STORM WARNINGS – WILL STAGFLATION HERALD A NEW WAVE OF CORPORATE FAILURES?

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Legal Briefings – By **Thomas Baker**

With inflationary pressures and battered supply chains plaguing business, the debate has resumed over how long struggling firms can put off restructuring

With governments winding down Covid-19 support, supply chains buckling under multiple disruptions, growth stalling and high inflation taking hold, it is unsurprising that businesses are feeling the pressure at 2022's halfway mark. The worsening climate recently prompted JPMorgan Chase chief executive Jamie Dimon to warn investors of an incoming economic "hurricane".

That storm has been long forecast. The Covid-19 pandemic saw governments engage in stimulus levels unprecedented in peace time – itself remarkable given the legacy of the 2008/09 banking crisis – while monetary policy remained ultra-loose and alternative sources of capital abundant. The lifting of lockdown measures promptly released pent-up consumer demand, resulting in a strong 2021 for many firms.

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>
> *John Whiteoak, global co-head of Restructuring, Turnaround and Insolvency*

But the environment has changed dramatically as 2022 progressed with businesses who avoided overdue restructurings in recent years being forced to face new realities. There is also the matter of working through the backlog of 2020, when Covid measures virtually shut the insolvency market. At some point a reckoning for struggling firms being kept on corporate life support beckons, especially as interest rates rise to tackle soaring inflation. The US Federal Reserve jolted markets on 15 June with a 0.75% hike in benchmark rates, followed the next day as the Bank of England announced the latest in a string of rate rises amid projections of inflation this year hitting 11%.

"You have a situation where businesses which have not been restructured or refinanced with long-term issues have kept going throughout the pandemic thanks to government support. But those issues have not gone away," says John Whiteoak, Herbert Smith Freehills' co-head of Restructuring, Turnaround and Insolvency. "There's a lot of debt in companies who haven't restructured, and debt is becoming more expensive. This is combined with increasing costs for business. The scenario people are working to is companies are going to need to deal with their debt stack and we expect things getting busy in the latter part of this year or early next."

Data from the first quarter of 2022 provides little encouragement for businesses feeling the strain. Total company insolvencies hiked 112% year-on-year and were 6% higher than the fourth quarter of 2021, according to the Insolvency Service. The increase was largely driven by a 117% annual surge in voluntary liquidations among smaller businesses. Moreover, UK consumer confidence – historically a bellwether of wider economic prospects – has already plunged this year in a series of closely-watched surveys. The EY ITEM Club downgraded its 2022 consumer spending growth forecast to 5.1% from the 5.6% expected in early February, with growth expected to fall to just 1.7% in 2023. More ominously, figures from the UK Office for National Statistics on 13 June unnerved analysts by showing the economy contracting by 0.3% in April, adding to a 0.1% fall in March.

With almost all sectors feeling the pinch, few are immunised against sharply rising costs in energy and freight while the conflict in Ukraine increases food costs, with the country responsible for roughly a quarter of the global grain market. In the short term, food producers, retail and energy-intensive companies – such as chemical and paper manufacturers – are particularly vulnerable. But even low-consumption service industries must contend with gloomier consumers and rising wage costs from a perversely tight labour market.

Pretend no more

Despite the grim omens, how the expected wave of restructuring ultimately unfolds remains unclear, echoing a theme familiar to insolvency veterans over the last 15 years; jaded advisers have grown used to seeing cheap debt keep a lengthening line of firms stumbling along on 'amend and pretend' financing despite poor fundamentals. The key question is the extent that the era of easy finance will endure if stagflation entrenches in Western economies.

Meanwhile, the UK has positioned itself as a leading global hub for restructuring, most recently through the Corporate Insolvency and Governance Act 2020, which introduced a much-touted tool for debt workouts: the Part 26A Restructuring Plan. In essence, the plan allows one class of creditors to bind dissenting lenders to a restructuring plan, so long as the class in favour makes up at least 75% by value of those present and voting. This is a stark contrast to a conventional scheme of arrangement, which must be approved by each class of creditors. The new mechanism was notably deployed by Pizza Express, Virgin Active, and Virgin Atlantic Airways during their high-profile restructurings and hopes for the process remain high amid attempts to follow US-style turnaround culture.

To date, however, there has been a reticence to use the plan, primarily due to the high costs. However, Whiteoak believes this reluctance will ultimately pass, resulting in more restructuring plans being pursued by debt-laden companies. "It's like company voluntary arrangements back in the day; these schemes will become more commoditised, debtors will feel more relaxed using them and creditors less inclined to challenge them. After that, you'll see a lot more rolling out."

While we are likely to see restructuring candidates reach for the scheme as familiarity and comfort grow, there are other structural changes which could see companies kicking the can down the road rather than tackle unsustainable capital structures.

The Pension Schemes Act 2021 ushered in new criminal offences for individuals failing to take due care to protect defined benefit pension schemes, such as by hindering the benefits of a pension scheme being received without having a "reasonable excuse" for their actions. Restructurings – which are often wrenching and fast moving – can have an adverse impact on all creditors and stakeholders, including pension scheme members. Fear of criminal liability could inadvertently prove a powerful deterrent for legitimate restructuring activities.

Says Whiteoak: "There are very powerful tools here in the UK and they're not currently being utilised because people are not testing them. The government has given us all the tools in the world to actually save companies. It will happen eventually, but the pension scheme angle is another reason for reluctance."

Meanwhile, the storm clouds gather. The free flow of capital and reticence of firms to reach for restructuring schemes can delay the reckoning but a spike in workouts is as inevitable as it is unpredictable. After all, such waves have historically emerged like the famous literary description of how individual firms go bankrupt: gradually, then suddenly.

For more restructuring analysis see our briefing on the new Part 26A restructuring plan and listen to our Corporate Insolvency and Governance Act 2020 soundbite series.

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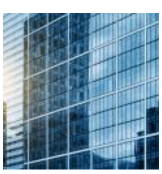

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