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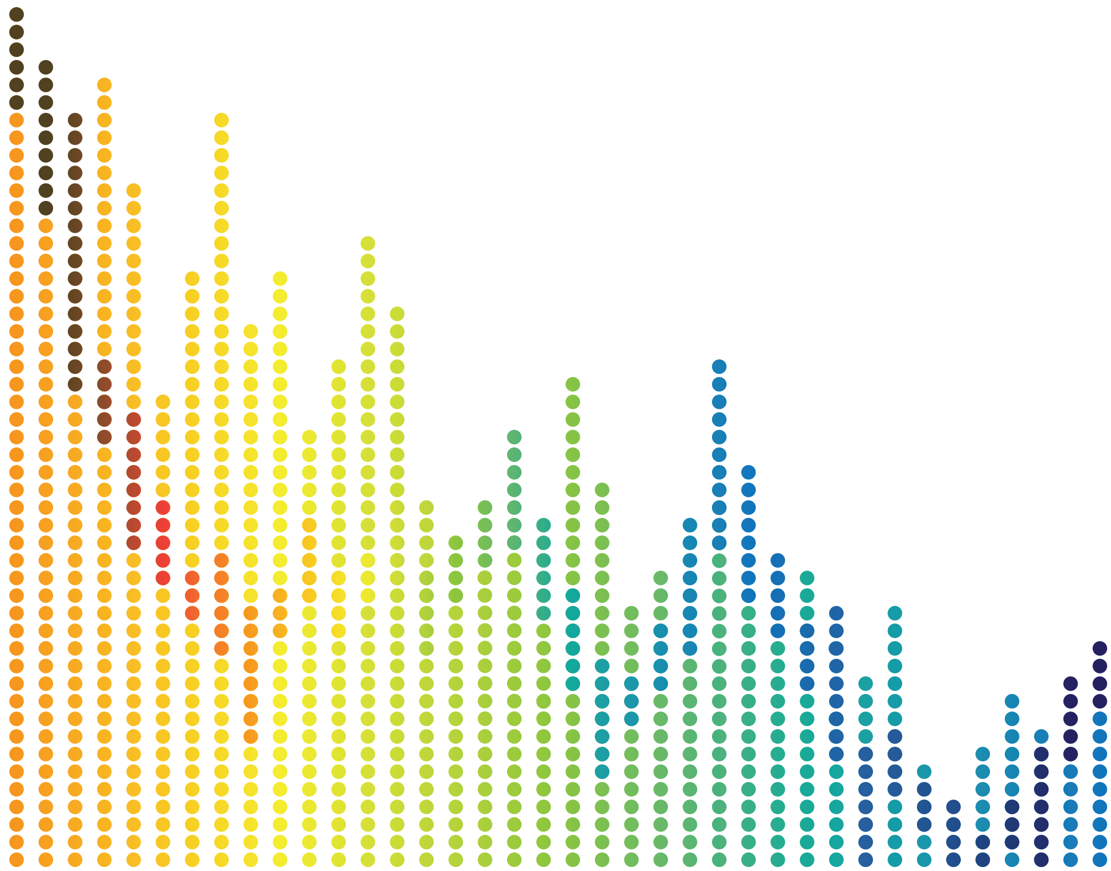

# The 2020 Economic Crisis:

## A Historical Perspective on Global Economic Distress and the Unique Impact the COVID-19 Crisis Will Have on U.S. Restructurings

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# Introduction

The global community is currently facing an unprecedented challenge based on the outbreak of a respiratory illness caused by a novel coronavirus known as COVID-19. Since the beginning of 2020, cases of COVID-19 have gradually spread across the world, creating a health crisis pandemic. The spread of COVID-19 and its economic effects, including the closure of all non-essential businesses, remains highly uncertain. Most of the world's major economies are experiencing partial or even near complete lockdowns. As a result of the economic slowdown, the COVID-19 virus threatens a global economic crisis unlike any faced in our lifetimes.

This two-part article explores the underlying risks to the U.S. economy posed by the COVID-19 health crisis and how restructuring efforts can be utilized to facilitate a durable solution for the U.S. economy. Part one discusses the current status of the U.S. economy and examines historical foreign and domestic responses to dramatic economic crises over the last 40 years. Part two examines the unique challenges posed by the COVID-19 crisis that will require a new and innovative response to remedy underlying weaknesses in the U.S. economy. Importantly, U.S. restructurings—both in and out of court—will play a crucial role in realigning industries and right-sizing corporate balance sheets to successfully adjust the U.S. economy to our new reality.

 The authors would also like to thank the following individuals for their invaluable contributions to this article: Nancy Mitchell, Peter Friedman, Sung Pak, Tobias Knapp, and David Deaton.

## PART I: THE CAUSES OF THE 2020 ECONOMIC CRISIS IN CONTEXT

## The COVID-19 Pandemic Exposes Significant Weaknesses of the U.S. Economy

The recent shutdown of large segments of the U.S. economy in response to the COVID-19 health crisis comes against the backdrop of an economy that has amassed nearly $10 trillion of non-financial corporate debt[1] among large publically traded corporations as of June 30, 2019; a record 47 percent of U.S. gross domestic product ("GDP").[2] Since the start of the last global financial crisis, U.S. non-financial corporate debt has risen 52% from its last peak of $6.6 trillion or about 44% of U.S. GDP in the last quarter of 2008.[3] These figures, however, do not take into account the funded debts of small- and medium-sized enterprises, family businesses, and other businesses not listed on stock exchanges. After adding the $5.5 trillion of additional debt amassed by these smaller, non-traded companies, the total amount of U.S. corporate debt is actually closer to $15.5 trillion, or 74% of U.S. GDP.[4] When combined with pressures, right or wrong, on public companies to repurchase stock rather than maintain cash on the balance sheet, the ability of businesses to withstand macroeconomic disruptions have been significantly compromised.

If the quantity of debt is alarming, the quality is even worse. Of the $15.5 trillion of U.S. corporate debt, about one-third is in the form of either (1) leveraged loans or (2) bonds rated BBB or lower, placing them in the high-yield (or "junk bond") category.[5] Of these high-risk debt categories, junk bonds are the largest by debt amount, with approximately $3.8 trillion outstanding.[6] Over the last decade, investors have flocked to the junk bond market in search of higher yields as central banks maintained treasury interest rates at or near zero.[7] The easy availability of refinancing allowed low-rated companies to continue to revolve their debt at low interest rates, which led to running up corporate debt with the hope that they could indefinitely postpone repayment of these debts in full.

With the economic downturn resulting from the COVID-19 pandemic, reduced demand, disruptions to long and complex global supply chains, and an impending liquidity crunch (which has been at least temporarily mitigated by recent Federal Reserve actions), marginal companies will likely be required to pay their substantial debt obligations at maturity.[8] Over the next five years, a record $1.2 trillion of high-yield bonds will mature.[9] Of these maturities, approximately 90 percent are concentrated within 15 major industries, including: (1) services ($205 billion); (2) technology ($125 billion); (3) media ($103 billion); (4) oil and gas ($99 billion); (5) telecommunications ($90 billion); (6) healthcare ($72 billion); (7) retail ($70 billion); (8) manufacturing ($59 billion); (9) consumer products ($51 billion); (10) gaming and lodging ($39 billion); (11) packaging ($38 billion); (12) automotive ($37 billion); (13) chemicals ($34 billion); (14) wholesale distribution ($26 billion); and (15) transportation ($22 billion).[10]

To put this in proper perspective, U.S. corporate high-yield debt is currently more than 20 times higher than in 1987, when the Dow Jones Industrial Average plunged 22.6% to its largest one-day percentage-point drop ever,[11] similar to the Dow's worst single-day point drop of 2,013.76 points on March 16, 2020.[12] In 1987, U.S. corporate high-yield debt was approximately $187 billion[13] (or 3.8% of U.S. GDP in 1987)[14] as compared to about $3.8 trillion today (or 17.8% of U.S. GDP in 2019).

The hope is that massive federal stimulus packages and liquidity backstops will soften the economic impact of the devastating shutdown of the U.S. economy and that once the pandemic subsides the economy can return things to normal quickly. This hope is drawn, in part, upon our experience with the economic recovery from the 2008-2009 global financial crisis, which saw defaults of high-yield debt drop within a year from 12 percent to 2 percent due in large part to the federal government's stimulus efforts, including the Federal Reserve's quantitative easing program and TARP (as discussed below).[15]

This time around, we may not be as lucky because of a confluence of events that have created a perfect economic storm. *First*, the U.S. economy is currently operating under the staggering amount of corporate debt described above. To make matters worse, many of these debt-ridden firms are mere "corporate zombies"—over 40 percent of companies listed on U.S. stock exchanges in 2019 were unprofitable.[16] *Second*, in March 2020, oil prices collapsed by about 50 percent and continue to decline because of an ongoing price war between Saudi Arabia and Russia that has increased crude oil production at a time when the COVID-19 pandemic has slashed global demand.[17] *Third*, U.S. states, territories, and municipalities are currently under severe economic strain. According to a 2019 study, the states have racked up approximately $1.5 trillion in unfunded debt and at least 40 states do not have enough money to pay all of their obligations.[18] To make matters worse, the most substantial deficits are concentrated among some of the highest-populated states that already have high tax rates, including: (1) California ($275 billion deficit); (2) Illinois ($223.9 billion deficit); (3) New Jersey ($208.8 billion deficit); (4) New York ($136.6 billion deficit); (5) Massachusetts ($82 billion deficit); and (6) Pennsylvania ($75 billion deficit).[19] *Fourth*, the near-total shutdown of the U.S. economy—as required by state "shelter-in-place" orders and federal social-distancing guidelines announced on March 15, 2020—has pushed companies with weak balance sheets to the brink.[20] According to recent Wall Street forecasts, the sudden stop in U.S. economic activity due to preventative measures against COVID-19 spread could cause U.S. GDP to drop as much as 34 percent in the second quarter of 2020, with the unemployment rate topping out at 15 percent or more before any meaningful recovery can take hold.[21]

The reality is that, even after the housing and banking industries recovered from the last global financial crisis, corporate debt in the United States has remained perilously high, and many companies that probably should have gone through restructurings continued in business due to the availability of easy credit. As the cost of debt remained exceedingly low, these marginal companies continued to add high-yield debt to their balance sheets with covenant light credit agreements and bond indentures. This may result in a higher default risk for these companies this time around. According to S&P, the default rate for junk bonds is expected to triple in the next 12 months, rising from 3.1 percent at the end of 2019 to between 10-13 percent by the end of 2020, depending upon how long efforts to combat

COVID-19 drag on and the efficacy of federal stimulus measures.[22] And the default rate could be even worse for certain industries, such as oil and gas, which was experiencing an annual default rate of 13.4 percent on the industry's high-yield bonds even before last month's oil price collapse.[23]

Still other tests indicate a more severe scenario. According Dr. Edward Altman—the NYU professor emeritus who pioneered a financial-distress "z-score" formula for predicting bankruptcies—more than 30 percent of all BBB-rated companies at the end of 2019 are vulnerable to rating downgrades, which may cause debt defaults or liquidity crises that will likely result in "a lot of marginal companies [being] forced out of business."[24] New research from Deutsche Bank indicates a "severe global recession" through at least the second quarter of 2020 depending on whether COVID-19 containment measures succeed in flattening the epidemic's curve by mid-year.[25]

While force majeure may be the term du jour for excusing contractual performance, our problems go far deeper than that and the current crisis will take far longer to correct, unlike the 2008-2009 global financial crisis and similar crises faced by the U.S. and foreign countries over the last 40 years.

## How Does the COVID-19 Crisis Compare to Economic Crises We Have Experienced Over the Last 40 Years?

### FOREIGN ECONOMIC CRISES

#### Latin American Debt Crisis (1982-1989)

Following World War II, several nations entered into the Bretton Woods Agreement in 1944 to create the International Monetary Fund (the "IMF") designed to grant loans to sovereign nations and limit recessions during short-term economic difficulties.[26] In the 1970s, however, the Bretton Woods system began to deteriorate as IMF loans, which contained certain rigid prerequisites, became less attractive than cheaper loans from private foreign banks looking for higher investment margins in emerging markets.[27] Starting in the 1970s, many Latin American countries gorged on this cheap foreign debt to fund their development and infrastructure programs. As a result, Latin America's external debt rose seven-fold over the next decade, from about $48 billion in 1973 to about $350 billion in 1983 (or 58% of gross regional product).[28]

The Latin American debt crisis officially began in August 1982, when Mexico declared that it was unable to service its foreign debt.[29] Brazil, Venezuela, Argentina, and Bolivia followed shortly thereafter. Two converging factors caused the defaults in loan payments: (1) the oil crisis of the late 1970s led to higher oil prices and increased borrowing from Latin American countries to pay for oil; and (2) the rise of interest rates in the United States correspondingly increased the interest payments of debtor nations.[30] In response to the defaults, foreign banks initially offered bridge loans and debt rescheduling as means of restructuring Latin America's sovereign debt.[31] After eleven countries, including Argentina and Mexico, had to restructure their debt over 10 times during the 1980s, it became clear to foreign banks that other measures would be necessary.[32] In order to continue servicing their loans with foreign banks, Latin American countries were forced to take out new IMF loans in exchange for pro-market reforms and severe austerity programs that drove nearly half of the population below the poverty line.[33] To set Latin American countries back on their feet, the United States proposed the Brady Plan in 1989.[34] Under the Brady Plan, the loans owed by Latin American countries were converted into bonds (the so-called "Brady Bonds"), which were backed by U.S. Treasury bonds and issued at a discount.[35] The Brady Bonds reduced the borrower's obligations and allowed for longer maturity dates so that nations had more time to rebuild their economies and generate revenue, while the foreign banks could get the debt off their balance sheets.[36]

### The Tequila Crisis (1994)

After resolving its financial problems from the early 1980s, Mexico instituted broad economic reforms by reducing tariffs, deregulating and privatizing the banking sector, and reducing its budget deficit.[37] Foreign capital flooded into Mexico and provided very high returns for investors, including a 118% return in 1991.[38] But, political and economic instability returned in 1994. A series of U.S. interest rate rises strengthened the U.S. dollar, putting pressure on the peso, while the assassination of a presidential candidate and the secretary general of Mexico's ruling party caused political upheaval.[39] To avoid these increased risks, over $3 billion of foreign capital left the country in November 1994.[40] Despite the Mexican government's efforts to devalue the peso by 15% in December 1994, the Mexican stock market lost two-thirds of its value in dollar terms by the time it bottomed out in March 1995.[41] To prevent a sovereign default and the spread of a broader crisis to other emerging stock markets (particularly Brazil and Argentina), the United States backed a $50 billion bailout plan funded by the U.S. Treasury ($20 billion), the IMF ($18 billion), the Bank of International Settlements ($10 billion), and private banks ($2 billion).[42] The package included an austerity plan requiring an increase in Mexico's value-added tax, budget cuts, increases in energy prices, and tighter monetary policy.[43] Mexico repaid these loans ahead of time in January 1997.[44]

### Asian Financial Crisis (1997-1998)

Fifteen years after Latin America's debt crisis of 1982, history repeated itself in Asia. During the 1990s, substantial growth in Asia's export economies led to high levels of foreign direct investment in the region, including South Korea, Thailand, Malaysia, Indonesia, Singapore, and the Philippines.[45] Once again, eager investors and easy lending resulted in huge amounts of debt to foreign entities that could not be repaid when their currencies plummeted and hyperinflation spread. In late 1997, the IMF committed more than $110 billion in short-term loans[46] to Thailand, Indonesia, and South Korea to help stabilize their economies in exchange for deep budget cuts and aggressive austerity measures.[47]

### Ukraine Economic Crisis (2008 & 2014)

Between 2000 and 2008, Ukraine enjoyed a strong economy with 6.3% annual GDP growth, declining inflation, and significant external trade surpluses due to surging global prices for its core commodity exports: iron and steel.[48] During this boom period, the country's banking sector grew exponentially as

Ukraine gained better access to global capital markets and foreign-owned banks provided loans to the private sector.[49] Ukraine-based companies gorged on this readily available foreign capital and in four years more than doubled their total aggregate external debt to $103.2 billion at the end of 2008.[50] Although Ukraine's corporate debt was only 29% of its GDP (an amount below similar ratios for private-sector indebtedness in developed countries), more than half of the country's corporate debt was denominated in foreign currencies, which exposed borrowers to currency risks.[51] In addition, the rapid growth of domestic credit did not allow sufficient time for structural protections to develop within the banking system, leading to weak regulatory supervision and relaxed lending standards.[52]

When the global economy crashed in the last quarter of 2008 and demand for Ukraine's industrial commodities deteriorated, Ukraine suffered from the fallout as access to foreign capital dried up overnight, currency markets sold off the hryvnia causing hyperinflation, and credit rating agencies downgraded the country's corporate debt.[53] The Ukrainian government, however, proactively requested IMF support in mid-October 2008, and the IMF swiftly granted Ukraine a $16.4 billion loan in November 2008 conditioned on austerity measures that included achieving a balanced budget and reducing the minimum wage.[54] However, the IMF loan program was temporarily suspended in November 2009 when Ukraine passed a law raising the minimum wage and pension benefits. By July 2010, Ukraine restored its relationship with the IMF and committed to additional austerity measures in exchange for a $15 billion IMF loan.[55] Although the Ukrainian economy recovered in 2010, political turmoil related to the Russian annexation of Crimea caused the economy to contract by 8 percent in 2014.[56] In response to this new crisis, the IMF extended Ukraine an additional $17 billion loan subject to an economic reform program focused on exchange rate flexibility, banking stability, fiscal policy, energy policy, and structural reforms.[57]

### Greek Sovereign Debt Crisis (2010-2018)

In 1981, Greece became a member of the European Union but could not adopt the euro as its currency because its budget deficit was too high.[58] Although it was authorized to adopt the euro in 2001, Greece later announced in 2004 that it lied about its budget deficit so that it could enter the Eurozone.[59] Fearing that sanctioning or expelling Greece would weaken the euro, Greece was allowed to continue in the Eurozone.[60] By 2009, Greece's budget deficit reached 15.4 percent of GDP, which was five times the European Union's 3 percent limit.[61] In 2010, Greece warned that it might default on its debt, which threatened the future viability of the euro because Germany (the largest Eurozone economy) and its bankers were Greece's largest lenders.[62] To prevent Greece's default, the European Union and IMF provided €240 billion of bailout loans, the first of a series of bailout loans issued to Greece through August 2018.[63] The bailout package also imposed austerity measures on Greece, including increases to the VAT tax and corporate tax rates, pension reforms, and spending cuts.[64] Although the austerity measures helped Greece achieve a budget surplus of 0.8 percent and GDP growth of 1.4% in 2017, the measures also resulted in 22 percent unemployment and one-third of the population living below the poverty line.[65] When the Greece bailout program ended in August 2018, Greece owed six groups of funding entities (primarily funded by German banks) over €295 billion in bailout loans, representing the largest bailout of a sovereign nation in history.[66] As of January 2019, Greece has only repaid €41.6 billion and has scheduled debt payments through August 2059.[67]

## UNITED STATES ECONOMIC CRISES

### The Savings and Loan Crisis (1986-1995)

In the early 20th century, savings and loan associations ("S&Ls")—financial institutions that specialize in savings deposit accounts and mortgage loans—helped facilitate expanding homeownership in the United States by offering federally insured savings accounts up to $40,000 and low-interest mortgages.[68] During the 1980s, S&Ls experienced unprecedented losses on loans and investments as a result of, among other things, (i) high and volatile interest rates that exposed them to interest-rate risk; (ii) state and federal deregulation of the industry that allowed S&Ls to enter riskier loan markets; and (iii) the withdrawal of federal tax benefits for commercial real-estate investments.[69] By year-end 1986, the Federal Savings and Loan Insurance Corporation ("FSLIC"), the federal insurer of the S&L industry, was insolvent.[70] In response, the United States Congress created the Financing Corporation ("FICO") to issue long-term bonds to fund FSLIC. From 1986 to 1989, FSLIC closed or otherwise resolved 296 S&Ls with total assets of $125 billion. During this same period, however, an additional 974 S&Ls were either book insolvent or had tangible capital of less than 2 percent of total assets, but held 47 percent of industry assets.[71] In response to the worsening crisis, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), which tightened up the rules for S&Ls while giving Fannie Mae and Freddie Mac more responsibility for supporting mortgages for lower-income individuals. FIRREA also injected over $124 billion of taxpayer funds to resolve S&Ls placed into conservatorships or receiverships.[72]

Unfortunately, predatory lending continued and the credit crisis left the underlying economic problems unresolved. From 1989 to 1995, a second wave of failures resulted in the closure of an additional 747 S&Ls with total assets of $394 billion.[73] By the end of the crisis in 1995, the number of S&Ls operating in the United States declined by approximately 50 percent with total estimated losses of $153 billion.[74]

### U.S. Stock Market Crash (1987)

From the close of trading on Tuesday, October 13 to the close of trading on Monday, October 19, 1987, the Dow Jones Industrial Average declined by almost one-third, representing about a $1 trillion loss in value of all outstanding U.S. stocks.[75] The crash reached its crescendo on October 19, 1987, when the Dow plunged 508 points, losing 23% of its value in a single day.[76] The selloff was extraordinary in terms of the speed of falling prices and skyrocketing trading volume, which together led to mechanical and liquidity problems at all major exchanges.[77] By mid-day on October 20, the securities markets and the financial system approached breakdown as many firms could not catch up with customer orders, which created a price disconnect in the markets.[78] In immediate response to the crash, the Federal Reserve helped restore market confidence by issuing a statement of readiness to provide liquidity, support for keeping the stock markets open, and encouraging extensions of credit during the crisis.[79] In addition, statements from President Reagan provided important reassurances to investors that limited the impact and duration of the crisis.[80] Because the 1987 crash was short-lived, it did not lead to any meaningful solutions that might have blunted the junk bond crisis of 1989. The 1987 crisis did lead to the creation of a Working Group on Financial Markets in March 1988, which recommended the implementation of certain "circuit-breaker" mechanisms that provided for a 30-minute trading halt of all securities and derivatives instruments after a 350-point Dow decline in a day and a 1-hour halt after a 550-point Dow decline in a day.[81] These circuit-breaker mechanisms were eventually codified under the Market Reform Act of 1990, and are still in place today with modern modifications.[82]

### U.S. Junk Bond Crash (1989)

In the 1970s, Michael Milken, a finance executive at Drexel Burnham Lambert, pioneered and popularized the use of high-yield bonds for corporations that could not get financing from traditional banking sources. Due to the instability of interest rates during the 1970s and early 1980s, borrowers were seeking lower interest rates than private placements with fewer restrictive covenants, and investors were seeking a higher risk-adjusted rate of return than investment-grade bonds.[83] From 1979 to 1989, the junk-bond market grew exponentially from $10 billion to $189 billion, averaging a 34 percent increase each year.[84] During this period, investor yields averaged 14.5 percent and default rates were low, averaging only 2.2 percent.[85] The junk bond market, however, was dominated by a single firm—Drexel—which underwrote 57 percent of the $46 billion of new junk bond issuances between 1978 and 1985.[86] After Milken pled guilty to criminal charges related to securities fraud and racketeering and a general recession placed stress on the high-yield market in 1989, Drexel filed for chapter 11 protection on February 13, 1990.[87] As a result, the use of junk bonds was briefly stigmatized and no significant new high-yield bonds were issued for more than a year after Drexel's collapse.[88]

### Dot-Com Bubble (1999-2001)

At the turn of the century, the creation and expansion of the internet facilitated a euphoric (and often unrealistic) attitude toward the future of online commerce, which promoted a bull rush of investment into technology companies (known as "dot-coms").[89] In the mid- to late-1990s, Internet entrepreneurs were enamored with dreams of becoming dot-com millionaires, inspired by the success of companies like Amazon and eBay.[90] The excitement over the internet's possibilities and the availability of cheap debt allowed investors to ignore fundamental investment principles, such as analyzing P/E ratios, market trends, and business plans.[91] As the economy slowed and interest rates rose, easy money dried up and the dot-com bubble popped, resulting in hundreds of dot-com bankruptcies, including Pets.com (an online pet food and supply company), Webvan.com (a grocery delivery service), eToys.com (an online toy retailer), Flooz.com (an online currency company), and theGlobe.com (a web page creation platform).[92] After the dust settled, the dot-com bubble cost investors approximately $5 trillion.[93]

## Post-9/11 Crisis (2001-2002)

On September 11, 2001, terrorist attacks in New York and Washington, D.C. caused an immediate shutdown of financial markets and widespread concern over the security of production, distribution, finance, and communication in the United States.[94] In the nine-months prior to the attacks, the pace of growth in the U.S. economy was beginning to slow from 5 percent at the beginning of 2001 to 2 percent in the fall of 2001.[95] By October 2001, industrial production fell by 1.7 percent and the unemployment rate rose to 5.4 percent.[96] The costs of the terrorist attacks were disproportionately borne by the airlines, the tourism industry, insurance companies, and small businesses in the New York and D.C. metro areas.[97] In response, the federal government provided $21.7 billion of humanitarian and economic aid to New York City, and a $15 billion rescue package for the airlines.[98] In addition, the Federal Reserve added about $300 billion in liquidity over three days to assist the financial community.[99]

The post-9/11 economic recession brought to light that the bull market leading up to the attacks was at least partially based on corporate fraud.[100] As the economic slowdown caused a liquidity crunch in the financial markets, companies such as Enron, WorldCom, Global Crossing, and Tyco could no longer hide their accounting scandals, which resulted in multi-billion dollar bankruptcies and criminal convictions of chief financial officers.[101] In response to the crisis, Congress passed the Sarbanes-Oxley Act in 2002, which created federal oversight of the accounting industry, established new corporate governance requirements to avoid conflicts of interest, and imposed stricter criminal and civil liabilities for financial statement certifications, among other things.[102]

## Global Financial Crisis (2008-2009)

The global financial crisis was the worst economic disaster since the Great Depression of 1929. There were three converging causes of the crisis. *First*, lax lending practices allowed banks to invest in risky mortgages by lending to homeowners with subprime credit.[103] *Second*, banks then divided the mortgages into tranches and issued mortgage-backed securities to investors, which included hedge funds, mutual funds, pension funds, and other financial institutions around the world.[104] *Third,* a novel insurance product known as credit default swaps ("CDS") emerged to protect investors from risky assets, which generated increased demand for mortgage-backed securities and the subprime mortgage loans used to collateralize them.[105]

By March 2008, the scheme began to unravel and the federal government began a year-long process of bailing out the banking and automotive industries, which were deemed "too big to fail." In March 2008, the Federal Reserve provided a $30 million guarantee for JPMorgan Chase to take over investment bank Bear Stearns after investors sold off their shares.[106] On September 16, 2008, the Federal Reserve loaned $85 billion to insurance company AIG as an initial bailout after it could not fund its toxic CDS obligations.[107] The next day, investors made a run on money market funds, moving a record $172 billion to safer U.S. treasury bonds.[108] Two weeks later, Congress approved the $700 billion Troubled Asset Relief Program ("TARP"). In 2008, Treasury disbursed $441.8 billion of TARP funds, of which: (i) $245.1 billion was used to buy bank preferred stocks to give liquidity to financial institutions; (ii) $79.7 billion was used to bailout General Motors and Chrysler; (iii) $67.8 billion was used to supplement the bailout of AIG; (iv) $19.1 billion was used to secure credit markets; and (v) $30.1 billion was used to modify mortgage loans.[109] By 2018, the federal government sold its entire equity stake in the companies it bailed out and fully repaid the TARP fund while making a $900 million profit. Instead of using the remaining TARP funds, in February 2009, Congress enacted the American Recovery and Reinvestment Act, which gave $831 billion to consumers and small businesses through tax cuts, stimulus checks, and public works spending.[110]

Although the government's drastic bailout measures successfully ended the financial crisis by July 2009, the U.S. economy's underlying problems were not addressed due to government intervention. For example, because the government provided rescue loans rather than allowing illiquid and insolvent firms to restructure in a traditional bankruptcy or fail, companies with marginal balance sheet continued to obtain credit.[111] As a result, firms over the last decade have resorted to raising capital through debt rather than selling stock, which could exacerbate future financial crises and create greater need for new government bailouts.[112]

# PART II: HOW THE 2020 ECONOMIC CRISIS IS DIFFERENT FROM HISTORICAL CRISES AND RECOMMENDATIONS FOR A DURABLE RESPONSE

## Comparison of U.S. and Foreign Resolutions to Debt Crises

As noted in part one, the major foreign debt crises of the last four decades were resolved largely through IMF loans conditioned on austerity and painful right-sizing measures. Yet each of the crises encountered in the United States have been resolved without resorting to economic austerity. For the last several decades, the flood of foreign money into U.S. treasuries has allowed the Federal Reserve to prop up marginal companies through expansionist monetary policy and by printing money at will to fund corporate bailouts without any accountability. While too much austerity can be detrimental to an economy and potentially extend the severity of a recession,[113] the failure to impose any financial restraints can be just as damaging if it allows increasingly risky behavior to continue without consequence. Although Congress attempted to impose financial restraints through the Dodd-Frank Act of 2010 to minimize the risky behavior that caused the 2008-2009 global financial crisis, Dodd-Frank in fact did nothing more than to remove the tools used to combat that crisis. By limiting the Federal Reserve's lending powers to non-banks, preventing the FDIC from expanding guarantees to bank depositors without congressional approval, and imposing stiff liquidity requirements that resulted in liquidity hoarding at large traditional banks, Dodd-Frank created an environment that led to the increased role of private, non-bank lenders in the financial markets.[114] While this created opportunities for new types of lenders searching for yield in a persistently low interest rate environment, the impact of Dodd-Frank merely shifted to the risk to new participants without addressing the insatiable appetite of borrowers to access cheap credit that has led to the bloated corporate balance sheets we see today.

One could say that the Federal Reserve's repeated willingness to come to the assistance of companies dubbed "too big to fail" has lessened the sensitivity of corporate borrowers, lenders and investors to the consequences of risky behavior. As shown in the recent sovereign debt crises faced in Latin America, Asia, and Europe, the availability of cheap foreign debt to artificially prop up fiscally unsound economies exposed those countries to substantial default risk from an external crisis, such as from currency or commodity devaluations that trigger calls of debt that cannot be repaid. Similarly, the exorbitant levels of U.S. non-financial corporate debt at companies that probably should have either gone out of business or realigned their balance sheets a decade ago exposes them to the negative economic effects of an external event (here, a viral pandemic) that will trigger repayment demands that cannot be satisfied. In essence, the perpetuation of government bailouts and easy access to cheap capital creates market distortions that never fully address the underlying cause of the immediate economic crisis, thus dooming the economy to repeat the same mistakes with the potential for increasingly more severe consequences. To progress, we must stop the vicious cycle.

Although COVID-19 has put many otherwise healthy companies in dire straits through no fault of their own, these same companies also failed to use the economic growth of the last decade to reinvest in their businesses or build cash reserves to weather a future economic downturn. For example, one goal of the $1.5 trillion corporate tax cut in 2017 was to spur further economic growth through increased business investments in buildings, factories, equipment and technology.[115] Although there is evidence that the tax cut spurred business investment in the first and second quarters of 2018 and fueled record job creation and wage growth, the tax cuts also created some collateral negative effects.[116] One of these negative effects was that corporations spent $124 billion of their tax cut savings on stock buybacks and one-time bonuses rather than reinvestment.[117] The fact that companies continued to borrow cheap money during the decade-long bull market rather than invest profits and tax savings in their businesses only compounds the substantial debt risk in the U.S. economy heading into the COVID-19 crisis.

## The COVID-19 Crisis is Different than Past Economic Crises and May Lead to Broader Societal and Political Shifts Requiring Fundamental Economic Changes

A key distinction of the COVID-19 economic crisis is that the external event was not rooted in a financial trigger or event as were the crises described above. Here, however, the external event is a biological virus that not only threatens to infect a significant portion of the U.S. and world population, but also has caused an unprecedented shutdown of the global economy. In some ways, the COVID-19 economic crisis is more akin to a war, wherein governments force the shutdown of significant portions of society with an unknowable scope and duration in response to a factor beyond their control. Because the underlying problem is not financial, there is no monetary policy response that can fully address it. In addition, the scope of the COVID-19 crisis is all-encompassing, affecting all geographical regions and industries. As a different kind of problem, the COVID-19 crisis will require a different kind of solution.

Due to the unique nature of this crisis, fundamental economic changes may be required to address broader societal shifts caused by COVID-19. Because COVID-19 is changing the way modern society operates, it may cause the acceleration of certain trends while reversing others. For example, the rapid development of a robust internet infrastructure and innovative communication technologies over the last two decades has made remote work more productive and more accessible than ever.[118] While working from home was typically a special accommodation just a few weeks ago, the COVID-19 crisis has forced the shift of many businesses to a remote-only work model.[119] As a result of this forced experiment, many employers are learning that their businesses can operate successfully with completely remote teams, which may accelerate the broader societal shift towards a remote workforce.[120] Conversely, the COVID-19 crisis may reverse the trend of Americans dining out for most meals, as the shutdown of restaurants and bars to facilitate social distancing has forced Americans to rethink their eating habits.[121]

In addition, our increased capabilities for remote learning deployed during this crisis will challenge the current model for higher education in the United States. Currently, over 45 million U.S. borrowers collectively owe a record $1.6 trillion in student loan debt.[122] For the past several decades, higher education costs have been increasing steadily by about 3-4 percent annually, climbing to an average of $10,116 per year for public colleges and $36,801 per year for private colleges (excluding room and board) for the 2019-2020 school year.[123] The problem of higher education costs is not new, and the federal government has taken several steps to alleviate the burden on student borrowers. In the aftermath of the 2008 financial crisis, the federal government adopted a Pay As You Earn (PAYE) program, in which student borrowers could establish repayment plans so that payments do not exceed 10 percent of discretionary income and, if timely payments are made for 20 years, the remaining principal balance would be forgiven.[124] In response to the COVID-19 crisis, the federal government implemented an automatic six-month suspension of payments and waiver of interest on federal student loans.[125] As the costs of a four-year education outpace their ability to pay,[126] students and families will likely reconsider the value and necessity of an expensive, on-campus education. Universities may also re-evaluate how their services are delivered and offer more remote learning opportunities. For centers of higher education that do not respond to these changing circumstances, many will be forced to merge with other healthy institutions or go out of business.

The healthcare system in the United States is also likely to undergo a fundamental transformation as a result of the COVID-19 crisis. As of 2018, national healthcare spending in the United States was $3.6 trillion, or 16.9% of U.S. GDP—nearly twice as much as the average developed nation.[127] Despite record amounts of spending, U.S. healthcare outcomes have deteriorated, with the lowest life expectancy and highest chronic disease burden among the 11 richest nations in the world.[128] The United States also has a very low supply of physicians compared to its peer nations.[129] Although the United States is the global leader in drug discovery, most pharmaceutical ingredients and medical devices are imported from foreign manufacturers.[130] Over the last several weeks, this supply chain vulnerability has caused policymakers to reconsider how medicines are obtained in the United States to avoid shortages in the event of a war, trade conflict, or future public health crisis.[131] In light of the shortage of healthcare facilities, doctors, and equipment needed to respond to the COVID-19 crisis, the condition of the U.S. healthcare system and pharmaceutical supply chains will certainly become the focal point of debate and policymakers will re-evaluate how the system prepares for future pandemics and potential biological warfare.

The crisis may also require the United States to address three key shifts in the political landscape.

*First*, the COVID-19 crisis may lead people to question whether the government should be restructured to avoid detrimental interference by private enterprise when the lives of citizens are at risk. For example, in response to the near-pandemic posed by the H1N1 swine flu in 2009, the U.S. federal government paid $6.1 million to a private company to make ventilators for our national stockpile in preparation for a future outbreak.[132] But a few months after signing the government contract, a competitor purchased the small medical device manufacturer and not a single ventilator was produced.[133] Now that a true pandemic is upon us, the scarcity of ventilators has caused a public health emergency that could have been mitigated if the private sector had not interfered with the government's efforts.

*Second*, the COVID-19 crisis may lead to fundamental changes in the relationship between the federal and state governments. The current crisis has revealed that state governments are closer to the people and better able to administer critical resources appropriately than the federal government. Rather than waiting for the federal government to act, states have collaborated in an unprecedented way to implement coordinated shelter-in-place orders weeks before similar federal guidelines were issued.[134] For example, the states of New York, New Jersey, and Connecticut jointly adopted a plan for limiting social gatherings and called on the federal government to adopt a similar plan for other states to follow.[135] This revelation could cause a shift in two directions. Because states have shown they can mobilize more quickly than the federal government, state governments may take a leading role in national issues with the federal government only acting in response to the states. Alternatively, the federal government may realize that it needs to mobilize more quickly and could impose broader orders rather than guidelines for states to follow.

*Third*, the COVID-19 crisis has caused substantial strain on the United States' social safety net. During the week ending March 28, an unprecedented 6.6 million people filed new unemployment insurance claims as a result of the shutdown of the U.S. economy,[136] double the record amount of 3.3 million the week before.[137] The 9.9 million new jobless claims over the last two weeks represents 6 percent of the U.S. labor force, which is projected to increase to 20 million or more.[138] This development of mass unemployment is particularly troubling because the loss of human capital takes years to redevelop, which some firms simply will never be able to recapture before having to go out of business.[139] In addition, mass unemployment places a substantial strain on states to pay unemployment claims. Even prior to this crisis, the latest report on the status of U.S. entitlement programs indicates that Medicare's hospital insurance fund will be insolvent by 2026[140] and Social Security reserves depleted by 2052.[141] Although this surge in claims may end up being temporary and the costs may not accelerate the impending insolvency of the system, both federal and state governments are likely to re-evaluate the structure and cost of social security programs to ensure their future viability.

The lingering issue is how both the global and national economies will react to the shutdown. Moreover, it remains to be seen how quickly the U.S. economy will restart as spread of the COVID-19 virus abates and restrictions on everyday activity are lifted. How high will the default rate reach? Will federal stimulus packages and "temporary" liquidity backstops be enough to mitigate the damage? What will be the new normal for individuals and businesses in a post-pandemic economy?

The reality is that the economy will need to go through a painful realignment—much like after 9/11, life will never be the same. Those companies that were propped up by cheap debt may find it difficult to restructure, even with available liquidity. Consolidation in many industries and layoffs will certainly occur. State governments and municipalities—further strained from unprecedented stresses on the social safety net—will need to restructure their own debt, especially large states with high annual deficits and substantial taxpayer burdens. The bankruptcy process will be an essential part of the cure. In 2009, the chapter 11 cases of General Motors and Chrysler were critical to the rescue of the U.S. auto industry, enabling both companies to restructure over $60 billion of combined liabilities in separate proceedings that each lasted less than 40 days. Given the sheer magnitude of our current crisis, the bankruptcy process will be even more important: As painful as this reckoning is likely to be, substantial restructurings must occur across several industries on accelerated timelines.

The bottom line is that the economic crisis of 2020 may ironically be the event that results in companies with weak balance sheets and poor controls being acquired by healthy companies or simply going out of business. Although the Federal Reserve recently announced that it is prepared to bailout every industry to the tune of $4 trillion[142] and some projections indicate that the Federal Reserve's balance sheet could exceed $9 trillion,[143] such actions would be an unprecedented reaction to a crisis that is rife with ongoing uncertainty that may beyond the control of government policy altogether. We simply do not know. Even if Federal Reserve and other government action is able to avoid (or at least mitigate) a total economic catastrophe, the built in layer of unprecedented U.S. corporate debt levels going into this crisis points to the need for a significant realignment of balance sheets, and many weak businesses will not survive. For healthier companies and governments fortunate enough to survive, the aftermath of this crisis may finally provide the wake-up call they need to re-evaluate their balance sheets and return to responsible borrowing and prudent lending practices.

## The COVID-19 Crisis Will Also Negatively Affect Healthy Companies, Creating Opportunities for the Private Debt Market

Although many companies with weak balance sheets will need to restructure or liquidate as a result of the COVID-19 crisis, healthy companies in certain industries are also at risk. With entire states on lockdown and manufacturers retooling to make desperately needed personal protective equipment and respirators, it is clear that the productivity, profitability, and viability of many companies will be tested in unprecedented ways.[144] The energy, hotels, gaming and entertainment, transportation, retail, automotive, construction and healthcare industries are all being hit hard,[145] and the loss of several months of revenue will transform strong companies into highly leveraged ones if they are forced to borrow more. This presents an opportunity for bridge loans and other investments to help these companies deal with short-term maturities until businesses recover from the crisis and financial performance begins to normalize.

Private debt funds are in a unique position to take advantage of this. The private credit industry was essentially birthed by the 2008-2009 global financial crisis, as legislative responses (such as the Dodd-Frank Act, Basel III, and the FDIC's Final Joint Guidance on Leveraged Lending) focused on restricting the lending activities of traditional banking institutions, which allowed non-banking institutions to fill the gap in search of increased yield.[146] The current crisis provides an opportunity for the sector to reach full maturity. Without the overlay of regulation, private debt funds can lend at higher multiples and receive returns through equity in addition to interest and fees.[147] They can also use board seats and control and ownership mechanisms as a hedge against loss. Conversely, commercial banks have multiple consumer operations that are being negatively impacted by the current crisis, which severely diminishes their appetite for risk. In addition, history has shown that the commercial lending market shuts down quickly during an economic crisis because financial institutions focus primarily on core key customers and good credits. Private debt funds do not have these same competing claims on their capital.

Still, private credit managers have to be cautious. Even after the U.S. economy normalizes, future fundraising activity likely will be slow to return to the robust levels we have seen over the last decade. Also, investors who have seen their net worth negatively impacted may balk at funding their commitments. For leveraged funds, there is also the risk that declines in existing portfolios may limit or cutoff access to net asset value funding, and withdrawing and defaulting investors will also negatively affect the borrowing base for subscription facilities. All of these risks will need to be carefully managed against the opportunities for new investments.

For highly leveraged companies with weak business models, there may be no alternative to bankruptcy and possible liquidation. Those restructurings, however, will create opportunities for others to provide exit financings or purchase assets. For middling and strong companies currently short on liquidity as a result of the COVID-19 crisis, there will be more opportunities to maneuver. But even some of these companies may choose bankruptcy to implement a financial reset and get out of leases and other long-term commitments that do not reflect the new market conditions.

## Conclusion

There is no doubt that COVID-19 has and will continue to change our lives profoundly, even if it is unclear exactly how and to what extent. Even assuming social distancing and other mitigation efforts successfully bend the curve, the sobering human costs of COVID-19 will linger in our collective psyche and, in turn, this experience will fundamentally change how we do business with each other. As we learned from 9/11, a crisis based on fear of an external threat will forever change how we interact and do business, as companies must respond with improved security measures and disaster mitigation efforts. And as we learned from the dot-com bubble, economic crises tend to expose businesses that have become obsolete, while creating new opportunities for innovative industries to respond to new market demands and flourish. As in times of historical economic crisis, the restructuring process—guided by restructuring advisors both in and out of formal proceedings, and the wisdom and experience of bankruptcy judges—will be necessary to help markets deal with the aftermath of this crisis by providing for economic recovery and a prosperous future. In these uncertain times, the markets will need to lean on the restructuring process as we all adjust to a new way of living and doing business.

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