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Bankruptcy’s Role in the COVID-19 Crisis

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April 2, 2020

Abstract
Policymakers have minimized the role of bankruptcy law in mitigating the financial fallout from COVID-19. Scholars too are unsure about the merits of bankruptcy, especially Chapter 11, in resolving business distress. We argue that Chapter 11 complements current stimulus policies for large corporations, such as the airlines, and should be treated as a precondition for receiving government-backed financing. Chapter 11 offers a flexible, speedy, and crisis-tested tool for preserving businesses, financing them with government funds (if necessary), and ensuring that the costs of distress are borne primarily by investors, not taxpayers. Chapter 11 saves businesses and employment, not shareholders. For consumers and small businesses, however, bankruptcy should serve as a backstop to other policies, such as the CARES Act. Consumer bankruptcy law’s primary goal is to discharge debts, but that’s not what most consumers need right now. What they need is bridge financing, and perhaps forbearance, until the crisis ends, they get back to work, and they regain their ability to pay their debts again. These key policy levers—bridge financing and forbearance—are available in theory to small businesses in Chapter 11, especially if the government supplies the bridge financing when credit markets are dysfunctional. The practical reality is that bankruptcy is expensive for small businesses, which may deter them from using it in the first place. Equally important, our courts will be flooded if Chapter 11 is the primary rescue policy for small businesses.

1 We thank Ken Ayotte, Douglas Baird, Tony Casey, Jared Ellias, David Skeel, and Kate Waldock for helpful comments.
1. Introduction

Social distancing guidelines have shut down large sectors of the American economy. Many U.S. households and businesses are now experiencing a sudden decline in income and, with it, a mounting inability to pay debts. This is a problem that bankruptcy law can address. For households, bankruptcy is a pathway to eliminate financial stress: the law can halt collection efforts and reduce or discharge debts in exchange for the household’s assets or future income. For businesses, bankruptcy resets the bargaining table with creditors: Companies are given time to renegotiate debts, propose a repayment plan consistent with their ability to pay, and renovate operations. This typically involves wiping out the rights of old shareholders and converting old debt into new equity. Through these procedures, debtors receive a “fresh start” and the economy is, presumptively, better off.

These solutions are time tested. When the financial crisis of 2008 threatened some of the largest industrial corporations of the United States, including General Motors and Chrysler, bankruptcy was the solution. When industry-wide distress destabilized the airline industry during the early 2000s, bankruptcy was the solution for Delta, United, Northwest, and U.S. Air, among others. Can bankruptcy be deployed once again?

While bankruptcy is an off-the-shelf remedy for today’s challenges, policymakers exhibit aversion to deploying it. The purpose of this essay is to explain whether (and when) such aversion is sensible. By way of preview: We think bankruptcy aversion makes sense when we are talking about consumers and small businesses. For them, the process can be expensive and time

2 See, e.g., Michael D. Shear, Trump Extends Social Distancing Guidelines through End of April, NEW YORK TIMES, Mar. 29, 2020 (available here).
3 And the federal government assisted these businesses through the bankruptcy process, as discussed later in this essay.
4 Our essay is related to the work of Ken Ayotte and David Skeel, who analyzed the pros and cons of bankruptcy versus bailouts for financial institutions during the 2008 financial crisis. Kenneth Ayotte and David A. Skeel, Jr., Bankruptcy or Bailouts?, 35 J. Corp. Law. 469 (2010).
consuming, especially given the capacity constraints of our bankruptcy courts. More fundamentally, the ultimate goal of bankruptcy is to eliminate debt, but for many households today that’s stronger medicine than necessary: They can pay their debts when the COVID-19 shutdown ends and they return to work; they just need financial assistance in the interim to bridge a short-term (we hope) emergency. We conclude that policies such as government-backed loans and forbearance are superior to bankruptcy for most households and small businesses facing distress today. We reach a different conclusion for large corporations: For them, bankruptcy law is an essential part of the optimal policy response, as it has been in the past. Congress, in our view, is making a mistake by authorizing Treasury to extend financing to these firms without first considering whether they should enter bankruptcy as a precondition to receiving a bailout.5

Before explaining these punchlines, we start with an overview of how bankruptcy works.

2. How It Works: Consumer and Corporate Bankruptcy

Three “chapters” of the U.S. bankruptcy law provide the primary avenues of relief for distressed consumers and businesses:

- Chapter 7 (a liquidation proceeding available to both individuals and businesses);6
- Chapter 11 (a restructuring proceeding used primarily by corporations);7 and
- Chapter 13 (a repayment plan available to individuals with regular income).8

5 The CARES Act compounds this mistake by prohibiting the Treasury from extending financing to midsized businesses that have filed for bankruptcy. See CARES Act, Title IV, §4003(c)(3)(D)(V)
7 §§ 1101 et seq.
8 §§ 1301 et seq.
A bankruptcy petition triggers an “automatic stay,” halting collection efforts by all creditors anywhere in the world. For individuals, the automatic stay gives the debtor time to assess his or her situation, negotiate with creditors (especially secured creditors), and either liquidate assets (Chapter 7) or propose a plan of repayment (Chapter 13). For businesses in Chapter 11, the stay affords time to assess firm value, determine which debts must be written-down or restructured, and propose a plan of reorganization.

The automatic stay may be the most important benefit of a bankruptcy filing, especially during the COVID-19 crisis, because it prevents creditors from collecting their debts. During a crisis that is expected to be temporary, this “pause button” may be all that many debtors and businesses need. Equally important, it is a benefit that debtors obtain simply by filing a bankruptcy petition; no judicial action is needed. Although the bankruptcy law contains some deadlines, and allows creditors to file motions to speed up the case, the judge retains the authority to “suspend” proceedings (allowing the debtor to enjoy the benefits of the automatic stay) if, in the judge’s view, that would be best for the debtor and creditors. That authority is already being invoked during the current crisis.

For consumers, Chapters 7 and 13 offer different kinds of trade-offs. Both discharge virtually all of the consumer’s debts, but at different costs. In Chapter 7, the consumer must relinquish assets that exceed what state or federal law says the consumer absolutely needs for his or her fresh start. She will also lose some assets, such as a home or car, if these are subject to mortgages or other secured debts that she can’t pay off in due course. The

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9 § 362. There are important exemptions to the automatic stay. One permits the counterparties to swaps, repos, and other financial contracts to terminate the contracts and seize collateral. This exception was critically important during the previous crisis, which began in the banking sector where many financial contracts loom large, but will likely play a less significant role in this current crisis because, presently, bank insolvency is not a precipitating factor.

10 § 305.

process is speedy: For the honest debtor who discloses all assets to the court, it can be completed within a matter of weeks.

For consumers who want to retain assets that would be lost in Chapter 7, the better option is Chapter 13. Instead of giving up assets, the consumer gives up “disposable income” for a period of three to five years. For every month, the consumer pays off secured creditors and, if any income remains after covering living expenses, pays the remainder to unsecured creditors. This isn’t easy. Legal fees are substantially higher in Chapter 13 as compared to Chapter 7. Worse, roughly two-thirds of consumers are unable to make the payments required by Chapter 13. Their cases are dismissed or converted to Chapter 7.

For businesses, the choice between Chapters 7 and 11 is more straightforward. Chapter 7 is a funeral; Chapter 11 is a shot at renewal. Specifically, Chapter 7 turns the business over to a trustee, who is charged with liquidating its assets and distributing proceeds to creditors. Chapter 11 leaves the business in the hands of management, which is given an opportunity to obtain new financing (with priority ahead of old debts), propose a reorganization plan that values the going concern firm, reduces debts to a level consistent with its ability to pay, and proposes essential operational changes (such as changes to labor contracts). Creditors vote on the proposed plan. If the court approves the plan, the reorganized firm exits bankruptcy with a new capital structure: Old debts are eliminated and replaced with new debts owed by the newly reorganized firm; old shares are deleted and replaced with new shares issued by the reorganized firm. One fundamental rule looms in the

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12 § 1325(b)(2). See also Official Form 122C-2, available here.

13 § 1326.


15 See, e.g., Edward R. Morrison and Antoine Uettwiller, Consumer Bankruptcy Pathologies, 173 J. Instit. & Theoret. Econ. 174 (2017), and sources cited therein.

16 The liquidity-enhancing role of Chapter 11 is the focus of Kenneth Ayotte and David A. Skeel, Jr., Bankruptcy Law as Liquidity Provider, 80 U. Chi. L. Rev. 1557 (2013).
background as management crafts a plan: Senior creditors must be paid before junior creditors, who must be paid before shareholders receive anything. This is the “absolute priority rule,” which generally means that shareholders are wiped out in Chapter 11 reorganizations. Junior debt may be wiped out too. The only creditors who retain rights after the firm is reorganized are those whose claims are (a) most senior and (b) collectively consistent with the firm’s ability to pay. Among these creditors, equity in the reorganized firm is typically transferred to the most junior creditors.

There are ways to speed up the Chapter 11 process. The most important and commonly used is to sell the firm to a buyer via a “363 sale.” Proceeds from the sale will then be distributed to creditors in order of priority.

So far we’ve said nothing about the judge, who plays a critical role in the Chapter 11 process. Unlike federal (Article III) judges, bankruptcy judges serve renewable 14-year terms and are not politically appointed (they are appointed by the courts of appeals). The job of the bankruptcy judge is to oversee the bankruptcy case and resolve stakeholder disputes, often under extreme time constraints and emergency situations. Many scholars have shown that the dynamics of a Chapter 11 case, including its duration, costs, and ultimate outcome, depend on contestable and hard-to-predict judicial decisions about creditor priority and firm value.

Because of this, Chapter 11 can be very expensive. For small businesses, thirty percent of firm value can be burned up by professional fees. Additionally, around two-thirds of all small-business Chapter 11s terminate in

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liquidation or dismissal (which leads to liquidation under state law).\textsuperscript{21} Indeed, for small businesses, the complexity, uncertainty, and costs of Chapter 11 can be prohibitive. This is due, in part, to the fact that most do not undergo regular audits and have few or no human resources dedicated to financial management.\textsuperscript{22} Thus, when these businesses enter Chapter 11, their financial affairs are difficult to unscramble. As a result, the vast majority never file a bankruptcy petition; they simply close shop.\textsuperscript{23} This is one reason why we are skeptical, as explained more fully below, that bankruptcy is an appropriate remedy for small businesses during the current crisis. In normal times, the costs of bankruptcy deter many firms from seeking a bankruptcy remedy. We don’t want that to happen during the current crisis, when a remedy needs to be extended to many businesses very quickly.

For large corporations, the Chapter 11 process is more user-friendly. Large corporation Chapter 11s can be speedy because, among other things, many have professional support and the business foresight to negotiate with creditors before a bankruptcy filing, thereby clearing the way for a less controversial, or even pre-approved, reorganization plan (these are called “prenegotiated” and “prepackaged” cases). Frequently, this negotiation will not only clear away creditor objections, but will also involve the debtor’s commitment to sell the firm quickly after the bankruptcy filing.\textsuperscript{24}

\begin{footnotesize}
\textsuperscript{22} Baird and Morrison, \textit{Serial Entrepreneurs}, supra; Morrison, \textit{Bankruptcy Decision Making}, supra.
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As a result, some of the largest U.S. corporations have used Chapter 11 to remedy distress and emerge financially healthier. These corporations include airlines (such as United and Delta), car manufacturers (General Motors and Chrysler), financial institutions (CIT Group), and oil companies (Texaco). Other major corporations have used Chapter 11 as a quick way to merge themselves with other corporations via a 363 sale. A good example is American Airlines. It acquired TWA through a 363 sale. Subsequently, during its own Chapter 11 case, American merged with U.S. Airways.

Equally important, Chapter 11 is highly adaptable, which makes it an attractive alternative to “stimulus” or “bailouts”. Bailouts can take the form of cash grants, loans, or other kinds of transfers that rely on the public fisc. Bailouts, in other words, reduce industry distress by shifting the costs of distress to the public. Bankruptcy works very differently: A firm’s distress is reduced by shifting costs to investors. Shareholders see their investments wiped out, and creditors take haircuts. If the firm is, for example, systemically important (a/k/a “too big to fail”) and needs an emergency loan from the government to sustain it, that’s possible in bankruptcy. And, unlike cash injections, the burden on the public fisc (and taxpayer risk) can be reduced as these loans are usually collateralized by the firm’s assets and take priority over all other creditors.

Our bankruptcy laws have proven exceptionally useful and agile in the rehabilitation of near-grave American industries during crises. A good example is the restructuring of General Motors and Chrysler. Both neared death during the Great Recession, but were taken into Chapter 11, where each received financial support from the federal government (many other businesses also used Chapter 11 successfully during the crisis, but received no government support25). Each was sold off to a buyer within weeks. The speedy bankruptcies, financed by the federal government, allowed both

25 Examples include Lear Corp. and Visteon Corp. in the auto parts industry and Tronox Inc. in the chemicals industry.
companies to renegotiate or shed legacy liabilities that had been a drag on innovation for decades. In the process, the U.S. government was also able to, in essence, rescue the supply-side chain of these auto giants, thereby preserving jobs up and down the entire auto industry. Whatever the federal government decides to do now for the aerospace or airlines industries, this is recent precedent that government-supported restructurings can help stabilize the American economy – and prove a good investment for taxpayer funds.

This is not to say that Chapter 11 is perfect. It can generate important disruptions in operations as investors jockey for recoveries. One study, for example, finds that workers suffer long-term declines in wages when their firms enter bankruptcy. Additionally, scholarship has shown that secured creditors have outsized influence over the process. This is because the firm’s pre-bankruptcy secured creditors are typically the same financiers (and usually the only available financiers) of the bankrupt business. This gives them outsized influence, which can lead to quick sales at “fire sale” prices instead of reorganization. Although these downsides of Chapter 11 are important, we think they are potentially less concerning in the current crisis. Workers suffer large declines in wages when their firms become unprofitable, regardless of whether the firms file for bankruptcy. Although a filing can exacerbate this wage decline in normal times, it’s unclear whether to expect the same effect during this crisis, especially if the government is the primary supplier of liquidity to the bankrupt firm and uses that power as leverage to influence payroll (as it is currently doing under the CARES Act). Additionally, we think the risk of “fire sales” in the current environment will be mitigated by the fact that an economy-wide slump in asset prices will encourage debtors and their creditors to avoid sales and favor traditional reorganizations instead. And, again, the government can use its lending power to encourage reorganizations.

\[27\] The same authors find that workers receive wage premiums at firms with high bankruptcy risk. John R. Graham, Hyunseob Kim, Si Li, and Jiaping Qiu, “Employee Costs of Corporate Bankruptcy,” working paper (available here).

instead of fire sales or, at least, sponsor a structured, going concern sale (as what we saw for Chrysler and General Motors in 2009).

Although Chapter 11 is a poor fit for most small businesses, as noted above, Congress took a major step to improve the fit with the “Small Business Reorganization Act of 2019” (or Subchapter V of Chapter 11), which went online on February 19, 2020. The Act’s central feature is that it eliminates part of the absolute priority rule in bankruptcy. As noted above, this rule prohibits shareholders from retaining their shares unless creditors are paid in full (or consent to shareholders retaining the shares). This is why shareholders are typically wiped out in Chapter 11, which presents a real challenge to small businesses, who often have a single owner-manager. Indeed, the absolute priority rule can pre-ordain small business cases for failure: Many businesses are organized around the skills of the owner-manager. Without her, there is no business. An absolute priority rule that wipes out the owner-manager is a rule that strongly discourages her from helping the business navigate its way through bankruptcy. Under the new law, by contrast, a small business owner can retain her equity interest even if unsecured creditors will not be paid in full, as long as the Chapter 11 plan commits all of the business’s “disposable income” to these creditors for a three to five-year period. This abrogation of the absolute priority rule makes Chapter 11 substantially more attractive to small businesses for two reasons: first, a business owner will no longer be deterred for fear of losing ownership. Second, by retaining her interest, she has a stronger incentive to help the firm revive itself, including paying off its remaining debts.

But the viability of this Act in a COVID-19 world is far from certain, particularly given its limited scope: It applies only to small businesses with debts totaling less than $7.5 million.29 Moreover, the Act has some administrative challenges: It appoints a “standing trustee” to monitor the debtor’s progress in proposing and completing the multi-year plan of reorganization. The trustee may help identify nonviable businesses early on

29 The limit was just raised from about $2.7 million to $7.5 million by the CARES Act.
(seeking their dismissal or conversion to Chapter 7), and help viable businesses craft a feasible plan. It is unclear whether there are adequate standing trustees to assist with the potential increase in post-COVID-19 filings by small businesses. What we do know, however, is that neither these trustees nor the bankruptcy courts have substantial experience yet in administering these cases.

3. The Limits of Bankruptcy Law During a Crisis

There are several reasons to think that bankruptcy may be an inadequate response at this moment for U.S. households. First, those who could benefit from bankruptcy may avoid it because of the perceived stigma associated with a filing, the fact that a bankruptcy filing is a “flag” on credit reports for many years, or, for corporations, that shareholders are typically wiped out in bankruptcy. Studies have shown that only a fraction of consumers who could benefit from bankruptcy actually petition for bankruptcy protection. Unless the perceived costs associated with bankruptcy decline during crises (we have no evidence showing this), the “takeup rate” for bankruptcy may be lower than we need during the current crisis.

Second, as discussed above, the bankruptcy process takes time and can be expensive. Individuals and small businesses barely have the savings to endure this crisis, let alone to fund a bankruptcy case.

Third, bankruptcy can be overly strong medicine. Chapters 7 and 13 wipe out debts, but many households don’t need that drastic help. Rather, they face a temporary inability to remain current on their monthly expenses. Further, both consumers and creditors are harmed by an unnecessary bankruptcy discharge: Consumers become ineligible to obtain another discharge for many years (8 years must pass between Chapter 7 discharges); creditors receive only a fraction of what they are owed in the typical consumer bankruptcy.

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Fourth, bankruptcy relies on judicial decision-making and lawyering, which, together, are imperfect. Bankruptcy judges depend on the lawyers and evidence brought before them, and are regularly called upon to render decisions under extreme time constraints. Studies have shown that judges change their behavior when caseloads spike: A sudden increase in caseloads makes courts more likely to liquidate small firms, reorganize big firms (but take longer to do so), and terminate cases of firms that end up filing for bankruptcy again. If these decisions by time-strapped judges are errors, we should worry about the errors that may occur if a flood of cases reaches the bankruptcy courts during the current crisis.

These are good reasons for bankruptcy aversion, but their importance depends on the context. They are, in our view, highly important when we talk about consumers and small businesses. Quick relief is needed during this crisis, but many consumers may be reluctant to seek bankruptcy relief because of its stigma. Moreover, as noted above, bankruptcy does more than most consumers need; they need temporary financial assistance, not a discharge of their debts. For small businesses, too, bankruptcy may be unattractive due to the risk of delay, expense, and judicial error, especially if courts become congested with filings. More importantly, because of the financial stress being experienced by many banks, small businesses should worry that secured lenders (which generally are banks) will be especially aggressive in seeking to liquidate small businesses. Prior research has shown that strained banks are more likely to seek liquidation of debtors in bankruptcy.

We therefore think that non-bankruptcy policies, such as the CARES Act, are appropriate responses to consumer and small business distress. The CARES Act, for example, extends billions of dollars of government-guaranteed, forgivable loans to the small business sector. This large-scale provision of liquidity to stressed businesses could stabilize them, provided the crisis is a short-term event. We worry, however, that small businesses need more than liquidity right now. Many have already laid off workers and are unlikely to hire them back until customers feel comfortable returning to the marketplace. These firms need forbearance as much (or more than) they need liquidity: As these companies lay dormant, they need policies that prevent creditors, landlords, and other counterparties from dismembering their businesses. They need forbearance analogous to the “pause button” of an automatic stay. We recommend that Congress enact policies that create an automatic stay for the benefit of small businesses. Congress has done this before for members of the military. It is time to do it again.

For large corporations, however, bankruptcy law should serve as the primary response to the current crisis. It is a time-tested remedy for corporate distress during a crisis. Indeed, a bankruptcy filing should be a condition for receiving funds authorized by the CARES Act. Lending funds through a Chapter 11 case would optimize the use of bailout funds because the bankruptcy process would empower these firms to make financial and operational changes that they otherwise could not do. For example, bankruptcy law gives the firm special powers (unavailable outside of bankruptcy) to renegotiate contracts and labor agreements and jettison assets that are incompatible with expected changes in the economic environment. Unfortunately, the benefits of bankruptcy are ignored by the CARES Act and

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34 The legislation was the Servicemembers Civil Relief Act of 2003.
35 The National Bankruptcy Conference (NBC) made the same recommendation in a recent letter to Congress (available here). (Disclosure: Morrison is a member of the NBC.)
related policies, which do not require bankruptcy filings and provide little or no incentive to make the operational adjustments needed in a post-COVID-19 world.

To be sure, bankruptcy courts would get busier if a large number of corporations entered Chapter 11, but we believe the costs of congestion will be low (because these cases will be well-lawyered and the government will be able to speed things along because it will be the primary lender).\(^{36}\) Even if the systemic costs are not low, we think they are offset by an important benefit of a Chapter 11 process that permits government-assistance, but forces investors to shoulder the costs of the firm’s distress. Our country has a history of bailing out airlines and automakers.\(^{37}\) These bailouts allow shareholders to enjoy economic booms but be sheltered from sharp recessions, even though they were well-aware of the risks (such as pandemics\(^ {38}\)) that might trigger a sharp recession. Shareholders are therefore protected, during sharp recessions, from the consequences of taking on debt. That moral hazard is mitigated by the Chapter 11 process. Equally important, when the government provides financing to a firm in bankruptcy, the financing comes with oversight by a judge, which can help limit political favoritism.

Before closing, we should highlight one important drawback to using Chapter 11 for large corporations: The takeup problem. Because shareholders are typically wiped out in bankruptcy, a corporation’s directors may delay

\(^{36}\) Costs might also be mitigated if cases are filed in bankruptcy courts with substantial accumulated expertise with corporate distress, such as Delaware and the Southern District of New York. Though controversial, “forum shopping” by corporations has resulted in a large flow of complex corporate bankruptcies to these courts, allowing them to develop expertise that’s needed in a crisis. General Motors, for example, is a Detroit corporation that filed for bankruptcy in New York during the 2008 financial crisis. See Jared A. Ellias, What Drives Bankruptcy Forum Shopping? Evidence from Market Data, 47 J. Legal Stud. 119 (2018).

\(^{37}\) Examples include Lockheed in 1971, Chrysler in 1979, and the airlines during the aftermath of 9/11, as summarized by ProPublica here.

\(^{38}\) See, e.g., United Airlines’ 10-K for the period ending Dec. 31, 2018 (here). Item 1A (“Risk Factors”) alerts shareholders to the risks arising from pandemics.
filing in an effort to preserve share value. This may be especially a concern when the firm’s directors are also its shareholders, as is the case in many firms that are part of a portfolio company or owned by a private equity fund. These owners may prefer winding down outside of bankruptcy, where they may successfully negotiate for some recovery. It may be necessary to offer these owners a payoff in bankruptcy in order to induce them to file a Chapter 11 case that preserves the firm.

4. Conclusion

Bankruptcy law should be the first line of attack as the government addresses the distress of large corporations. Congress should not repeat the mistake it made in CARES Act, which uses the public fisc to support large corporations without simultaneously requiring a Chapter 11 filing as a condition precedent to lending. On the other hand, Congress should continue to focus on nonbankruptcy policy solutions for consumers and small businesses, such as the CARES Act and other recent federal agency actions targeted at mortgage and student debt loan relief. Certainly, in the longer term, bankruptcy law may prove an important tool for U.S. households and small businesses dealing with post-COVID-19 repercussions. In the immediate term, however, the time and expense of bankruptcy render it a suboptimal solution for the financial challenges facing Main Street U.S.A. today. What is needed instead is a set of policies that extend liquidity, and perhaps forbearance, on a nationwide scale. These policies would be more effective in rapidly mitigating the stress of households and small businesses and shifting that stress to institutions that are better able to internalize it, such as the Federal Reserve and the financial system that it oversees.

39 See FHA Suspends Foreclosures and Evictions for Enterprise-Backed Mortgages, March 19, 2020 (available here); and Sections 4021-4024 in the CARES Act (Sec. 4021. Credit protection during COVID–19; Sec. 4022. Foreclosure moratorium and consumer right to request forbearance; Sec. 4023. Forbearance of residential mortgage loan payments for multifamily properties with federally backed loans; and Sec. 4024. Temporary moratorium on eviction filings).