

BUSINESS CONTINUITY LOANS: KEEPING AMERICA'S LIGHTS ON DURING THE PANDEMIC

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I. EXECUTIVE SUMMARY

We argue that a one-time program, which we call the **Business Continuity Loan (BCL) Facility**, should be included in the Treasury and Federal Reserve's response to the COVID-19 pandemic and the resulting sudden economic stop. The goal of this program is to prevent the sudden stop from triggering an unprecedented wave of non-financial business bankruptcies, which would greatly amplify the economic contraction and inhibit economic recovery once the health emergency passes. **Put simply, the goal is to try to "flatten the business failure curve," enabling American businesses to keep the lights on during the health emergency so they can rapidly reopen afterwards.** This new BCL program, in combination with the existing programs the Treasury and Fed have already announced, will maximize the chance of a rapid recovery and minimize the chance of a deep, prolonged recession.

Under our plan, the Treasury and Federal Reserve would create a program that **makes junior debt investments designed to enable impacted non-financial businesses to meet their recurring fixed obligations**—including interest, rent, lease, and utility payments. To maximize taxpayers' bang-for-buck, this program would be targeted toward firms that have been most affected by the pandemic. Crucially, as we detail below, it is desirable to structure BCL investments as junior subordinated debt with deferrable interest payments. This is a "softer" form of debt than a traditional unsecured bond or loan. There are two advantages to structuring the investments this way. First, much like preferred stock investments, these BCL investments would help program participants avoid solvency concerns and the associated "debt overhang" problems once the health emergency has passed. Second, making BCL investments "soft" debt claims would increase take-up among firms facing financial distress due to the economic stop. Large firms that receive BCL should face temporary restrictions on their ability to pay dividends and repurchase shares, as well as limitations on executive compensation.

This BCL program would complement the direct business lending programs previously announced by the Treasury and Federal Reserve, including the Primary Market Corporate Credit Facility and the forthcoming Main Street Lending Program. The goal of these more conventional lending facilities appears to be—and should be—to provide unsecured bridge financing, ensuring that affected businesses can refinance maturing debt as it comes due. The announcement of this "backstop" has already had a positive impact on the investment grade credit market. While it is necessary to ensure that the pandemic does not lead to a debt rollover crisis, to further avoid financial distress and business bankruptcies, we believe the government must also help affected businesses meet their recurring fixed obligations—i.e., interest, rent, lease, and utility payments—during the sudden stop. Thus, our BCL proposal should be viewed as a complement to the facilities that have already announced.

In the next section, we discuss how the Treasury and Federal Reserve could design a Business Continuity Loan Facility, working within the constraints imposed by the Federal Reserve Act and the recently enacted CARES Act. In the final section, we describe how Congress could create a new tax-based program designed to accomplish the same set of policy goals, perhaps as a part of a subsequent COVID-19 fiscal package. We flesh out this tax-based proposal in a companion piece.

II. DESIGNING A BUSINESS CONTINUITY LOAN PROGRAM

To implement our proposed BCL program, the Federal Reserve would create a special purpose vehicle (SPV) that makes junior debt investments in affected firms. This SPV would finance these BCL investments using a combination of (1) an equity capital contribution from Treasury using the \$454 billion of funds recently allocated under the CARES Act and (2) and a loan from the Federal Reserve under Section 13(3) of the Federal Reserve Act that is secured by all of the SPV's assets.

Once each quarter, eligible non-financial firms would apply for BCL to meet their recurring fixed obligations. Following a rapid approval process, the SPV would make a junior debt investment in affected firms. The face amount of this junior debt investment would increase each quarter by the amount of BCL the firm receives that quarter.

For larger firms, the Fed's SPV could directly make junior debt investments in eligible firms that apply for BCL. For smaller firms, the government would need to use banks to process BCL applications and originate these junior debt investments, which would then be sold to the Fed's SPV. Banks would earn a fee for processing applications and originating these investments. Crucially, the Treasury and Federal Reserve would need to create a set of clear and highly automatable underwriting guidelines that banks could follow.

II.A. Eligibility for BCL

Each quarter non-financial firms would apply for BCL up to a maximum limit based on their recurring fixed obligations. We propose measuring these recurring fixed obligations using each firm's most recent corporate tax return that pre-dates the inception of the BCL program. The relevant items can be read off the front page of any business's tax return, which offers two advantage.¹ First, it facilitates rapid underwriting and approval either directly by the Fed's SPV or indirectly by banks. Second, since these businesses tax returns have already been filed with the Internal Revenue Service, they are difficult to manipulate at this point and easy for the Treasury Department to verify after the fact.

Any formula based on corporate tax returns is going to be imperfect, but the goal should be to arrive at an easily implementable formula with the least imperfections for the greatest number of firms. Concretely, we propose measuring a firm's recurring fixed obligations as:

$$\text{\$Obligations} = \text{\$Revenues} - \text{\$Cost of Goods} - \text{\$Wages} - \text{\$Depreciation} - \text{\$Profits}.$$

The idea is simple. A firm's revenue must go towards (i) variable costs of production as captured by the cost of goods sold, (ii) compensating employees and managers (iii) depreciation, (iv) equity holder profits, or to (v) covering fixed obligations.² By subtracting off items (i), (ii), (iii), and (iv) from revenue, we can reasonably approximate a firm's fixed obligations.³

¹ See [Form 1120](#) for C corporations, [Form 1120S](#) for S corporations, [Form 1065](#) for Partnerships, and [Schedule C of Form 1040](#) for Sole Proprietorships.

² We have chosen to subtract depreciation because we believe the depreciation deductions that businesses are allowed to claim under the U.S. tax code are, with few exceptions, overly generous relative to true economic depreciation—i.e., relative to the capital expenditures that must undertake to maintain the true economic value of their physical capital.

³ Alternately, our measure of obligations is the sum of a firm's tax deductions for (a) repairs and maintenance, (b) bad debts, (c) rents, (d) taxes and licenses, (e) interest, (f) charitable contributions, (g) depletions, (h) advertising, (i) pension plans, (j) employee benefit plans, and (k) other. Thus, since each of these tax deductions is non-negative, our proxy for each firm's fixed obligations is always non-negative. The case for including bad debts is that this is a way of helping non-financial firms that are unable to collect their accounts receivables because their customers are suddenly in trouble.

Several issues are worth flagging. First, in our view, financial firms should not be eligible for BCL. Financial firms receive contractually fixed payments on their assets and are obligated to make contractually fixed payments on their liabilities. Since our BCL program would help many non-financial firms meet their fixed contractual payments to financial firms, financial firms would still receive a large fraction of their normal income under our plan. Thus, financial firms should be obligated to continue servicing the fixed obligations to their liability holders.

Second, while we believe the BCL program should be broadly available to a wide set of non-financial firms whose operations have been adversely impacted by the pandemic, the terms of the program should be most generous for small and medium-sized businesses as we discuss below.

Third, if banks are involved in the underwriting process, to ensure maximal take up, banks should have few, if any, obligations to verify borrower data that is not contained on firm's past tax returns. Any firm that is determined to have made a fraudulent application to the BCL program should be required to immediately repay all its BCL-related debt. A bank that processes fraudulent BCL applications should only face "put-backs" if it is determined that the bank aided and abetted fraud by applicants.

II.B. Optimal Targeting

To accomplish the goal of "flattening the business failure curve" in a way that is both fiscally prudent and fair, to the extent possible, the BCL program should be targeted towards firms that suddenly find themselves at the greatest risk of undergoing costly failures due to the sudden stop. We discuss how to best target BCL both in the cross-section of firms and dynamically over time.

Cross-sectional targeting: There are two main program features that policymakers can harness to efficiently target BCL in the cross-section of firms at a given time. First, policymakers can use firm characteristics to adjust the amount of BCL that each firm is eligible to apply in a given quarter. Second, firms that obtain BCL will be required to repay the benefits they receive over time. And, as specified in CARES Act, large firms receiving BCL should face temporary restrictions on distributions to common shareholders and executive compensation. In addition to being fair and fiscally prudent, these program terms and conditions will help ensure that BCL is well-targeted: facing such terms, firms will only have an incentive to apply for BCL if they genuinely need it.

Here we discuss how program designers might determine the amount of BCL each firm is eligible to apply for each quarter. Specifically, beyond the level of a firm's recurring fixed obligations, program designers should ideally take the following factors into consideration:

- **The realized shortfall in a firm's revenue due to the pandemic**, which determines a firm's ability to meet its recurring fixed obligations during the pandemic in the absence of government support. In principle, policymakers could use information on a firm's industry to approximate the expected revenue shortfall due to COVID-19—e.g., one expects larger revenue shortfalls in the retail trade, restaurant, and hospitality industries than, say, among firms that produce non-durable consumer goods. In practice, given the uncertainty about the distribution of revenue shortfalls and the imperative to rapidly roll out this program, we believe that any targeting along industry lines should be limited, at least at the outset.
- **The financial constraints facing a firm**, which determine a firm's ability to smooth a large shock to revenue on its own without facing the threat of bankruptcy. While financial constraints are difficult to measure, in practice it likely makes sense to proxy for a firm's financial constraints using a combination of (i) firm size—e.g., measured using past revenues or employees—and (ii) whether the firm's shares are publicly traded.

- **A firm’s costs of financial distress and bankruptcy**—i.e., the expected deadweight loss from allowing the firm to approach and then potentially file for bankruptcy. Costs of distress are also difficult to measure, but there are good reasons to think that they are also greater for smaller firms, which are more likely to be liquidated in bankruptcy, than for larger firms.

Combining these factors, in quarter t firm i would be eligible to apply for BCL no greater than:

$$\$BCL_{i,t} \leq (\$Obligations_{i,t-1}/4) \times Factor_t \times \%Vulnerable_{i,t},$$

where $\$Obligations_{i,t-1}$ is our tax-return-based proxy for firm i ’s annual recurring fixed obligations based on its previous tax filings, $Factor_t \geq 0$ controls the overall generosity of the BCL program in quarter t , and $\%Vulnerable_{i,t}$ is a number between 0% and 100% that reflects firm i ’s financial vulnerability to the COVID-19 economic shock and controls the generosity of the BCL program in the cross-section of firms in quarter t .

Time-series dynamics: How should the amount of BCL that firms can apply for each quarter be managed dynamically over time? At a high level, there are two relevant scenarios for the path of the COVID-19 health emergency and the current global economic recession:

- In a “V-shaped” recession scenario, the COVID-19 global health emergency will be contained in the next few months and public health officials will implement strategies that enable the global economy to safely “re-open” and rapidly recover. In this case, policymakers should begin to quickly withdraw BCL once the recovery is underway. Specifically, BCL should be withdrawn by reducing $Factor_t$ over the course of a several quarters until it reaches zero. In this optimistic scenario, the BCL program would have served to prevent a large, but ultimately short-lived shock from triggering a wave of business failures that permanently hobbles the productive capacity of the U.S. economy.
- In a “L-shaped” recession scenario, the U.S. economy will enter a deep and protracted economic recession—or maybe even a depression. This pessimist scenario might occur for public health reasons, or because the current economic stop unleashes powerful knock-on and amplification effects that induce a deep and long-lasting recession. In this pessimistic scenario, a large number of U.S. businesses will ultimately need have their liabilities permanently restructured in bankruptcy, and many firms will need to be liquidated. For reasons of efficiency, fairness, and fiscal prudence, policymakers should not attempt to indefinitely delays business bankruptcies in this case. Nonetheless, even in this pessimistic case, policymakers should still seek to “flatten the business failure curve,” to avoid the severe congestion problems that would arise if a large fraction of U.S. businesses were to simultaneously file for bankruptcy.⁴ To do so, policymakers would gradually withdraw BCL to firms by slowly reducing $Factor_t$ over time. If it also becomes clear than many firms in a particular industry will need significant restructuring, policymakers might also choose to reduce $\%Vulnerable_{i,t}$ for firms in that industry. In this pessimistic scenario, the BCL program serves to ensure that this unavoidable bankruptcy wave plays out in a far more *orderly* fashion than it otherwise would have, thereby limiting the associated deadweight costs and collateral damage to the broader economy.

⁴ Such a wave of business bankruptcies would likely create significant delays in bankruptcy court proceedings—which might be further exacerbated by the need to conduct proceedings remotely for public health reasons—and a shortage of debtor-in-possession financing for firms operating under bankruptcy protection. Due to the resulting court delays, rushed business liquidations, and business fire sales, we worry that any attempt to simultaneously shepherd a significant number of firms through bankruptcy would create large deadweight losses for society, further deepening the recession.

II.C. Financial Terms

We believe it is desirable to structure BCL investments in affected firms as junior subordinated debt with deferrable interest payments.⁵ Outside of bankruptcy, such debt is economically similar to preferred stock. There are two advantages to structuring program investments this way. First, it will help businesses avoid insolvency and the associated “debt overhang” problems once the health emergency has passed. This helps set the stage for a rapid recovery. Second, it will likely increase BCL program take-up among non-financial firms that are facing financial distress.

The specific debt instrument we envision would contain the following features:

- The debt instrument would be senior to preferred stock in liquidation preference, but junior to other forms of debt.
- The debt instrument should have a long maturity—e.g. 20 or 30 years—and should be redeemable at the issuer’s option.⁶
- While the Treasury and Federal Reserve are still providing quarterly BCL to firms, the face amount of this junior debt investment would increase each quarter by the amount of BCL the firm receives that quarter.
- The debt instrument should include an interest deferral clause that allows the company to defer interest payments for up to, say, 5 years at the issuer’s option. This interest deferral feature is consistent with the interest deferral provisions listed under the “Warner plan” in Section 4003(c)(3)(D)(i) of the CARES Act.
- Assuming that the prohibitions on distributions to common shareholders and limits on executive compensation in CARES Act Section 4003(c)(3)(A)(ii) apply to all firms that issue debt to the SPV, then an interest deferral event should potentially trigger a “stopper clause” that imposes additional restrictions on issuing firms.⁷
- Alternately, even if the Section 4003(c)(3)(A)(ii) restrictions are waived for smaller firms who participated in the BCL program by invoking Section 4003(c)(3)(A)(iii), then an interest deferral event should trigger a standard “dividend stopper clause” that switches on all of the Section 4003(c)(3)(A)(ii) restrictions. In other words, even small firms should face some penalty for deferring interest on BCL instruments.

II.D. Conditions on Businesses Receiving BCL

As outlined in the CARES Acts, all publicly-traded firms and larger private firms that receive BCL should be temporarily restricted from distributing capital to their common shareholders—whether through dividends or share repurchases—and should face temporary limitations on executive compensation. These conditions are essential from a fairness standpoint: shareholders and executives of large firms receiving taxpayer support must share in the sacrifice during this national emergency. Furthermore, these conditions will also help ensure that the only large firms that apply for BCL are those that genuinely need taxpayer help.

Other than these restrictions for large firms, we believe BCL should come with few, if any, additional strings attached. Adding further restrictions is likely to unnecessarily limit program take-up by affected

⁵ Junior debt of sort is typically used in the kinds of “Trust preferred” securities issued by banks and utilities.

⁶ The 5-year maturity restriction in Section 4003 of the CARES Act applies to the Treasury’s direct lending programs under Section 4003(b)(i) to (iii), but not to the Treasury plus Fed facilities under Section 4003(b)(iv).

⁷ For instance, the company should have to stop paying dividends on any preferred stock that is outstanding. One could come up with other restrictive conditions.

firms, frustrating the goal of flattening the business failure curve. For instance, we believe that smaller private firms that receive BCL should face few, if any, restrictions on capital distribution and employee compensation. For small private firms, capital distributions are conceptually analogous to wages earned by the small business owner. Our formula for maximum BCL investment treats shareholder profits and wages symmetrically, implying that further restrictions are not necessary.

III. A RELATED TAX-BASED PROPOSAL

In an accompanying note, we describe how the Internal Revenue Service (IRS) could implement a closely-related program—which we called **Business Continuity Insurance (BCI)**—that is also motivated by the policy goal of “flattening the business failure curve” and that shares the same underlying economics as our BCL proposal.

Under this tax-based implementation, non-financial businesses would apply directly to the government for BCI assistance each quarter during the public health crisis. Following an automated approval process, the IRS would then send cash assistance to firms’ bank accounts using an electronic funds transfer. Some portion of this cash assistance could be treated as a grant for very small firms and the rest would become a tax liability that the firm would be required to repay to the IRS over time. Specifically, beneficiary firms and the IRS would maintain a tax account tracking each firm’s accumulated BCI liabilities. Once the health emergency is over, beneficiary firms would gradually repay their BCI liabilities through a special corporate tax surcharge. As in our BCL proposal, firms—especially large firms—that receive BCI assistance would face temporary restrictions on their ability to pay dividends and repurchase shares, as well as limitations on executive compensation. And an analogous set of measures to those discussed above for our BCL proposal could be used to optimally target BCI, both in the cross-section of firms and dynamically over time.

Unlike the BCL proposal outlined above, this tax-based BCI proposal would require new Congressional legislation—e.g., a BCI program could be included in a subsequent COVID-19 fiscal package. We believe that such a tax-based implementation would likely make it even easier for small and mid-sized businesses to access the program since (i) the IRS has direct access to the corporate tax returns needed to construct our measure of recurring fixed obligations and (ii) almost all small businesses have a bank account. At the same time, because it would require new legislation, it might take more time to stand-up a tax-based BCI program than the BCL program we have outlined. And, in light of the severity of the current economic crisis, we suspect that every day and week will likely matter from the standpoint of flattening the business failure curve.