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NEWS

It’s time to give winding up a rewind: from digital to analogue insolvency

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Howard Morris (Credit: Morrison Foerster)

Howard Morris, head of business restructuring and insolvency at Morrison & Forester in London, argues we should look to the “analogue” tools of yesteryear – trading administration, provisional liquidation and liquidation – to tackle the nuclear winter that’s set to follow the coronavirus’ economic impact. These tools don’t have to be a death knell for businesses, he says: they can offer shelter and survival.

In the event of an atomic war, the government has a back-up plan for communications. The electromagnetic pulse of a nuclear explosion high in the atmosphere would fry complex electrical equipment. This would end the digital world. Communications could survive using fixed-line copper wire phones with a crank handle. From the digital to the analogue. Analogue solutions are still solutions and right now, some of the old tools in the insolvency playbook, which we haven’t needed to use for years, will be key to helping to straighten out the economy.

For several years before the health crisis, commentators had been calling a significant readjustment to the economy as imminent. We'd seen the huge growth in lending to poorer risk companies on cov-lite terms, we'd seen the inversion of the bond yield curve and been given a few other scares along the way. Central financial authorities around the world had laid a paper trail of warnings and cautions to which they could later point. Yet, somehow, the economy kept rolling along, indeed stock prices climbed ever higher. When the economic crisis was reached, its proximate cause was nothing anyone had anticipated. The banks are, post-Lehman, undoubtedly much stronger to withstand the rigours we must now face, but the rest of the economy is constructed on a lattice of fragile supply chains that give little strategic security and services that people may be reluctant to use for some time or simply won't be able to afford.

Whether we get battered with a hockey stick or U- or V-shaped downturn, there is the certainty for us all that our economy is in decline and we will spend a period crawling across gravel before the ascent to recovery. Insolvency and restructuring lawyers may have jobs but a depression is no good for anyone; nothing sells in a depression because no one has money and even if they do, why invest when no one will buy the products or services?

I wrote the other day about what I saw in post-Soviet Russia in 1991. I was one of a number of international experts called in by the World Bank to work on a symposium on insolvency law to try to trigger privatisation through insolvency processes. Russia's centrally planned economy had collapsed. Every state enterprise owed more than it owned and so privatisation simply wouldn't happen. Assets and market share could be freed if enterprises were forced into insolvency procedures, but no creditors would take that step because they were equally vulnerable. The moribund economy couldn't be ignited because completely bust behemoth state enterprises that kept millions of people in jobs plodded on as they had for decades and no one was going to topple another enterprise into insolvency for fear the same would happen to them and, anyway, who would buy the assets? And what possible recovery would there be for creditors?

Of course, the UK is nowhere near this state, but we are now temporarily in a centrally planned economy with enterprises eking out their existence with the support of government. How do we get from this to a healthy economy where the most efficient businesses succeed and consume the market share and acquire the assets of the least efficient? This is going to be a challenge in weaning. We shall need a coarse filter to dispose of inefficient enterprises so that new growth can come through.

In the 18th century, warfare followed customs. Armies behaved in a predictable way. They didn't ambush each other and battles were fought between soldiers in ordered lines taking turns to shoot. The monarchies that ruled Europe didn't want wars of destruction. They liked the way things were ordered and were simply competing to be the most powerful monarch. While wars were, of course, brutal, they weren't fought with bitter intensity. Insolvency, too, follows customs. While the restructuring of companies has seldom been chivalrous, over the past 15 or more years the market has achieved some settled approaches. The place of the banks and the funds and the direct lenders is ordered and understood, the secondary market is constrained by white lists and blacklists, and the dominance of the borrower has been assured by the huge amounts looking for yield resulting in cov-lite and security-lite lending on an immense scale. The market has refined its approach, not always decorous or without rancour, but effective to reach compromises and secure deals down the well-trodden path to a scheme of arrangement. The scheme of arrangement tackles the financial restructuring often with the transfer of ownership from the original equity to the bondholders and a CVA is used to tackle operational restructuring. Administration may be employed to enable a pre-pack sale of the business to a new company owned by the bondholders.

But now the features of the market that shaped the approach have gone. Asset values have collapsed. Many companies are in a fight for survival that will only become more acute as central governmental ammo runs out and they're on their own.

The courtly, consensual approach will simply not work so well and market participants are waking up to the new reality. Fortunately, there are playbooks, a bit dusty, for this situation.

Pre-packs are unattractive if no one wants to buy or the prices are absurdly low. We must look at using administration or Chapter 11 to continue businesses operating while the exit is sought.

We may want to mothball assets so admin-lite is seeing a renaissance. Administration, provisional liquidation and even liquidation itself aren't the extinction of value anymore, but tools that will be the means to save many businesses. They are unfamiliar in some hands, but for others the muscle memory quickly returns.

If we are having to build up the economy with analogue tools, so be it — at least we have the tools.

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