of critical/systemic firms who find themselves in COVID-19-induced financial distress. We also demonstrate why bankruptcy is the wrong tool to address the problems of these types of firms.

The current pandemic threatens lives and livelihoods across the world. A key difference compared to previous market shocks is that lockdowns and related measures have, in certain instances, made it impossible for businesses to conduct their operations. This has resulted in a very specific type of distress, one that bankruptcy is not in the best position to address effectively. If there are no revenues, the design of bankruptcy laws makes them an inadequate tool – and the sheer volume of companies going through the process may put severe stress on the system. The difficulties that the vast majority of companies are encountering may be better solved using different tools: bailouts, bail-ins or a combination thereof, deployed by the government in wide-ranging statutory schemes.

However, these schemes may not adequately address the issues of all companies; and the preservation of some of them – those that we refer to as critical/systemic – may be of such significant value to society that more intense assistance from the government is justified. We engage with the characteristics of firms that should be considered critical/systemic and the principles that should guide ad hoc rescues of those companies by the government. Firms are critical/systemic if their failure imposes significant negative externalities on the economy (or, conversely, their preservation generates significant positive externalities) or if they provide the public with an "infrastructure" not otherwise provided by the private sector. If firms are critical/systemic, the government should have the ability to bail them out, going beyond applicable statutory schemes and ensuring that the relevant externalities are considered when deciding whether to keep these companies as going concerns. Bankruptcy is a private process. It is not designed to vindicate such public considerations.

Government bailouts, however, should be governed by principles, as any government intervention in the economy, and its associated efficiency and distributional effects must be considered with care. The guiding principles that we propose and elaborate on are (i) proportionality, (ii) efficiency, (iii) equity and (iv) transparency. The application of these principles should ensure that, if the government takes ownership of a private firm through an ad hoc bailout, this is a tool of last resort, and not more than temporary – and that the pre-distress investors properly contribute to the necessary measures.

Keywords: COVID-19, Bankruptcy, Bailout, Bail-in, Critical/Systemic Firms, Public Policy, Principled Regulation

JEL Classifications: K2, E6, G3

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Abstract

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However, these schemes may not adequately address the issues of all companies; and the preservation of some of them – those that we refer to as critical/systemic – may be of such significant value to society that more intense assistance from the government is justified. We engage with the characteristics of firms that should be considered critical/systemic and the principles that should guide *ad hoc* rescues of those companies by the government. Firms are critical/systemic if their failure imposes significant negative externalities on the economy (or, conversely, their preservation generates significant positive externalities) or if they provide the public with an "infrastructure" not otherwise provided by the private sector. If firms are critical/systemic, the government should have the ability to bail them out, going beyond applicable statutory schemes and ensuring that the relevant externalities are considered when deciding whether to keep these companies as going concerns. Bankruptcy is a private process. It is not designed to vindicate such public considerations.

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Introduction

The COVID-19 pandemic threatens lives and livelihoods across the world. The necessary healthcare measures adopted by governments across the globe, from social distancing to strict lockdowns, disrupt the business models of a large number of companies. Scholars on both sides of the Atlantic have gone to significant lengths to establish the best way to meet the challenge of massive numbers of businesses simultaneously in distress across vast parts of the economy.[3] Policymakers are committing public rescue funds to assist struggling firms on an unprecedented scale.[4] However, irrespective of how well constructed and implemented the general policy response may be, it will not be sufficient in all cases.

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[3] *See*, *e.g.*, Kristin van Zwieten, Horst Eidenmüller and Oren Sussman, *Bail-outs and Bail-ins are better than Bankruptcy: A Comparative Assessment of Public Policy Responses to COVID-19 Distress*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (ECGI) LAW WORKING PAPER NO. 535/2020, August 18, 2020 (revised November 14, 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3669541 (last visited February 3, 2021); Jared Ellias and George Triantis, *Congress is ignoring the best solution for troubled companies: bankruptcy*, FORTUNE, May 15, 2020, https://fortune.com/2020/05/14/bankruptcy-cares-act-aid-coronavirus/ (last visited February 3, 2021); Edward R. Morrison and Andrea C. Saavedra, *Bankruptcy's Role in the COVID-19 Crisis*, Working Paper June 26, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3567127 (last visited February 3, 2021); David Skeel, *Bankruptcy and the coronavirus*, ECONOMIC STUDIES AT BROOKINGS, April 21, 2020, https://www.brookings.edu/research/bankruptcy-and-the-coronavirus/ (last visited February 3, 2021); David Skeel, *Bankruptcy and the coronavirus: Part II*, ECONOMIC STUDIES AT BROOKINGS, July 6, 2020, https://www.brookings.edu/research/bankruptcy-and-the-coronavirus-part-ii/ (last visited February 3, 2021); Peter Coy, *Stiglitz calls for 'Super Chapter 11' to Avoid Systemic Collapse*, BLOOMBERG BUSINESSWEEK, April 9, 2020 https://www.bloomberg.com/news/articles/2020-04-09/could-super-chapter-11-help-an-economy-avoid-systemic-collapse (last visited February 3, 2021); Todd Baker & Kathryn Judge, *How to Help Small Businesses Survive COVID-19*, Columbia Law School Faculty Publications, 2020, https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3643&context=faculty_scholarship (last visited on February 25, 2021).

[4] The latest announcement in this regard can be found, for the US, in Lauren Fedor and James Politi, *House of Representatives passes $1.9tn Covid stimulus package*, FINANCIAL TIMES, February 27, 2021, https://www.ft.com/content/21c4bdb4-41eb-4c57-b4af-630da956a950 (last visited March 1, 2021); for the UK, see George Parker, *Sunak to give £5bn boost to Covid-hit companies in Budget*, FINANCIAL TIMES, February 28, 2021 https://www.ft.com/content/9c6e7088-5577-4b17-adc1-502bffd33a76 (last visited March 1, 2021). A report by McKinsey & Co. notes that, already during Summer 2020, the size of the economic stimulus deployed by Western democracies significantly exceeded, in terms of percentage of GDP, the stimulus advanced during the Great Recession (*see* Ziyad Cassim, Borko Handjiski and Yassir Zouaoui, *The $10 Trillion rescue: How governments can deliver impact*, MCKINSEY & CO. OUR INSIGHTS, June 5, 2020, available at https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-10-trillion-dollar-rescue-how-governments-can-deliver-impact (last visited February 20, 2021)). In the case of the US, we see an increase from 4.9% to 12.1%; for other countries, the increase is even steeper: 1.5% to 14.5% in the UK, 2.2% to 21.0% in Japan and 3.5% to 33.0% in Germany. Another significant reference point, in relation to the US, is that with the packages approved in December 2020, the size of the fiscal response exceeds $5 trillion and far surpasses, in terms of percentage of GDP, the size of the response to the Great Recession (*see* Committee for a Responsible Federal Budget, *The Federal Response to COVID-19 will be Larger than the Great Recession Response*, December 22, 2020, available at https://www.crfb.org/blogs/fiscal-response-covid-19-will-be-larger-great-recession-response (last visited February 20, 2021)). These significant responses to the pandemic (addressed at both

Since the outbreak of the COVID-19 pandemic, a number of companies have emerged as potential candidates for special treatment by their respective governments, in an attempt to keep them operating outside bankruptcy.[5] We have already witnessed headline-grabbing bailouts, such as the German government rescue of flag carrier Lufthansa[6] and tour operator TUI[7], France stepping in to assist Renault[8] (and carmakers generally)[9] or the US Treasury bailout of defense contractor YRC Worldwide.[10] More such *ad hoc* bailouts will undoubtedly follow as the economic impact of the COVID-19 pandemic continues to slash the financial resources of companies across the globe. Additional government interventions are already being contemplated in other high-profile cases, such as with respect to railroad operator Eurostar or Franco-Dutch airline Air France-KLM.[11]

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businesses and households) are, in principle, intended to stabilize the economy – and not to affect the allocation of resources or redistribute them. However, if stabilization is the only objective, well-respected scholars are starting to voice their concerns that the stimulus size may be too large and may well lead to the creation of some serious undesirable side effects (essentially inflationary pressures and an overheated economy). *See* James Politi, *Democrats hit back at Summers after criticism of stimulus bill*, FINANCIAL TIMES, February 6, 2021, https://www.ft.com/content/2ed793d2-fb65-4ec7-9b4c-5851b2c780f3 (last visited February 25, 2021), for an overview and references to the views espoused by Larry Summers and Olivier Blanchard. Also, *see* Lawrence H. Summers, *Opinion: My column on the stimulus sparked many questions. Here are my answers*, THE WASHINGTON POST, February 7, 2021, https://www.washingtonpost.com/opinions/2021/02/07/my-column-stimulus-sparked-lot-questions-here-are-my-answers/ (last visited February 25, 2021).

[5] Note that throughout this essay, we will be using the term bankruptcy in its normal meaning in the United States, thus covering what for the purposes of English law (and in Continental Europe) would be referred to as "insolvency".

[6] Joe Miller and Laurence Fletcher, *Lufthansa shareholders back €9bn bailout package*, FINANCIAL TIMES, June 25, 2020, https://www.ft.com/content/e7f87a03-e77f-46cc-933e-95cd50a60640 (last visited February 20, 2021).

[7] Bryce Elder, *Two-tier ownership is Tui's passport to nowhere*, FINANCIAL TIMES, December 10, 2020, https://www.ft.com/content/d96b4551-e235-4096-93a7-932dff4a5230 (last visited February 20, 2021).

[8] For the announcement, *see* Reuters Staff, *France's Renault reaches deal on 5 billion euro state-backed loan: sources*, REUTERS, May 19, 2020, https://www.reuters.com/article/health-coronavirus-renault-loan/frances-renault-reaches-deal-on-5-bln-eur-state-backed-loan-sources-idUSP6N2BQ03U (last visited February 20, 2021). For the finalization of the deal with the government, *see* Reuters Staff, *Renault finalizes $5.6B credit facility with French state*, AUTOMOTIVE NEWS EUROPE, June 2, 2020, https://europe.autonews.com/automakers/renault-finalizes-56b-credit-facility-french-state (last visited February 20, 2021). Note that before this bailout (a €5bn facility), the French government already owned 15% of the carmaker (and had been the sole owner until its privatization in 1996).

[9] Katy Dartford and Craig Crowther, *France promises €8bn to bail out struggling car industry*, EURONEWS, updated May 27, 2020, https://www.euronews.com/2020/05/27/france-promises-8bn-to-bail-out-struggling-car-industry (last visited February 20, 2021).

[10] James Politi and Sujeet Indap, *US Treasury takes stake in trucking company with $700m bailout*, FINANCIAL TIMES, July 1, 2020, https://www.ft.com/content/3d614d3f-6b58-4df5-9e25-e2894de2c479 (last visited February 20, 2021).

[11] For Air France-KLM *see* David Keohane, *Air France-KLM warns of deeper pain as fresh aid set to finally land*, FINANCIAL TIMES, February 18, 2021, https://www.ft.com/content/348df777-250b-4ade-987c-e0333dbab5ed (last visited February 20, 2021). For Eurostar, *see* Gill Plimer, Jim Pickard and Victor Mallet, *Eurostar calls for UK bailout after passenger numbers collapse*, FINANCIAL TIMES, January 17, 2021, https://www.ft.com/content/fc5ab797-15ed-4acc-9289-dfc2c3ad51b9 (last visited February 20, 2021) (on the UK perspective on the bailout) and Alexandre Holroyd, *Letter: It is short-sighted for the UK to rebuff Eurostar's bailout bid*, FINANCIAL TIMES, January 25, 2021, https://www.ft.com/content/6e7f32b7-be30-43fd-9f41-0c963e424dac (last visited February 20, 2021) (on the French perspective). Note that Eurostar (the railroad operator) is different from Getlink/Eurotunnel, the owner of the actual

This narrower subset of businesses, the ones we will refer to as critical/systemic, arguably will warrant an *ad hoc*, tailored response – both because their situation cannot be effectively remedied with all-encompassing measures and general stimuli to the economy and because their particular characteristics call for such a heightened effort.

This essay intends to make two key contributions in this respect. The first is to explain why it is not a good idea to let critical/systemic businesses go through bankruptcy proceedings. The second is to detail the principles that should be followed when implementing alternative proceedings designed to deal with the distress of those critical/systemic businesses, what we will generally refer to as "(non-statutory) *ad hoc* bailouts".

We begin in Part I by explaining why the current wave of COVID-distressed firms is special, and why bankruptcy laws may not be the right tool to deal with these firms. We subscribe to the view that the appropriate way to manage the cohort of distressed businesses resulting from the pandemic is primarily through statutory schemes of government-led bailouts or government-mandated bail-ins.[12] In Part II we discuss which characteristics are required for a business to be considered critical/systemic and thus be a potential subject of a "(non-statutory) *ad hoc* bailout" (as well as why those characteristics make bankruptcy an especially poor tool to deal with this type of businesses). Part III then builds on the concept of (non-statutory) *ad hoc* bailouts and the characteristics of critical/systemic businesses to establish the guiding principles for the implementation of such bailouts. These are public interventions with public money to pursue public objectives. It is crucial that the rights of everyone involved (from the shareholders of the companies to the governments and the taxpayers) are properly safeguarded and the intervention does not have unintended and adverse consequences for public welfare.

below-ocean infrastructure, which has a quite storied relationship of its own with bankruptcy. It is important to consider that in both these cases, Eurostar and Air-France KLM, (at least some of) the relevant governments already hold an equity stake in the companies: France owns 55% of Eurostar through state-owned SNCF and 14% of Air France-KLM; Netherlands owns 14% of Air France-KLM; Belgium owns 5% of Eurostar through state-owned SNCB; the UK owned 40% in Eurostar until 2015.

[12] *See* Van Zwieten, Eidenmüller and Sussman, *supra* note 3.

I. Bail-ins, bailouts and bankruptcy – a comparative assessment

With every shock or crisis there is always the temptation to justify what is unique about it and why our past models do not work. Most of the time, there is nothing that new. However, the COVID-19 pandemic has indeed created a quite peculiar situation for many businesses. The public health measures adopted by governments across the globe have resulted in a very specific situation affecting vast numbers of businesses across most industries: economically viable (and financially sound) businesses have seen their revenues evaporate overnight.[13] In addition, these circumstances often combine with other issues pre-dating the COVID-19 pandemic, such as very high levels of debt in the capital structures of companies across both sides of the Atlantic,[14] and a tally of "zombie" companies[15] far exceeding that seen during the Great Recession.[16]

Bankruptcy law is a useful tool to reorganize businesses in normal times, whether in the growing or contracting phase of a regular business cycle. The bankruptcy process is governed by legal rules providing certainty and predictability. Many jurisdictions around the world have one or more

[13] To give some reference points, in the UK the number of businesses in significant financial distress without government support has been steadily increasing from an estimated 500,000 in Q1 2020 (in research by Begbies Traynor referred to by Daniel Thomas, *More than 500,000 UK companies in financial distress as support ends*, FINANCIAL TIMES, October 29, 2020 https://www.ft.com/content/1bf6edab-0744-4dac-8334-d56b29bf6c3d (last visited February 22, 2021)) to more than 630,000 in Q4 2020 (*see* the updated research by Julie Palmer of Begbies Traynor, *630,000 UK businesses now in significant financial distress as new lockdown comes into effect*, January 21, 2021, https://www.begbies-traynorgroup.com/news/business-health-statistics/news/firm-news/630000-uk-businesses-now-in-significant-financial-distress-as-new-lockdown-comes-into-effect (last visited February 22, 2021)).

[14] For Europe, *see* Robert Smith, *Debt-laden borrowers revel in Europe's buyout boom*, FINANCIAL TIMES, February 6, 2019, https://www.ft.com/content/0fa9a75e-1b0e-11e9-9e64-d150b3105d21 (last visited February 22, 2021). For the US, *see* Joe Rennison and Colby Smith, *Debt machine: are risks piling up in leveraged loans?*, FINANCIAL TIMES, January 21, 2019, https://www.ft.com/content/64c9665e-1814-11e9-9e64-d150b3105d21 (last visited February 22, 2021).

[15] "Zombie" companies are defined as companies that are unable to cover debt-servicing costs from operating profits (or cash flows) for an extended period. *See*, for instance, Ryan Banerjee and Boris Hofmann, *The rise of zombie firms: causes and consequences*, BIS QUARTERLY REVIEW, September 2018, https://www.bis.org/publ/qtrpdf/r_qt1809g.pdf (last visited February 22, 2021).

[16] For Europe, *see* Claire Jones, *European Zombification becomes even scarier*, FINANCIAL TIMES, December 3, 2020, https://www.ft.com/content/da175a86-17ad-44bf-9237-db8d4708fb21 (last visited February 22, 2021). For the US, *see* Joe Rennison, *Pandemic debt binge creates new generation of 'zombie' companies*, FINANCIAL TIMES, September 14, 2020, https://www.ft.com/content/9b304e20-49cf-4fba-81a0-4d06f930d7a1 (last visited February 22, 2021). For a cautionary tale of the potentially negative consequences to the companies' capital structures and viability even once the COVID-19 abates, *see* Eric Platt, *Distressed debt specialist Howard Marks warns on corporate borrowing burden*, FINANCIAL TIMES, January 5, 2021, https://www.ft.com/content/5585b123-7b9d-40fe-8f63-95f7491e8193 (last visited February 22, 2021).

dedicated "restructuring proceedings" on their statute book.[17] In jurisdictions such as the US and the UK, there is a long history of fine-tuning of this type of law[18] and a great ecosystem of judges, lawyers, bankers and other bankruptcy practitioners that has been optimized for a certain "normal", which includes anticipated downturns in the business cycle.[19]

However, the design features of bankruptcy procedures are inapt to handle the massive influx of COVID-distressed businesses. Bankruptcy is complicated and costly. A procedure such as Chapter 11 of the Bankruptcy Code in the United States is geared towards an encompassing financial and possibly economic restructuring of a distressed firm. The firm's finances are rescheduled, and management gets some "breathing space" for an operational restructuring in a lengthy process that could last more than a year. However, this benefit comes at a cost: the direct and indirect costs of bankruptcy can eat up as much as 10-20% of a firm's value or even more.[20]

The overwhelming majority of COVID-distressed firms does not need such a process, nor are these firms in a position to afford the bankruptcy costs just mentioned. These firms do not require a

[17] From Chapter 11 in the US to proceedings such as the scheme of arrangement, the restructuring plan or the company voluntary arrangement under English law, the *procédure de sauvegarde* in France, the *Schutzschirmverfahren* in Germany, the *concordato preventivo* or the *accordi per la ristruturazzione dei debiti* in Italy, or the *concurso de acreedores* in Spain.

[18] *See*, for instance, the reform of Chapter 11 introduced by the Small Business Reorganization Act of 2019, which included a new Subchapter V and brought about the largest reform of small business bankruptcy in more than a decade.

[19] Therefore, scholars are often skeptical about potentially permanent changes of the system to deal with out-of-the-ordinary situations. *See*, for instance, Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions*, 82 TEMP. L. REV. 449 (2009). Furthermore, the efficiency implications of the existing regimes are reasonably well understood; for instance, there is evidence supporting the fact that bankruptcy does a good job in filtering between companies that should be liquidated or reorganized, thus ensuring a proper allocation of assets to their best and highest-value use. *See* Edward R. Morrison¸ *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcy*, 50(2) J. L. & ECON. 381 (2007).

[20] For indirect costs, a 1998 paper by Andrade and Kaplan pointed to 10-20% for large, leveraged companies: Gregor Andrade and Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53(5) J. FIN. 1443 (1998). Direct costs for large companies are assessed at around 1%; *see*, e.g., LYNN M. LOPUCKI AND JOSEPH W. DOHERTY, *Professional Overcharging in Large Bankruptcy Reorganization Cases*, 5 J. EMPIRICAL LEGAL STUD. 983 (2008). Though the level of direct costs seems to be relatively settled in the literature, the same cannot be said about indirect costs. For small and medium-sized businesses, costs may be as high as 30%; *see* Skeel, *supra* note 3. For a recent survey of research on direct and indirect costs of bankruptcy, *see* EDWARD I. ALTMAN, EDITH HOTCHKISS AND WEI WANG, CORPORATE FINANCIAL DISTRESS, RESTRUCTURING AND BANKRUPTCY: ANALYZE LEVERAGED FINANCE, DISTRESSED DEBT, AND BANKRUPTCY (4th ed. 2020), at 71-81. *See* also STEPHEN J. LUBBEN, *The costs of corporate bankruptcy: how little we know*, in RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW (Barry E. Adler ed., 2020) for another review of recent research on bankruptcy costs and insights on internal institutional issues that may be affecting the magnitude of these costs (particularly direct costs).

substantial financial and/or economic restructuring. Rather, they are experiencing a temporary cash-flow problem because of lockdown-induced trading disruptions. What these firms need is temporary and limited financial assistance. That is not what bankruptcy is designed to provide.

Hence, bankruptcy is not a good "solution" to COVID-induced financial distress.[21] This deficiency is not primarily a problem of lack of resources.[22] Bankruptcy's failure to adequately address the special features of COVID-distress is *structural* and not so much one of scale.[23] The bankruptcy process does not provide the fix that the overwhelming majority of COVID-distressed firms need.

Nor is it a good idea to try to adapt bankruptcy laws to better deal with the requirements of the pandemic, as many jurisdictions have tried.[24] A tested instrument, which works well for most firms in normal times, should not be modified to deal with an extraordinary situation such as the current

[21] See, generally, Van Zwieten, Eidenmüller and Sussman, *supra* note 3.

[22] Hence, we disagree with the views espoused by the Large Corporations Committee of the Bankruptcy & COVID-19 Working Group led by Jared A. Ellias in their letter of 7 May 2020 (available at https://www.uchastings.edu/wp-content/uploads/2020/05/Large-Corporate-Committee-of-Bankruptcy-Scholars-Letter-to-Congress-5.7.20.pdf (last visited February 22, 2021). The additional resources will assist in dealing with some of the issues exposed by the COVID-19 pandemic (the overload of the system due to increased numbers of companies requiring bankruptcy protection), but will prove insufficient to deal with other critical matters discussed in this essay unless it is combined with a bailout or a bail-in.

[23] Though we acknowledge that the pressure on resources results in large numbers of simultaneous petitions having to be shepherded through the system at the same time, and that there is evidence that the system itself behaves in a different (not optimal) way when overloaded. *See* Benjamin Iverson, *Get in Line: Chapter 11 Restructuring in Crowded Bankruptcy Courts*, 64 MANAGEMENT SCIENCE 5370 (2018).

[24] Some jurisdictions have established temporary changes to deal with the first shock of the pandemic until lockdowns are no longer required – insofar as these changes do indeed remain temporary, they do not warrant too much criticism. Some examples of such temporary tweaks include the suspension of duties to file for bankruptcy (*e.g.*, in France, Germany, Italy, Spain), the suspension of wrongful trading provisions (UK), the suspension of equitable subordination for shareholder loans made available during the suspension period (*e.g.*, in Germany, Italy), the limitation of avoidance actions in relation to the transactions made during the suspension period (*e.g.*, Germany), or the stay of liquidations due to breach of a previous insolvency agreement if an alternative plan is provided (*e.g.*, Spain). For a survey of legal responses to the COVID-19 pandemic involving bankruptcy laws, *see* Aurelio Gurrea-Martínez, *Insolvency Law in Times of COVID-19*, IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE WORKING PAPER NO. 2/2020, March 27, 2020 (revised June 9, 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3562685 (last visited February 20, 2021). Some jurisdictions have taken the chance to also introduce permanent changes to their bankruptcy laws. These changes have been particularly relevant in the UK, though it has to be acknowledged that these amendments had been in the making well before the start of the COVID-19 pandemic. In particular, English law now has established (via the Corporate Insolvency and Governance Act 2020) a standalone moratorium (*see* Part A1 of the Insolvency Act 1986), a prohibition of *ipso facto* termination rules for the supply of goods and services (*see* Section 233B of the Insolvency Act 1986 – though rules for essential services already existed in Sections 233 and 233A), and a new tool, the restructuring plan, which allows (for the first time in England) the carrying out of cross-class cramdowns (*see* the new Part 26A of the Companies Act 2006).

one. Whatever tweaks may serve to make bankruptcy law marginally better at dealing with COVID-19-related distress will also move the legislation and its application from its current efficient equilibrium to a sub-optimal situation in the long run.

Accordingly, we posit[25] that the best option is an approach based on providing financial relief to the businesses affected by significant but temporary decreases in revenue, avoiding the need to file for formal bankruptcy protection at least until the current COVID-19 situation has been brought under control and these businesses are in a position to resume "normal" trading. Such relief can be effected by the relevant governments in two main ways (or different combinations thereof), namely bailouts and bail-ins. In a bailout, it is the state (or other public institution) who funds the relief; in a bail-in, it is private stakeholders. The difference is in the *source* of the relief funds. The *size* of these funds is not decisive when characterizing a measure as a bailout or bail-in. Rather, the direction or goal is important, *i.e.*, the intention to provide financial breathing space to the company when bankruptcy seems to be the only other option.

Hence, bailouts comprise "government … payments (including loans, loan guarantees, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors and counterparties …".[26] Bail-ins serve a similar function, *i.e.*, to provide some breathing room to businesses until trading can resume. However, they do so by pausing or reducing claims at the expense of counterparties, not the taxpayers. One can define bail-ins as a government mandate to "in a 'one time' way, outside of formal reorganisation law … [provide] some degree of forgiveness by creditors or counterparties."[27]

In the current COVID-19 crisis, a first type of government response came in the form of deploying statutory bailout and bail-in schemes that were already in place pre-pandemic.[28] In addition,

[25] In this recommendation we follow Van Zwieten, Eidenmüller and Sussman, *supra* note 3.

[26] Anthony J. Casey and Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479 (2016), at 481.

[27] *See* Van Zwieten, Eidenmüller and Sussman, *supra* note 3, at 23.

[28] An example are short-term work schemes (furlough schemes) designed to bail out companies in difficulties by providing temporary support to preserve employment, such as the German *Kurzarbeit*, the Italian *cassa integrazione guadagni straordinaria* or the French *chômage partiel*; such schemes have been used in previous crises and also during "normal" times. *See*, for reference, Pierre Cahuc, Francis Kamarz and Sandra Nevoux, *When Short-Time Work Works*,

dedicated (new) COVID-19 schemes were created and implemented to combat the economic effects of the pandemic.[29] Finally, instead of being based on a general statutory scheme, which applies to a larger group of firms, a bailout can also be effected *ad hoc* to rescue an individual firm or a small group of firms.[30] If private stakeholders bail out the firm, we have a private workout (see Table 1).

Source of Funds/Type of Scheme	***Statutory Scheme, Pre-Pandemic***	***Statutory Scheme, Post-Pandemic***	**Ad hoc *Intervention***
Public	Statute-Based Bailout	Statute-Based Bailout	*Ad hoc* Bailout
Private	Statute-Based Bail-In	Statute-Based Bail-In	Private Workout

Table 1

INSTITUTE OF LABOR ECONOMICS (IZA) DISCUSSION PAPER NO. 11673, July 2018 (available at https://www.iza.org/publications/dp/11673/when-short-time-work-works (last visited February 20, 2021)), or Giulia Giupponi and Camille Landais, *Subsidizing Labor Hoarding in Recessions: The Employment & Welfare Effects of Short Time Work*, CENTRE FOR ECONOMIC POLICY RESEARCH (CEPR) DISCUSSION PAPER NO. 13310, November 2018 (revised May 2020) (available at https://cepr.org/active/publications/discussion_papers/dp.php?dpno=13310# (last visited February 20, 2021)).

[29] For example, the Coronavirus Business Interruption Loan Scheme (CBILS) in the UK (*see* Press Release, European Commission, State aid: Commission approves UK schemes to support SMEs affected by coronavirus outbreak, March 25, 2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_527 (last visited February 21, 2021)), the Spanish Solvency Support Fund (*see* Press Release, European Commission, State aid: Commission approves €10 billion Spanish fund to provide debt and capital support to companies affected by the coronavirus outbreak, March 25, 2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1426 (last visited February 21, 2021)), a French scheme providing state guarantees on commercial loans to enterprises with up to 5,000 employees through the public investment bank Bpifrance (*see* Press Release, European Commission, State aid: Commission approves French schemes to support economy in Coronavirus outbreak, March 21, 2020, https://ec.europa.eu/commission/presscorner/detail/en/IP_20_503 (last visited February 21, 2021)), the establishment of the Economic Stabilization Fund (WFS) in Germany (see Press Release, European Commission, State aid: Commission approves German fund to enable up to €500 billion of liquidity and capital support to enterprises affected by the coronavirus outbreak, July 8, 2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1280 (last visited February 21, 2021)), or the CARES Act implemented by the US Treasury (*see* US Department of the Treasury, *The Treasury Department is delivering COVID-19 Relief for All Americans*, https://home.treasury.gov/policy-issues/cares (last visited February 21, 2021)) including, for instance, the Paycheck Protection Program managed by the US Small Business Administration (*see* US Small Business Administration, *Coronavirus (COVID-19): Small Business Guidance & Loan Resources*, https://www.sba.gov/page/coronavirus-covid-19-small-business-guidance-loan-resources (last visited February 21, 2021)).

[30] When Casey and Posner, *supra*, note 26, at 481 say as part of their definition of bailout that "a bailout occurs… when the agent is not entitled to those payments under an statutory scheme", we understand that said statutory scheme is the type of scheme that we are referring to as "pre-pandemic", *i.e.*, one that was in place before the relevant "trigger situation" occurs.

Politically, bailouts are more popular than bail-ins. Bailouts shift the financial burden to future generations, and they spread this burden over the whole population – there are clear winners and no clear losers. By comparison, bail-ins target a select group of private stakeholders, and they are hit today. From a fairness perspective, both approaches have (some) merit: the pandemic affects us all, hence financial aid should come from taxpayers' resources; on the other hand, stakeholders of private firms have voluntarily assumed specific risks, including, in particular, bankruptcy risks.

The statutory bailout schemes in place in many jurisdictions to support COVID-distressed firms help prevent a mass influx of distressed businesses into their respective bankruptcy systems. However, sometimes these statutory schemes do not provide sufficient resources to successfully allow certain (large) critical/systemic companies to remain viable without requiring further arrangements. Moreover, despite the easing of certain concerns regarding the use of bankruptcy proceedings – there are many fewer such systemic/critical companies, and they should not overload the system –,[31] bankruptcy proceedings remain an unattractive option, for reasons we explore in the next Part.

From now on, we specifically focus on the bailouts in the upper-right corner of Table 1, those that constitute non-statutory *ad hoc* interventions.

II. Specific problems of critical/systemic firms

A. A definition of critical/systemic firms

Which companies are critical/systemic and what are the characteristics that allow us (and the relevant governments) to identify them? This is one of the key questions that we set out to address with this essay, since the characteristics of those firms permit us to tackle two very important issues: what are the reasons that justify firms being subject to an *ad hoc* bailout, if needed, and, importantly, why "regular" bankruptcy proceedings may not be the most appropriate tool to deal with them.

[31] This is a problem that is discussed *supra*, note 23.

A first approach at defining critical/systemic firms may be to understand what types of companies (and in what sectors) different governments across the world have considered important enough to directly intervene on an *ad* hoc basis to ensure their survival. Though "circular" in its reasoning, understanding *what* type of firms have been rescued by governments across the globe in *ad hoc* bailouts, and *why* they have been rescued, may provide us with a starting point against which to test our proposed definition.

According to empirical research on *ad hoc* bailouts conducted in the aftermath of the Great Recession, *ad hoc* bailouts that are conducted by governments in practice exhibit a series of commonalities.[32] First, governments tend to bail out firms that present a "systemic risk".[33] Second, the political orientation of governments seems to have an effect on the type of firms that receive support. Left-of-center governments tend to rescue more firms and firms with larger numbers of employees,[34] while right-of-center governments tend to rescue fewer firms but those tend to be more significantly concentrated around capital-intensive businesses.[35] Third, the presence of strong special interests that would be harmed by the failure of the firm also appears to have an effect on the bailout likelihood.

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[32] *See* MICHAEL G. SMITH, THREE ESSAYS ON THE POLITICAL ECONOMY OF CORPORATE BAILOUTS (Ph.D. Diss., Columbia University, 2014). Smith conducted empirical research on two samples of government bailouts. The first one (the "General Dataset") contained a dataset of "631 firms that approached bankruptcy between the years of 1987 and 2011 and that span 17 industries and 50 countries", which was constructed using media keyword searches that yielded a total of 747 instances of distressed firms in the period. The second one (the "EEA Dataset") was a dataset containing all bailouts in the European Economic Area (EEA) for the period 1999-2011, as they must be reported by the Member States in compliance with the regulations on state aid.

[33] Of course, what is meant by systemic risk is the key issue at hand. Smith, *supra* note 32, finds (on the basis of the General Dataset) that the largest firms and those operating in the financial industry are more likely to receive a bailout, considering that a good proxy for systemic risk. Most of the literature has focused on the type of systemic risk brought about by financial institutions, that is, a contagion risk that destabilizes the banking system and the capital markets. *See*, for reference, Morrison, *supra* note 19, at 450. The analysis in Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435 (2011), at 438, extends the concept and considers a wider approach based on the political relevance of the consequences ("the risk that individual firms' failures will result in a socially unacceptable impact on the broader economy"). Our view, further explained in this Section, is that a firm is critical/systemic when its continuation (failure) results in significant positive (negative) externalities for the economy.

[34] Smith, *supra* note 32, at xvi, 40, finds (on the basis of his General Dataset) that left-leaning governments are 11.5% more likely to bail out a business, and this effect increases with the number of employees of the firm.

[35] Smith, *supra* note 32, at xvi, 54, finds (on the basis of his EEA Dataset) that left-leaning governments bail out labor-intensive businesses roughly 1.6 times more than others, while right-wing governments bail out companies in capital-intensive sectors roughly 2.5 times more than others.

Most relevant from these findings for our purposes are the scope of the definition of "systemic" and a better understanding of the underlying circumstances favored by governments of different political orientation in decisions on bailouts. On the definition of "systemic", the industries where the higher share of distressed firms tend to be bailed out are finance, transportation and utilities,[36] the main reason being that "out of concern for aggregate welfare costs, governments might be more likely to provide bailouts to firms that pose the threat of systemic risk to the broader economy".[37] As to the circumstances that appear to play a role depending on the political orientation of the government, the key difference seems to be the relevance and threshold of "subsidiarity" – *i.e.*, the point at which the type and gravity of the effects appears to warrant state intervention[38] (see Part III below). The presence of strong special interests does not have an effect on our characterization of critical/systemic firms, but will certainly play a role in the design of the principles governing bailout interventions, as described below.

A taxonomy of actual government bailout practices regarding presumptively critical/systemic firms is a helpful starting point. However, it is not sufficient for constructing a "normative" view of what these firms should be, or which of their characteristics justifies government intervention to rescue them. For these purposes, and before developing our own view, we discuss other instances of actual or proposed governmental and/or regulatory protection of certain types of firms and justifications for such interventions. We analyze (i) the restrictions on foreign direct investment (FDI) within the OECD, (ii) the EU regulations on state aid, (iii) the concepts of "infrastructure" and "public utilities" as applied in the theory and practice of regulation,[39] and (iv) the scope of activity of state-

[36] *See* Smith, *supra* note 32, at 160 (Table A.2). These industries (as determined by NAICS codes 52, 48 and 22, respectively) are the only ones in the General Dataset where bailouts exceed 30% of the instances of bailed out to distressed firms. The data in Table A.2 also shows a large absolute number of bailouts in the manufacturing industry (NAICS code 31).

[37] *See* Smith, *supra* note 32, at xx.

[38] Governments will only intervene when there is a sufficiently large risk, and this perception of risk seems to be well aligned with partisan lines. *See supra*, note 35.

[39] In particular, we are interested in the scholarship on governmental action designed at the turn of the 20th century, between the Civil War and the New Deal, *i.e.*, during the Brandeisian era of the "public utility" or "public service corporation", which has been revived by the law & political economy scholarship. *See*, for reference, K. Sabeel Rahman¸ *Infrastructural Regulation and the New Utilities*, 35 YALE J. ON REG. 911 (2018); Morgan Ricks, *Money as Infrastructure*, 2018 COLUM. BUS. L. REV. 757 (2018); William Novak, *Chapter 4: The Public Utility Idea and the Origins of Modern Business Regulation*, in THE CORPORATION AND AMERICAN DEMOCRACY 139 (N.R. Lamoreux & W.J. Novak eds. 2017).

owned enterprises (including the EU caselaw on "golden shares"). We use these regulations as a proxy to understand which types of firms policymakers and public officials consider being of pivotal relevance to the economy, and why.

Restrictions to FDI. The first proxy that we consider relates to instances in which states exercise their jurisdictional power to limit the "access" of foreigners to their markets. For a long time, the OECD has monitored the ways in which both its members and third countries have established such restrictions. One of the most comprehensive studies available in this regard was conducted at the turn of the century.[40] However, in recent years, governments have been broadening the scope of these restrictions to foreign investments,[41] a trend that has only intensified since the start of the COVID-19 pandemic.[42] As specific examples of the current scope of these limitations, we focus on restrictions in the US[43] and the UK.[44] In the US, foreign investors willing to invest in "any

[40] Stephen S. Golub, *Measures of Restrictions on Inward Foreign Direct Investment for OECD Countries*, OECD ECONOMICS DEPARTMENT WORKING PAPER NO. 357, June 2, 2003, available at https://www.oecd-ilibrary.org/economics/measures-of-restrictions-on-inward-foreign-direct-investment-for-oecd-countries_335043060125 (last visited February 18, 2021).

[41] For instance, *see* the EU regime for foreign direct investments established in 2019 with Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union, O.J. 2019 (L 79 I) 1 (March 21, 2019) (the so-called FDI Screening Regulation).

[42] A number of these provisions are meant to be temporary measures to address the COVID-19 pandemic, but others had been under discussion before the start of the pandemic. Some examples to be considered: France has just blocked the acquisition of retailer Carrefour by a Canadian group on the grounds of "food sovereignty", added to the foreign investment restriction regime in April 2020 as an addition to a substantial reform conducted in May 2019 (*see* Didier Martin, *Protectionism is back on the French economic menu*, FINANCIAL TIMES, February 17, 2021, https://www.ft.com/content/7a3e0b84-9387-4425-8d05-ffb4f09f70a4 (last visited February 21, 2021)); Italy changed its FDI regime, extending the scope of the restrictions to additional strategic sectors and lowering the thresholds for intervention (*Decreto-Legge 8 aprile 2020*, n. 23, G.U. April 8, 2020, n. 94, also known as *Decreto Liquidità*); Spain has similarly changed its FDI provisions twice (*Real Decreto-Ley* 8/2020 of 17 March, B.O.E. 2020, 73, and *Real Decreto-Ley* 34/2020 of 17 November, B.O.E. 2020, 303), extending the scope of affected sectors and affected investors as well as lowering the applicable thresholds. *See* also, in relation to the FDI Screening Regulation (discussed *supra*, note 41), Communication from the Commission – Guidance to the Member States concerning foreign direct investment and free movement of capital from third countries, and the protection of Europe's strategic assets, ahead of the application of Regulation (EU) 2019/452 (FDI Screening Regulation), C(2020) 1981 final, March 25, 2020, providing further guidance taking into account the COVID-19 pandemic.

[43] Essentially, this is the CFIUS (Committee on Foreign Investment in the US) regime, although other agencies such as the FCC or the DCSA also have the ability to restrict certain types of foreign investment. The CFIUS regime is established under Section 721 of the Defense Production Act, Executive Order 11858 and the regulations at Chapter VIII of Title 31 of the Code of Federal Regulations (*see* US Department of the Treasury, *CFIUS Laws and Guidance*, https://home.treasury.gov/policy-issues/international/the-committee-on-foreign-investment-in-the-united-states-cfius/cfius-laws-and-guidance (last visited February 21, 2021)).

[44] As per the National Security and Investment Bill 2019-2021, HL Bill [165] (UK), available at https://publications.parliament.uk/pa/bills/lbill/58-01/165/5801165_en_1.html (last visited February 21, 2021) and current merger control regulations (primarily contained in the Enterprise Act 2002).

person engaged in interstate commerce" may need to deal with CFIUS (the Committee on Foreign Investment in the US) if the proposed control transaction could affect US "national security" (though the scheme also refers to national defense and critical infrastructure).[45] The core industries and types of firms affected by CFIUS regulations are defense, infrastructure, semiconductors and sensitive technologies, telecommunications, financial institutions and information technologies.[46] In the UK, the historical practice was not to restrict foreign investment in any material way. If the National Security and Investment Bill proposed in 2020 were to be finally enacted,[47] the UK would have its first[48] stand-alone foreign investment regime. Following public consultation,[49] it seems that there will be a number of key sectors that will be directly subject to this new regime, supplemented by a general reference to "national security". These sectors include defense, energy, communications, data infrastructure, critical suppliers to government and emergency services, computer hardware, robotics, quantum technologies and biological engineering.

State aid. Another interesting proxy comes from state aid regulations, a quintessential expression of European Union (EU) substantive laws and political economy. The EU strives to implement a "single market" within its borders, and a number of tools are in place so that this objective is achieved. Among those measures, the regulation of state aid is enshrined in Articles 107-109 of the Treaty on the Functioning of the European Union (TFEU).[50] The general rule is that state aid is incompatible with the internal market and thus forbidden.[51] However, in certain cases (which

[45] Part 800.248 of Title 31 of the US Code of Federal Regulations defines a "TID U.S. Business" (involvement in which will trigger a CFIUS declaration under Part 800.401) as one dealing with "critical technologies" (including national defense-related goods and services), "covered investment critical infrastructure" or "sensitive personal data".

[46] *See* the Annual Report to Congress for the report period CY 2019, released to the public in July 2020 (available at https://home.treasury.gov/system/files/206/CFIUS-Public-Annual-Report-CY-2019.pdf (last visited February 21, 2021)).

[47] The Bill just underwent its second reading in the House of Lords. The current status in the legislative process can be seen at https://services.parliament.uk/bills/2019-21/nationalsecurityandinvestment.html (last visited February 20, 2021).

[48] Apart from the government's ability to issue public interest intervention notices under the Enterprise Act 2002. There were emergency reforms to this regime in July 2020 to address the COVID-19 pandemic.

[49] For reference, *see* https://www.gov.uk/government/consultations/national-security-and-investment-mandatory-notification-sectors (last visited on February 22, 2021).

[50] 2012 O.J. (C326) 47 (October 26, 2012).

[51] Article 107(1) TFEU: "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

include assistance to firms in certain industries[52] or regions, or rescuing and restructuring certain types of firms), the EU rules provide an exception because of the particular relevance of the interests that are present. And it is these exceptions that may help us in developing our concept of critical/systemic firms. The exceptions most relevant for our purposes are those included in the European Commission's Guidelines on state aid for rescuing and restructuring non-financial undertakings in difficulty.[53] These Guidelines focus on seven different "compatibility criteria" that need to be met for the specific state aid being permitted. Of these, the one that is particularly important is the need for the relevant aid to pursue "an objective of common interest, in that it aims to prevent social hardship or address market failure by restoring the long-term viability of the undertaking".[54] According to the Guidelines,[55] this objective is present when there are significant "externalities", the effects on employment are particularly severe, or where an important service would be interrupted (without any clear alternatives). Effects on employment and the provision of important services might generally be subsumed under the rubric of "externalities", but they present some specific facets (and are so salient in the public's mind) that it may be worth describing them as separate from (but closely related to) the more general "externalities".

[52] Sectoral aid is based on exemptions to state aid based on specific treatment accorded to those sectors by the TFEU itself: agriculture and fisheries (Article 42 TFEU), transport (Article 93 TFEU) or production of (and trading in) arms, munitions and war material in relation to essential interests of the state's security (Article 346(1)(b) TFEU). Furthermore, in application of the procedure in Article 107(3)(e) TFEU, coal and shipbuilding are also subject to a special regime in this regard.

[53] These Guidelines are contained in the Communication from the Commission – Guidelines on state aid for rescuing and restructuring non-financial undertakings in difficulty, 2014 O.J. (C249) 1 (July 31, 2014). An updated version of the Guidelines is now overdue, as they were supposed to cover the 2014-2020 period. Furthermore, the European Commission issued a Temporary Framework for state aid measures to support the economy in the current COVID-19 outbreak, allowing for specific assistance in addition to that available under the Guidelines. This Temporary Framework is contained in the Communication from the Commission C(2020) 1863 final of March 19, 2020. This followed the Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Investment Bank and the Eurogroup on Coordinated economic response to the COVID-19 Outbreak, COM(2020) 112 final of March 13, 2020. The aid in the Guidelines is understood to be allowed under the scope of Article 107(3)(c) TFEU and is subject to the "one time, last time" principle as per paragraph 8 of the Guidelines (*i.e.*, aid can generally only be received once within a 10-year period). The Temporary Framework provides for different types of state aid that would be compatible with previous aid received under Article 107(3)(c) TFEU: the compensation of direct damages suffered under exceptional circumstances allowed under Article 107(2)(b) TFEU and the additional temporary state aid measures approved under Article 107(3)(b) when there is a serious disturbance of the economy of a Member State (a situation that, according to the European Commission, applies to the COVID-19 pandemic).

[54] Paragraph 43 of the Guidelines, see *supra* note 53.

[55] Paragraph 44.

Infrastructure/public utilities. The concept of "public utility" or "public service corporation" in the Brandeisian tradition is based on the idea that there are certain economic activities that are "affected with a public interest" that should therefore be subject to a specific regime. The reason that these corporations conducting such specific economic activities are considered special is because they affect "*juris publici*", *i.e.*, rights belonging to the public at large.[56] This approach, developed in the US at the turn of the 20th century, was construed from traditional English common law principles, particularly those relating to "public" or "common callings" (the most famous of which was the "common carrier"), to which additional layers were added as the states built their general "police power" and established the first corporate regulations in the state charters of incorporation.[57] During the first decades of the last century, this "public utility" regulation had a preeminent position in US legislation and public policy. But after the New Deal, it disappeared from policy discourse and lawmaking.

However, in the past few years the approach has been experiencing a strong revival thanks to strong voices in law and political economy scholarship. The proponents of this tradition of the "public utility" have updated the original framework to our current world, and the focus now is on the concept of "infrastructural goods and services".[58] The main characteristics of what constitutes such "infrastructural goods and services", which are candidates to be subject to a special regulatory regime (as the public utilities were at the turn of the 20th century), will also prove helpful to us when delineating the contours of critical/systemic firms in this article. These characteristics[59] are (i) the existence of economies of scale for the production/provision of the goods or services, (ii) the position of the company as point-of-access to a wide range of downstream uses, and (iii) the vulnerability of the social infrastructure to private power or domination. We are thus talking of firms which are involved in the production and provision of public goods that are a gateway for other goods and services generally needed by citizens to conduct their normal lives and that, absent regulation, are susceptible to some form of private control because certain operators are capable of reaching a privileged position due to their scale.

[56] *See* Novak, *supra* note 39, at 146.

[57] For further details on the historical genesis of the "public utility" concept, *see* Novak, *supra* note 39, at 154.

[58] *See* Rahman, *supra* note 39, at 926-927.

[59] *Id.*

State-owned enterprises (SOEs) and "golden shares". State-owned enterprises normally respond to the need for the government to directly intervene in the market economy for very specific reasons, mainly to support national interests (*e.g.*, to generate income through natural monopolies, protect a nascent industry or provide certain goods or services in competition with the private sector) or to address market failures (provision of public and common goods, externalities).[60] In the EU context, there is a clear focus on "network" industries, such as energy, railways or telecommunications, as the natural fit for SOEs.[61] These are industries characterized by the existence of significant externalities and the provision of public goods.

"Golden shares"[62] represent an evolution from government's direct ownership of critical enterprises. When EU governments started privatization processes in the late 1990s with a view to achieving the fiscal requirements established for access to the monetary union, they decided that, given the relevance of these companies and the services they provided, they should retain some degree of control despite parting with all (or most) of its economic ownership interest. The way in which this control was established was in some cases through corporate protections or ownership of special classes of shares, and in many other cases through regimes established under the relevant public laws of the respective jurisdiction before or concurrently with the privatization of the relevant companies. The powers through which such "golden shares" were exercised were essentially limits to voting rights, the establishment of certain veto rights or special powers to appoint a certain number of members of the board of directors of the privatized company.[63] The companies that remained "protected" through this regime despite their privatization tended to be

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[60] *See*, for example, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), OWNERSHIP AND GOVERNANCE OF STATE-OWNED ENTERPRISES: A COMPENDIUM OF NATIONAL PRACTICES (2018), at 19; ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES, 2015 EDITION (2015), at 17-21.

[61] *See*, European Commission, *State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context*, European Economy Institutional Paper No. 31, July 2016, available at https://ec.europa.eu/info/sites/info/files/file_import/ip031_en_2.pdf (last visited February 26, 2021), at 1-2, 7, 23.

[62] *See*, for example, ANDREA BIONDI, *When the State is the Owner – Some Further Comments on the Court of Justice 'Golden Shares' Strategy*, in COMPANY LAW AND ECONOMIC PROTECTIONISM: NEW CHALLENGES TO EUROPEAN INTEGRATION (Ulf U. Bernitz and Wolf-Georg W. Ringe eds., 2011), at 96.

[63] *See* JONATHAN RICKFORD, *Protectionism, Capital Freedom, and the Internal Market*, in COMPANY LAW AND ECONOMIC PROTECTIONISM: NEW CHALLENGES TO EUROPEAN INTEGRATION (Ulf U. Bernitz and Wolf-Georg W. Ringe eds., 2011), at 59-67.

involved in utilities/energy (*e.g.*, EDP – Energias de Portugal, Endesa, SNEA – Société Nationale Elf Aquitaine (now Total)), infrastructure and transportation (*e.g.*, BAA (now Heathrow Airport Holdings)), telecommunications (*e.g.*, Portugal Telecom, Telefónica), defense-related activities (*e.g.*, Rolls-Royce, BAE Systems) or (allegedly) critical manufacturing (*e.g.*, Volkswagen). Though the challenge of these regimes before the Court of Justice of the European Union is an extremely important topic affecting the (legally permissible) structuring of ownership interests resulting from a bailout,[64] for our purposes in this Section that is secondary to the specific types of companies that the EU Member States' governments made subject to the respective regime in the first place.[65]

When considering all these types of regulation together, the following principle emerges: continuation (liquidation) of critical/systemic firms creates significant positive (negative) externalities, affecting society at large or a sufficiently wide group that is not represented within the stakeholders that are in a position to protect their interests in bankruptcy, and thus the loss allocation as per the bankruptcy laws is not (socially) acceptable. These externalities manifest themselves because critical/systemic firms provide society with a public good (including essential services that would otherwise not be provided) or an "infrastructure" which is necessary for the functioning of the economy.

This characterization of critical/systemic firms includes enterprises important for the stabilization of the economy and the limitation of the macroeconomic costs that would be imposed on the social security system (and on individuals) as a result of a significant shock to the labor market resulting from the liquidation of this type of firm.[66]

[64] Which we will discuss in more detail in Section III(A).

[65] To our knowledge, no case decided before the European Court of Justice on these matters has allowed a differential treatment based on the characteristics of the company subject to the "golden share". There are different groups of cases based on the type of mechanism that implements the "golden share", but not on the type of company.

[66] Thus considering both the allocation and stabilization aspects of government intervention. Bailouts do not seem to be the adequate tool to conduct distributional intervention (*see*, on a related note, Louis Kaplow and Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23(2) THE JOURNAL OF LEGAL STUDIES 667 (1994)). On the goals of the economic intervention of the state in economic policy, *see* AGNÈS BÉNASSY-

At the same time, it is important to note that what counts as a *relevant* positive or negative externality in a particular jurisdiction is jurisdiction-specific, reflecting the collective preferences in that jurisdiction. Hence, a company which may be critical/systemic in one jurisdiction may not be critical/systemic in another.

B. The bankruptcy process and public interests

Against the background of the described externalities as the key element (or property) of a critical/systemic firm, the next step is to assess whether bankruptcy is a good option or not for such a firm. We discussed the suitability of bankruptcy generally in Part I, but we are now considering a very specific and much narrower subset, and thus some other important issues must be considered.

First, there are far fewer businesses in this cohort. Hence, the argument against bankruptcy based on the negative effects on outcomes caused by system overload does not appear to apply with equal force to critical/systemic firms. However, the impaired ability of bankruptcy systems to work effectively under the conditions of the pandemic might also negatively affect its usefulness as a crisis tool for critical/systemic firms. A large truck will not find a place in a large garage if it is already full with many small cars.

More importantly, the expected bankruptcy costs are higher for critical/systemic firms compared to other firms – both in absolute and possibly also in relative terms.[67] Critical/systemic firms are not only large but often also listed. Hence, they are hit by changing market perceptions as to the

QUERÉ, BENOÎT CŒURÉ, PIERRE JACQUET AND JEAN PISANI-FERRY, ECONOMIC POLICY: THEORY & PRACTICE (2nd ed. 2019), at 17-32.

[67] As discussed in note 20, the evidence on indirect costs of bankruptcy is not as clear-cut as that on direct costs. However, there is research focusing on specific aspects affecting the level of indirect costs in certain industries that would increase with size; an example is Ali Hortaçsu, Gregor Matvos, Chad Syverson and Sriram Venkataranam, *Indirect Costs of Financial Distress in Durable Goods Industries: The Case of Auto Manufacturers*, 26(5) THE REVIEW OF FINANCIAL STUDIES 1248 (2013). *See* also Morrison, *supra* note 19, at 461-462 (noting that "the current regime is just more costly for taxpayers when systemically important institutions fail than one that permits immediate federal takeover", which he links to the swiftness and expertise of the regulators (as compared with bankruptcy judges) to minimize such indirect costs.

firm's future and loss of trust much more severely than other firms. In addition, the need for a swift resolution is stronger because of the correlation between time spent in bankruptcy proceedings and bankruptcy costs.

Second, the most important issue is the presence of the aforementioned externalities. By definition, such externalities fall on parties external to the companies which would be subject to a bankruptcy process. Under current bankruptcy laws and proceedings (at least in the US, the UK and the EU), these parties have no or only a very limited say in any decisions to be made during the proceedings. Bankruptcy is a private process in which the debtor and its creditors attempt to sort out the debtor's financial problems. The process is not designed to vindicate public interests going (much) beyond those of the stakeholders in the private entity which finds itself in bankruptcy. It is highly unlikely that the benefits (costs) of positive (negative) externalities are taken into account fully when deciding on the optimal course of action in the proceedings. This may result in a significant destruction of social value even if the actors involved (creditors, shareholders and management) act in a perfectly rational way.

A different process led by the government, such as an *ad hoc* bailout, creates or safeguards (social) value by ensuring that, for example, the effects of contagion[68] and on the labor market[69] are considered when deciding whether the critical/systemic firm should continue operating or not, and how it might best be restructured. This could not happen within a "regular" bankruptcy process, and therefore the relevant actors might decide on a (social) value-destructing liquidation. In order to avoid this, these firms need to be kept outside of the bankruptcy process.[70]

[68] *See* Levitin, *supra* note 33, at 455.

[69] *See* Zachary Liscow, *Counter-Cyclical Bankruptcy Law: An Efficiency Argument for Employment-Preserving Bankruptcy Rules*, 116 COLUM. L. REV. 1461 (2016).

[70] In a similar vein, scholars have noted that "using bankruptcy to resolve systemically important firms risks the over-politization of the bankruptcy process and the debasement of its rule of law virtues". *See* Levitin, *supra* note 33, at 487.

III. A principled approach to bailing out critical/systemic firms

So far, we have discussed why traditional bankruptcy laws may not be the best tool to address the problems of COVID-distressed companies in general. In addition, we have taken a further step considering the same issue in relation to what we have called critical/systemic companies. This is a subset of companies that, because of their very specific characteristics, may warrant a direct intervention of the government to allow them to survive.

We have mentioned "systemic risk" as one of the key rationales for the use of bailouts by governments. Particularly since the Great Recession (and especially in the realm of financial institutions), a significant regulatory effort has been made in relation to what has been called "macroprudential" regulation; that is, establishing a number of rules and provisions that, *ex ante*, allow us to reduce the level of risk in the economy. However, this *ex ante* regulation will not be sufficient in every case to prevent the occurrence of "systemic risk".[71] Hence, we will always be confronted, to some degree, with the need to react to crises *ex post*. However, being able to react flexibly to address issues that had not been anticipated should not be an excuse for arbitrary interventions.

The stakes may be high, and the parties involved quite important, but the negative consequences of an unconstrained use by states of their ability to bail out critical/systemic firms could be significant. Hence, principles or standards need to be established beforehand to help guide the actions of governments and their officials in these cases. Further, such actions need to be subject to judicial control (ideally after the fact) in accordance with provisions that provide the government with sufficient flexibility to address the difficult issues that will need to be confronted with limited information and under a pressing timeline.

Historically, it was economist and journalist Walter Bagehot in 19th century England who first formulated guiding principles for bailouts.[72] This first attempt at devising the principles that should

[71] We are of the same opinion as Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349 (2011), at 1356; or Levitin, see *supra* note 33, at 438, 462.

[72] *See* WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873).

guide a bailout of financial institutions in a banking crisis, with the government functioning as a "lender of last resort", was still in the mind of policymakers in the US when considering the rescue of automakers in 2008.[73] According to Bagehot, every intervention of the "lender of last resort"[74] should be characterized by three key features: (i) lend as widely as possible, (ii) against good collateral and (iii) at a high rate of interest. These principles were established to address a specific type of bailout for a narrow subset of companies,[75] but they have been used in practice by policymakers to frame responses for other more intrusive interventions and to be applied to firms in other sectors.[76] As such, we think that they are a good starting point for the discussion of the principles that we are proposing in this Part.

In our view, the following four principles ought to guide the actions of government when considering (or implementing) an *ad hoc* bailout of a critical/systemic firm: proportionality, efficiency, equity and transparency. These principles are essential in order to establish the legitimacy of the government intervention, a matter that is crucial if we aspire to justify it as an appropriate use of government power.[77] If government is conducting a public intervention with public money to pursue public objectives, it follows that, at the very least, we need to ensure that such intervention is perceived as legitimate by the polity/society.

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[73] *See* ERIC A. POSNER, LAST RESORT: THE FINANCIAL CRISIS AND THE FUTURE OF BAILOUTS (2018), at 46-50, 126. *See* also STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY (2010). The auto team led by Mr. Rattner thought that "further government funding should come only in exchange for fundamental restructuring that made automakers truly viable" and "all stakeholders… ought to share the pain of such an overhaul", id. at 53, Republican senator Bob Corker proposed the so-called "Corker's covenants", which centered around the requirement for a substantial contribution by creditors, unions and employees, id. at 37.

[74] The literature discussing bailouts has traditionally focused on the rescue of financial institutions within the context of a financial crisis. In this context, the government authority bailing out the financial institution is normally referred to as the "lender of last resort" (or LOLR), as the primary way to implement the bail-out in these circumstances was through extending funding that was not available in the market (normally liquidity issues were the core problems affecting the financial institutions). *See*, for example, on the economics literature, Xavier Freixas, Bruno M. Parigi and Jean-Charles Rochet, *The Lender of Last Resort: A 21st Century Approach*, EUROPEAN CENTRAL BANK (ECB) WORKING PAPER NO. 298 (December 2003), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=487484. (last visited February 25, 2021); on the legal literature, *see*, for example, the concept of "investor of last resort" developed in Jeffrey Manns, *supra* note 71, at 1352 and 1383 *et seq*.

[75] This is clearly formulated within the context of a widespread financial crisis, where the government is normally dealing with illiquid but ultimately solvent financial institutions.

[76] The main concern of policymakers while applying these principles was to address moral hazard and minimize the risk for taxpayers' funds. But the way in which this has been historically implemented is problematic, as it is based on what Manns, *supra* note 71, at 1368, calls a "break even" approach where government has failed to extract an adequate risk-adjusted return.

[77] *See* Levitin, *supra* note 33, at, for instance, 492, 514.

A. Proportionality

The first principle is about the proportionality of the intervention. Given the significant uncertainties of the situation – for example, absence of a counterfactual, difficulty in establishing the costs and benefits of the intervention –, it is fundamental that the government only intervenes when it is necessary to achieve its objectives, such as the preservation (minimization) of positive (negative) externalities by ensuring the continuation of the firm as a going concern, and that such intervention is conducted in the least intrusive way possible. This will mean generally that the government should only take equity participations in private companies when there is no other feasible alternative to preserve (avoid) the positive (negative) externalities associated with the rescue operation. Further, if it is deemed indispensable to take an equity stake in the company, it will need to be a temporary one with a clear exit path.

Consideration needs to be given to the specific tool the government uses to ensure the continued viability of the struggling firm. If provision of a guarantee is sufficient to achieve that end, no funds should be advanced. If funds can be advanced under a loan with sufficient collateral, there is no justification for taking an equity interest, *i.e.*, to commit more risky capital. The government should be operating in the market in a way similar to a private party to avoid market distortions to the extent possible. If the government intervention strengthens the equity position of the firm, the government needs to be entitled to a commensurate return.[78]

Proportionality requires that, even in such dire circumstances, distortions to the market are minimized and companies are allowed to continue operating without unnecessary meddling from a shareholder that is not particularly adept at running a private business.[79] If the government is

[78] *See* Manns, *supra* note 71, at 1386-1387. When Bagehot, *see supra* note 72, refers to a "high interest rate" he is not doing that to ensure a proper return on the risk assumed by the government with the taxpayers' money, bur rather to incentivize the quick return of funds in an attempt to minimize moral hazard.

[79] This is probably more the case under the current COVID-19 pandemic than at other times, as many of the companies requiring bailouts are not in such position because of poor management of the business by their current teams, and therefore continuation of their current management teams with their industry expertise is most likely the best way to lead to a recovery when normal times resume. On the issue generally, *see* European Commission, *supra* note 61, at 23: "In the new Member States the return on equity in private firms is in most cases substantially higher than in SOEs".

required to provide an equity (or equity-like) investment to reinstate and maintain the solvency of the company, there are different ways in which such investment can be structured so that it is adequately remunerated without exercising day-to-day control of the operations of the company and, at the same time, maintaining a sufficient influence to protect the taxpayers' interests.[80] In practice, this should result in government being reluctant to take positions in ordinary fully voting shares and ensuring that any such participations are restricted in terms of both scope and time. An interesting example is provided by the bailout by the German government of Lufthansa in June 2020.[81] The government ended up with 20% of the equity in the company after a €9 billion investment across the capital structure. That 20% made the German government the largest shareholder in Lufthansa. Despite that, the government undertook not to exercise their voting rights on a day-to-day to basis, took only two seats in the 20-member supervisory board[82] of the company and is only keeping the right to convert some of its hybrid-debt investment into an additional 5% equity stake in the event of a hostile takeover.[83]

Similarly, proportionality also requires (together with efficiency and fairness) that the government only assists to the extent necessary, after the pre-existing investors in the firm have done all that is possible for them to do to remedy or at least mitigate the situation of distress. In order to assess what this means in practice, it will be helpful to consider two principles with long-standing tradition in EU state aid rules for restructuring aid: "significant own contribution"[84] and "adequate burden sharing".[85] Similar requirements have been included in other formulations of key principles

[80] These interests could go from the purely economic (receiving a commensurate return for the risk undertaken with the bailout) to other general policy objectives that are valuable to the government and taxpayers and that could be included as prerequisites or conditional requirements for the rescue (*e.g.*, "good citizenship" requirements such as not to pay dividends or repurchase shares until certain milestones are achieved or to achieve certain levels of "green" investments in the business).

[81] Lufthansa is the country's flag carrier airline, that had been privatized in 1997.

[82] In German stock corporations there is a two-tiered board of directors composed of a supervisory board (*Aufsichtsrat*) and an executive board (*Vorstand*).

[83] *See*, for reference, *Lufthansa: thanks for the support*, FINANCIAL TIMES, June 25, 2021, https://www.ft.com/content/e05ce98b-2a46-430b-a2eb-b3fd5daf5e69 (last visited February 20, 2021) (on the final rescue package and its volume) and Joe Miller, *Lufthansa board refuses to approve bailout due to Brussels demands*, FINANCIAL TIMES, May 27, 2020, https://www.ft.com/content/cadfcc82-f58c-492a-a881-f9df624de1a7 (last visited February 20, 2021) (on rights attached to the government position). Note that the 25% stake is a statutory threshold under German law that would allow government to block an unwanted takeover attempt.

[84] Paragraphs 62-64 of the Guidelines, see *supra* note 53.

[85] Paragraphs 65-69 of the Guidelines, see *supra* note 53.

applicable to bailout practice in the US.[86] The investors in the firm that is being rescued need to contribute to the rescue of the firm if they are to retain any interest, *i.e.*, they need to absorb at least a part of the relevant losses to the extent this is necessary for the firm to be able to continue operating.[87] Such contribution or sharing is fundamental to ensure that moral hazard is kept to reasonable levels and to maintain a degree of fairness or equity that is necessary to ensure the legitimacy of a bailout. This means that, in practice, *ad hoc* bailouts will contain an element of *ad hoc* bail-ins. It is through this *ad hoc* decision as to which stakeholders and/or counterparties need to participate through the bail-in that government exercises a flexibility not available elsewhere to overcome the risks and issues connected to critical/systemic firms suffering from COVID-induced financial distress.[88]

Designing a rescue package for critical/systemic firms, which involves a combination of *ad hoc* bailout and bail-in measures, involves intricate negotiations. Government cannot simply dictate a bail-in with respect to such firms, allocating a cost to a specific party in a way that is not provided for in ordinary legislation and for which the government does not have an immediate legal authority. Forcing a bail-in outside bankruptcy creates significant problems such as the expropriation of private rights (including the takings clause in the US). But bail-ins are needed, among other reasons, to deal with moral hazard (as explained above, and also related to efficiency considerations), to reduce costs (also related to efficiency, as discussed in Section III(B) below) and to ensure fairness in the distribution of the costs and benefits resulting from the bailout (as discussed in Section III(C) below).

Hence, in the absence of legislative support to simply mandate a bail-in, and if "hijacking" the bankruptcy process to conduct a bailout is not a sensible option,[89] the main practical mode of

[86] *See* references to the bailout principles for the General Motors and Chrysler bailouts/bankruptcies proposed by the auto team led by Steven Rattner and by Senator Corker in note 73.

[87] This is one of the two "key structural issues" of bailouts discussed by Levitin, *supra* note 33, at 490, where it is referred to as a "haircut".

[88] An important decision to take is whether there should be a benchmark/backstop in the form of the results of a liquidation, so that stakeholders that receive less than that need to be compensated, as part of their interest has been expropriated. In accordance with the principle of proportionality, we understand that such compensation should be in place, as breaches of the pre-existing rights of the parties should be minimized.

[89] Such hijacking of the bankruptcy process is what a number of scholars claim happened with the General Motors and Chrysler bailouts/bankruptcies of 2009. *See* TODD J. ZYWICKI, *The Chrysler and General Motors bankruptcies*, in

implementing a bailout of a critical/systemic firm is to structure it in a way that a (partial) bail-in can be achieved. This should be relatively straightforward in the case of shareholders. Allocating costs to them is simply done by taking an equity participation that dilutes pre-existing shareholders. The matter becomes much more difficult when dealing with creditors or other stakeholders. What has happened in practice is that the need for the (partial) bail-in as a precondition for the bailout has forced creditors to "voluntarily" accept the bail-in –or risk a liquidation where their rights would be worth far less.[90] However, this creates far too much tension and delays processes to the point where avoidable losses are incurred because of the delay. In other situations, despite the need for a (partial) bail-in for the aforementioned reasons, exacting it at the time would be counter-productive to the objectives of the bailout. In such a case it is important to have a tool that allows for the bail-in to be effected at some time in the future when affected creditors are no longer at risk of facing financial distress as a consequence of the bail-in.[91]

B. Efficiency

A public intervention by the government to carry out an *ad hoc* bailout of a critical/systemic firm should also be assessed against the measuring rod of (economic) efficiency in the sense of the Kaldor/Hicks principle or of cost/benefit analysis. A number of arguments[92] may be made against using efficiency in this sense as normative goal, but despite its shortcomings it still is the most widely used benchmark in public policy.

Research Handbook on Corporate Bankruptcy Law (Barry E. Adler ed., 2020), at 324; Levitin, *supra* note 33, at 485; RATTNER, *supra* note 73, at 180-181.

[90] *See*, for example, RATTNER, *supra* note 73, at 172-178, in relation to the auto bailout and creditors holding out. This issue is discussed on a more theoretical level in Yair Listokin and Inho Andrew Mun, *Rethinking Corporate Law during a Financial Crisis*, 8 HARV. BUS. L. REV. 349 (2018), particularly at 366-380; they refer to the AIG (at 374-377) and Lehman Brothers (at 377-380) cases as examples of the shareholders and directors holding out.

[91] The simplest practical implementation of such a bail-in is through so-called "force-placed investments" where the creditor who benefits from the bailout of its debtor issues an instrument to the government in consideration for those benefits. The amount to be repaid to the government through the amortization of that investment is then the bail-in. This is what Levitin, *supra* note 33, at 512-513, refers to as a "gavage" investment. Levitin claims that an example of such a bail-in measure during the Great Recession was the "forced" equity investment of the US government in Goldman Sachs (a large creditor of AIG who benefitted enormously from its bailout), which "bears strong similarity" to a "gavage" investment even though "the federal government never articulated a connection between forced capital injections and haircuts".

[92] *See*, for instance, HORST EIDENMÜLLER, EFFIZIENZ ALS RECHSTPRINZIP (4th ed., 2015).

Since we discuss externalities as a key motivation for the intervention to rescue critical/systemic firms via *ad hoc* bailouts, it is of the utmost importance that it is ensured that the aforementioned measures of efficiency, when applied to the bailout, properly account for all the relevant (societal) costs and benefits that need to be internalized. Some of these externalities may have time-varying characteristics, with their value changing throughout the economic cycle.[93]

Even accepting that the assessment of those externalities will be tentative, it is clear that government needs to conduct the analysis to ascertain the adequacy of the intervention. The fact that there is uncertainty surrounding the exact benefits of the intervention should be an additional supporting argument for proportionality (in the sense of subsidiarity, as discussed above); only when the benefit is clear should we feel comfortable with the significant use of public resources that an *ad hoc* bailout of a critical/systemic firm entails.

But, even when we are reasonably certain about the increased social value resulting from the preservation (avoidance) of positive (negative) externalities in a specific case, government needs to be acutely aware of the important costs that could result from the intervention, namely in the form of market distortions, the creation of moral hazard or suboptimal governance structures, especially if the state takes a controlling stake in the distressed firm. It is important that no intervention causes material long-term distortions to efficient private bargains.

In general, COVID-distressed firms should only be bailed out if their business model is sound or can at least be re-engineered to make it sound (again).[94] This consideration applies, *mutatis mutandis*, also to critical/systemic firms: any public intervention should be calibrated such that the scope and mode of operation of the critical/systemic firm is adjusted to make it as efficient as possible under the circumstances.

In the end, a bailout is a way to allocate costs resulting from a shock. Government needs to make sure that the cost is effectively borne by society in the best possible way. That means that the result

[93] *See*, for instance, YAIR LISTOKIN, LAW AND MACROECONOMICS: LEGAL REMEDIES TO RECESSIONS (2019), at 140 *et seq*.

[94] *See*, for instance, CLEMENS FUEST, WIE WIR UNSERE WIRTSCHAFT RETTEN: DER WEG AUS DER CORONA-KRISE (2020), 57.

needs to make economic sense (normally through a cost-benefit analysis). But it also needs to be acceptable to the polity. And, for that, the way in which the decision-making process on the bailout is organized and its distributive effects (and the fairness thereof) are critical.

C. Equity

By definition, an *ad hoc* bailout of a critical/systemic firm will consist of a significant transfer of resources from the government (funded by the generality of taxpayers) to a very specific company and/or its counterparties. Such a transfer poses *per se* a number of questions as to the fairness of the intervention and its effects on different people. The government, using public funds for a public purpose, needs to ensure that its (public) intervention does not favor one constituency over another for no good reason.

A first issue here is what can be done to further the public purpose. A key element was discussed in Section III(A) above, when we mentioned the need for the government to ensure that it would retain a sufficient influence to protect the taxpayers' interests and that incumbent stakeholders should contribute to the rescue via a (partial) bail-in. Another task is to ensure that the intervention is efficient (as discussed in Section III(B) above) and that the relevant externalities[95] are appropriately addressed.

A further question is whether the government should leverage its position as provider of much needed resources to advance specific policy goals. For instance, if the government is providing resources to a company that is considered to be critical/systemic because of labor market considerations, it is only natural that it will exercise its power to ensure that the company undertakes to maintain certain employment levels and that it does indeed keep those commitments. Similarly, establishing restrictions to use of the funds[96] made available to ensure the viability of the firm – *e.g.*, not using the funds to pay out a dividend or conduct a share repurchase program –

[95] There is of curse a certain degree of jurisdiction-specificity here. The concept of a critical/systemic firm (see Section II(A) above) is subject to the collective preferences underlying the economic policy of a particular jurisdiction.

[96] In accordance with the proportionality principle discussed in Section III(A), such funds should be limited to those necessary to ensure the viability of the firm and the preservation (avoidance) of the associated positive (negative) externalities.

are unobjectionable.[97] Advancing other policy goals that do not directly affect the preservation of the firm – such as "green" goals beyond what is required under "normal" legislation[98] – is certainly subject to debate. It is our view that advancing these other relevant policy goals would be an appropriate and legitimate use of the government's power in deciding whether to use public funds to rescue a critical/systemic business.[99]

Up to this point, we have considered what can be achieved in terms of the benefits of a bailout. Now we need to turn to the issue of ensuring that the intervention does not bring about negative effects or that, if it does, these are limited and appropriately dealt with. The more general issue in this regard is that of the potential creation of distortions in the market.[100] Certainly, there should be sufficient safeguards to ensure that the interests of competitors of the bailed-out firm that do not receive government assistance are taken into account. In this regard, EU state aid regulations

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[97] Such restrictions are part of the Lufthansa bailout package, *see* Press Release, European Commission, State aid: Commission approves €6 billion German measure to recapitalize Lufthansa, June 25, 2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1179 (last visited February 22, 2021).

[98] For a discussion on how this can be achieved through a tool already discussed in this article (the "golden shares"), *see* Hogan Lovells, *Going for Gold: How golden shares can help lock in mission for social enterprises (Prepared for Big Society Capital)*, December 15, 2015, available at https://www.hoganlovells.com/en/news/golden-shares-are-a-solution-to-protecting-social-mission-says-hogan-lovells-and-big-society-capital (last visited February 21, 2021).

[99] *See* also, *supra*, note 80. As the government is using public funds to advance public objectives, it does seem appropriate in terms of fairness (and proportionality) that more forward thinking policies are undertaken in these situations even if their wider roll-out in the economy is not yet a possibility – note that with underlying environmental or "green" issues, as in the case of critical/systemic firms, there are huge externalities (and very important international spillover effects), and thus bailouts might be an appropriate place to address them. Public opinion (as proxy for the desires of the taxpayers funding these interventions) is increasingly supportive of conditionality or "good citizenship" requirements, and there have been calls for such measures to be taken in relation to some of the bailed-out companies. *See*, for instance, Katherine Dunn, *Climate conditions on airline government bailouts are rare – and the coronavirus likely won't be an exception*, FORTUNE, June 26, 2020, https://fortune.com/2020/06/26/airline-bailouts-climate-conditions-coronavirus/#:~:text=Lufthansa%2C%20the%20continent's%20largest%20carrier,government%2C%20without%20climate%20strings%20attached (last visited February 22, 2021). For specific deployments of this strategy in relation to the bailout of automakers, *see* Sam Morgan, *Spain underpins car sector bailout with green goals*, EURACTIV, June 15, 2020, https://www.euractiv.com/section/transport/news/spain-underpins-car-sector-bailout-with-green-goals/ (last visited February 22, 2021); David Meyer, *Germany's auto industry could get billions in funding to go green*, Fortune, November 2, 2020, https://fortune.com/2020/11/02/germany-auto-industry-subsidies-green-self-driving-cars-eco-friendly/ (last visited February 22, 2021).

[100] A good recent example of this comes from Ryanair CEO's statements in relation to the Lufthansa bailout by the German government. *See* Joe Miller and Peggy Hollinger, *Lufthansa chief says €9bn bailout larger than needed for survival*, FINANCIAL TIMES, June 3, 2020, https://www.ft.com/content/5c32cd83-e639-4421-9ae2-8165ecdd5097 (last visited February 20, 2021).

provide a good example of institutional safeguards,[101] established to provide fairness and transparency to the process and scope of bailouts, and to ensure that competitors that may have claims in relation to their fair (or unfair) treatment are duly heard.

A related area of concern is that of "specially connected" firms that may receive special (more beneficial) treatment. Research on state intervention in the economy and, more specifically, on the political economy of bailouts[102] suggests that there are indeed certain types of firms that are more likely to receive a favorable governmental intervention because of their preexisting relationship with government officials. However, it seems that institutional safeguards in democratic states manage to keep this kind of problem under control.

Finally, equity also manifests itself in procedural safeguards to ensure that the interests of shareholders and creditors are preserved (or not) in accordance with established guidelines. This also connects to the issues regarding bail-ins discussed in Section III(A) above. A first question to consider is whether it is fair for government to decide that a specific stakeholder is to suffer a loss on their interest. A second issue is the rationale behind the distinct treatment of stakeholders when imposing a bail-in on some while not on others. The first issue presents a number of important problems, particularly in relation to the protection of private rights against expropriation. Without attempting to provide a comprehensive answer to this problem, we think it is critical to identify the applicable protections against expropriation in a specific case and to establish the relevant benchmark to consider the effect on the stakeholder's rights. As to the latter, we think there is a good case to be made for the use of liquidation as the relevant benchmark, as without the government's intervention the company would not be viable. The second issue is a matter of considering which stakeholders are in a position to best absorb the relevant losses without creating the type of negative externalities that the bailout is trying to avoid.

[101] The Guidelines, see *supra* note 53, include tools such as the structural measures (paragraph 78), the market opening measures (paragraph 78) and others aimed at limiting market distortions. These tools, particularly the structural ones, tend to be a topic of contentious discussions and negotiations between the bailed-out company, the competent national government, the European Commission and the competitors of the bailed-out company. For the issues raised in the Lufthansa bailout, *see* Joe Miller, *Lufthansa accuses EU of damaging its business model*, FINANCIAL TIMES, July 14, 2020, https://www.ft.com/content/99617bce-73ed-45cb-94c4-f28fd95325be (last visited February 20, 2021).

[102] *See* Smith, *supra* note 32, at 12 *et seq*. *See* also Mara Faccio, Ronald W. Masulis and John J. McConnell, *Political Connections and Corporate Bailouts*, 61(6) J. FIN. 2597 (2006), at 2627-2629.

A key element to ensure equity (or fairness) rests with establishing procedures that guarantee consistency in the decision-making of the government and its officials, in a way that is transparent and can be "checked" after the fact by reference to pre-specified criteria or standards.

D. Transparency

Bailouts are an exercise of the "power of the purse" by governments, in a way that may have significant distributional effects. Hence, it is vital that the bailout of a critical/systemic firm is conducted for the right reasons, and the public accepts (at least implicitly) as legitimate the use of the funds. The only way in which this can be ensured, in a context in which government (or its agencies implementing the plan) has a high degree of flexibility and discretion to act, is by ensuring that the bailout is implemented by the government[103] using its abilities in compliance with processes which are conducted publicly and transparently.[104]

This general principle, though, needs to be adequately operationalized.[105] In the first instance, this means that relevant and detailed information as to the reasons justifying the intervention and its scope must be disclosed to and shared with the public. Further, a comprehensive discussion of the relevant normative criteria applied in the decision to bail out a critical/systemic firm is another key requirement for securing the needed legitimacy of the decision.

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[103] Note that in this article, we have not engaged with a critical question regarding the implementation of bailouts, which is who specifically should have the actual authority to undertake them (*e.g.*, Parliament, the Cabinet, an agency). This is not an oversight nor an indication of this not being a relevant issue; given the comparative/normative approach that we are following in this essay, duly engaging with this matter would far exceed its scope. Suffice to say that we consider this a critical issue in relation to the legitimacy of the bailout process. For a survey of the main issues and considerations in this regard from a US perspective, *see* Levitin, *supra* note 33, at 491-492; Manns, *supra* note 71, at 1384-1388.

[104] *See* Van Zwieten, Eidenmüller and Sussman, *supra* note 3, at 36-37. On the relevance of the process level for negotiation and conflict management *see* Horst Eidenmueller & Andreas Hacke, *The PPP Negotiation Model: Problem, People, and Process*, Oxford Business Law Blog, March 17, 2017, https://www.law.ox.ac.uk/business-law-blog/blog/2017/03/ppp-negotiation-model-problem-people-and-process (last visited on February 25, 2021). It is also interesting to consider in this regard the publicity regime established in the EU in relation to state aid under Article 108(3) TFEU; *see* CONOR QUIGLEY, EUROPEAN STATE AID LAW AND POLICY (3rd ed. 2015), at 404.

[105] This *ex ante* operationalization will, together with the transparency of the process, provide for the strong legitimacy that this type of interventions require. In a similar vein, *see* Levitin, *supra* note 33, at 491.

This need for material transparency might at some point be difficult satisfy in real time, given, for instance, the specific situation of the business being bailed out and potential knock-on effects or a pressing need to act swiftly. Even though such circumstances may justify some temporary adjustments to the principle of maximum transparency, full material disclosure ought to be made as soon as possible.

In any event, all decisions relating to the bailout will eventually become transparent because they are subject to *ex post* judicial control.[106] As has already been mentioned, officials should be given sufficient flexibility and discretion in carrying out the necessary interventions, as their very specific nature means that decisions will have to be made to swiftly react to circumstances "on the ground" in a context of very limited information and working against a counterfactual as to which we do not have any certainty whatsoever. However, that should not mean that these actions should be immune to judicial control.

As previously discussed, bailouts are *ex post* responses to a critical situation, and thus are not the best subject of specific rules formulated *ex ante*. But it is also true that what we can do *ex ante* is to establish sufficiently abstract guiding principles which provide policymakers with a framework for decision-making to ensure that the result, *i.e.*, the actual bailout which is implemented, is one that is satisfactory to the public and possesses the required legitimacy. Judicial control, *ex post*, of how the actions of the government and its officials meet those standards is therefore a necessity.[107]

Conclusion

The COVID-19 pandemic continues to threaten lives and livelihoods across the world in a dimension not seen since the influenza pandemic of 1918-1920 and the Great Depression of the

[106] Whether the extent to which they are currently open to such control is sufficient, is a different question. *See* Casey and Posner, *supra* note 26, at 534-536, particularly in relation to the limited causes of action in the absence of a bailout framework. The ability for the courts to control *ex post* the implementation of the bailouts should be as wide as possible, *provided that* those actions should not be second-guessed as long as they comply with the relevant guiding principles.

[107] *See*, for instance, Posner, *supra* note 73, at 97, 122, 179, noting that during a crisis the courts should (and actually do) defer to the judgement of the government/regulator avoiding a second-guessing that would delay the intervention and cause harm, but that there should be a clear procedure to claim against the government for their actions conducted for the purposes of the bailout – and where appropriate there should also be a general *ex post* analysis of the situation by independent government agencies.

1930s. Scholars and policymakers are struggling to identify how best to respond to the financial distress of millions of businesses suffering from the sudden and unprecedented loss of revenues caused by lockdowns. No consensus has yet emerged on whether bailouts, bail-ins, bankruptcy or a combination thereof is best suited to contain the pandemic-induced economic damage to firms and the economy as a whole.

In this article, we have investigated an issue in this context which, so far, has received little attention in scholarly and public debate: namely, whether the general considerations relevant for the policy question on bailouts, bail-ins and bankruptcy apply equally to what we define as critical/systemic firms. We characterize a firm as critical/systemic in a particular jurisdiction if continuation of the firm is associated with significant positive externalities and, conversely, discontinuation with significant negative externalities. Critical/systemic firms often are involved in the provision of public goods in a jurisdiction.

We demonstrate that bankruptcy is particularly ill suited to handle the financial distress of such firms. This is because bankruptcy is a *private* process in which the debtor and its creditors seek to resolve the debtor's financial distress by readjusting the involved stakeholders' claims on the debtor's assets. This process is not apt to vindicate *public* concerns and interests other than the debtor's narrow financial interests. A bankruptcy court is not a forum to adjudicate on positive or negative externalities associated with the financial failure and possible preservation of a critical/systemic firm. This rationale against bankruptcy is quite different from the arguments against the suitability of bankruptcy to handle COVID-induced financial distress for millions of small and medium-sized or even large, but not critical/systemic enterprises.

Hence, bailing out such enterprises often will be a sensible and sometimes even an inevitable decision. However, given the scale of the financial and non-financial interests at stake in such a bailout, it is all the more important that decisions are taken in a principled manner. Hence, we suggest four principles, which should guide policymakers who have to decide on and implement bailouts of critical/systemic firms: proportionality, efficiency, equity and transparency. Observing these principles should help policymakers navigate the tricky normative terrain of large-scale

bailouts, maximizing the perceived legitimacy of the government's actions while at the same time preserving the necessary flexibility and discretion.

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