INSOL INTERNATIONAL

GLOBAL INSOLVENCY PRACTICE COURSE (ONLINE)

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Case Study I

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Case Study I

GLOBAL INSOLVENCY
PRACTICE COURSE

Global Insolvency Practice Course 2021/2022

Take home case study module A

Please read and analyse the following case and answer the questions that follow.

Flow Management

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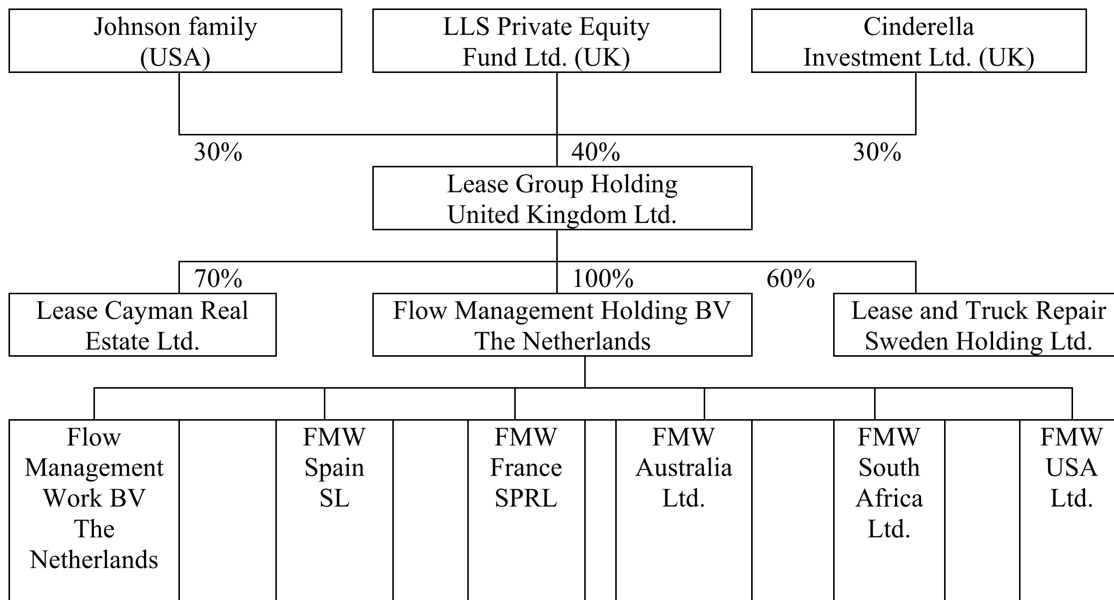
Flow Management Holding BV – based in The Netherlands (Amsterdam) - is part of an international group of companies that leases trucks and private cars and is also active in short leasing, real estate and truck repair. The group is owned by the Johnson family, as well as two investment companies (see organizational chart below; all relevant corporate entities are shown).

Flow Management Holding BV - being a privately held company - acts as the centre of main interest of six operating companies (subsidiaries) at home and abroad; all operating under local company laws. The entire company employs over 3.000 people and has more than 200,000 cars in its fleet.



FMW = Flow Management Work

On 16 November 2013 the four banks (A,B, C and D) of Flow Management Holding BV are invited by the board of Flow Management Holding for a meeting (at that moment, financing of

working capital at the main subsidiary called Flow Management Work BV totals € 360 million, other loans from these banks at Flow Management Work BV amount to € 55 million). The main reason for these talks is that the reported pre-tax profit until September 2013 of € 8 million really turns out to be a loss of € 5.4 million. In addition, faults have been found in the annual accounts of 2012. The result of € 3 million must be downgraded by € 8 million. The causes of the losses and negative corrections (as communicated by company management) are stated below:

- large management bonuses (€ 3 million) have been wrongfully issued (concerning salaries of the CEO and CFO of Flow Management Holding BV);
- a contingency gain relating to three years has been received in 2012 and has been wrongfully booked as a result in 2012. A negative correction of € 1.6 million must be made;
- in 2012, in anticipation of book profit ('paper gain') to be realised in 2013, a € 2.8 million book profit is made. This book profit was neither realised in 2012 nor in 2013;
- the 2013 loss is the result of the basic principles used in the cost price calculation deviating from reality (as a result of a 'formula error' in a spreadsheet, it emerges later). Since they failed to periodically check the real costs against the results of the cost price calculation, the prices charged were too low, resulting in a loss.

In order to remove the causes, management presents the following plans:

- discussions will be held with the main clients about possible price increases. The other clients will be notified about the price increases;
- spending cuts will be implemented (with regard to labour costs in particular).

Since the business structure is there and operates properly, there is market demand and the forecast for so-called "hiring and leasing days" are consistent with reality, management expects that, in view of the measures to be taken, a profit will be made again from January 2014.

Banks A,B,C and D agree to discuss the company's situation on 1 December 2013. In the mean time an accountancy firm (not being the company's auditor) is called in to investigate the procedures within the company. In addition, Flow Management Holding must report on the basis of actual costs and turnover each month and Lease Group Holding United Kingdom Ltd.[in this case also referred to as 'the shareholder' or 'shareholder company'] is asked to pay off the equity capital so the solvency rate (equity/total assets) returns to a minimum of 5% (currently this is 3.9%). The shareholder company - represented by its CFO - proposes to sell 350 cars in order to improve the solvency rate. The banks however prefer an actual settlement in money.

In December 2013 it emerges that the afore-mentioned loss of € 5.4 million only concerns Flow Management Work BV. On top of that, the foreign subsidiaries have made a loss of € 6.3 million as a result of which total losses of 2013, including a loss of the holding [Flow Management] of € 11.4 million, amount to € 23.1 million. A recently hired independent turnaround consultancy agency concludes that the company is viable, with a view to the market share and achieving the estimated turnovers. Furthermore, at that moment the following measures have been taken / plans have been drawn up:

- the main clients have been visited and they agree upon the price increases. Other contacts/clients (approximately 5,000) have been informed that prices will increase; only a few negative replies were received. A result increase of € 7.8 million is forecasted on the basis of these price increases;

- 130 staff members - employees and independent contractors - will be made redundant. This will yield an annual saving of € 3.3 million;
- extra savings will be realised through improved loss recovery, higher excess premiums and savings on car repairs. The total amount of savings is expected to be € 3.9 million.

So, on the short term the firm expects an increase of € 15 million in the results. Although, the banks are shocked by the entire company's situation, legal action will not yet be taken against the company, pending the final report from the consultancy agency. It is concluded by the bankers 'not to panic'. Moreover, it is decided that action must be taken jointly and in a controlled manner. Banks are of the opinion that the board of the shareholder company must take measures with regard to management (the CFO in particular) and that the shareholder must be put under pressure to raise € 35 million in order to repay part of the debts (originally planned on 31 December 2013), and to raise an amount of € 12.5 - 15 million to further strengthen the equity capital position. Furthermore, default interest will be charged in order to put healthy pressure on the relation.

On 20 December 2013 the (adjusted) actual results for 2011-2013 are announced. They have been listed below.

In € million	**Net profit**
2011	9.4
2012	-/- 6.1
2013	-/- 36.4

The total loss turns out to be even higher than stated on 1 December 2013. Solvency, at 0.1%, is virtually zero. It is concluded that there is enough cash to fulfil the current obligations until the end of April 2014. This does not take into account a scheduled repayment of € 35 million on 31 December 2014 which will not go ahead and with regard to which the banks have given their (implicit) permission. It is (again) announced by the banks that the shareholder must contribute at least € 12.5 million in order to reduce the pressure on liquidity.

The result for 2014 is estimated to be € -/- 5.7 million. This forecast is based on an expected profit in the Netherlands of € 7.5 million, continuing losses abroad, as well as a loss of € 14.4 million in the holding (predominantly based on write-off of goodwill). It is also expected that the management information system will have been improved so that the figures will be more reliable.

Although formally the banks have sufficient legal reason to terminate the credit agreements, this is not done. The reason is that – according to the banks – bankruptcy (i.e. liquidation) of the company (in Dutch: 'Faillissement') will negatively affect the proceeds of the assets. In addition, there is a problem with the securities (pledges) on the assets established at the banks. The contracts which were concluded in this respect are probably not foolproof, so that the proceeds will be substantially lower (or even zero) in the event of liquidation. The banks attempt to solve this problem as soon as possible.

In January 2014 the shareholder announces that she will make a decision within short term about the strategy of Flow Management Holding BV. Some of the possibilities are to continue restructuring the foreign subsidiaries as well as strengthening the balance sheet by injecting risk-bearing capital. Trust is put in the company and it is announced that it will appoint a new CFO soon. The banks conclude that the company's management and the shareholder constructively work together on a solution. They also realise that a joint approach from the banks is desired and

that a standstill agreement must soon be signed by the banks in order to achieve this (the expectation is that management and the shareholder will not formally commit themselves until the banks act as one party). It is agreed that an agreement will be signed no later than 31 March 2014 (in this way, there is also sufficient time to solve the legal problems with regard to the pledges).

Mid February 2014 it is clear that the process to come to a standstill agreement passes off with difficulty. Banks C and D are all of sudden not cooperating. Banks A and B are worried, since this reduces the negotiating power towards the company as a result of which, in the eyes of the bankers of A and B, required restructuring measures will possibly not be taken (the injection of necessary capital by the shareholder in particular). Furthermore, there could be (increased) discord among the now two groups of banks and the cooperation from the company could be jeopardised, so that the company's liquidation draws nearer.

On 21 February 2014, a profit forecast of € 9-10 million is announced for the Dutch subsidiary with a turnover of € 200-250 million. This is an increase compared to earlier expectations. The sale of Flow Management Holding BV to a financially healthy party is at that moment viewed by the banks as a good possibility in case the current shareholder cannot or will not contribute sufficient capital.

At the end of March 2014, no standstill agreement has been signed yet. There is still friction among the banks (A and B versus C and D), as well as among the banks as a group and the shareholder of Flow Management Holding BV about the cooperation in finding a solution. The main reason for this is the banks' general lack of confidence in the Flow Management company, considering the developments of the past six months (although most specifically felt by the bankers of C and D). In the middle of April 2014 the CEO of Flow Management Holding BV is replaced by the board of the shareholder company and at the same time she deposits € 10 million in the company as an unsecured loan, with the interest obligations being added to the principal sum of the loan. She also makes a proposal mid May 2014 to lend another € 27.5 million to Flow Management Holding BV under the same conditions.

At the same time banks A and B are investigating whether it would be possible to buy out banks C and D with a 15-20% discount, in order to act more decisively now that there (still) is no standstill agreement.

In the meantime the following plans have been drawn up:

- the strategy must be focused on increasing turnover by itself, in combination with large cutbacks;
- the entire business mix (product-range) will be evaluated and reassessed;
- the shares of the companies outside the Benelux-countries[1] will be sold off, as well as some (non-Benelux) foreign branches (non-legal entities) controlled by Flow Management Work BV.

However, the profit that has been forecast for 2014 does not seem to be feasible. A loss of € 8.5 million is expected, but on the other hand there is an expected profit of € 30 million in 2015, although the ranges applied (positive/negative) are € 4 million and € 10 million respectively. Also based on the afore-mentioned, the banks (instigated by bank A) announce they want to appoint a

[1] Benelux = Belgium, the Netherlands and Luxemburg.

certain person as CRO ('Chief Restructuring Officer') in the board of directors of Flow Management Holding BV, because she can be valuable in the restructuring process.

In June 2014 the shareholder holding company of Flow Management Holding BV makes a proposal in order to effectuate financial restructuring at Flow Management Work BV so that the equity capital, which is now negative (solvency is -/- 9.5%), returns to 5% again. The proposal is outlined as follows:

Working capital financing

- The amount of € 35 million of additional working capital which should have been repaid at the end of 2013, will be paid off in accordance with a repayment scheme from 2015.
- Refinancing the remaining working capital (€ 360 million) which is planned for November 2016 is postponed until 2019.
- Default interest is no longer charged.
- A waiver is granted for all other non-fulfilled contractual obligations.

Other loans

- Refinancing scheduled for 2017 is postponed until 2020, while repayment will be subject to liquidity, and *Cash sweeps* will take place.
- Repayments scheduled for 2014 are postponed until 2017.
- Default interest is no longer charged.
- A waiver is granted for all other non-fulfilled contractual obligations.

In addition, the shareholder will contribute at least € 27.5 million. Since a going concern sale at that moment is no longer an option (no interest) and a liquidation scenario will probably have low proceeds (a maximum of 55% of the total in outstanding debts), banks A and B are open to negotiations with regard to the proposal, provided that an amount of at least € 35 million is injected.

At the end of June 2014 it is announced in a press release by the CRO that a € 27.5 million loss is expected for 2014 despite earlier announcements and that a liquidity shortage is imminent. The reason is a delay in the reorganisation to be carried out (in respect of price increases and cutbacks among other things). At that time, banks C and D threaten to cancel the credit (it later emerges that this was somehow done to give off a signal to the company to hurry up). The shareholder is subsequently willing to deposit € 10 million in the short term and to contribute the remaining € 25 million in September / October 2014. All this on the condition that it is truly needed and that a standstill agreement will be signed.

Early August 2014, and the banks conclude that the time has come for a 'Go or No Go' in respect of the question whether financing should be continued. Although, the banks as a group are not happy with the constantly changing information given by the company, they are content about Flow Management Holding BV's new management (including the CRO) and they notice a slight result improvement due to the reorganisation. They therefore decide to pursue a standstill agreement in the short term. Nevertheless, sale scenarios are drawn up as well as a liquidation scenario. These scenarios must have been drawn up no later than September / October. The 120-day standstill agreement is subsequently signed in the middle of August 2014.

In October 2014 four scenarios have been drawn up:

1. a going concern option if the company proves viable, with shareholder and banks agreeing to an additional 180-day ‘stand still’ or refinancing. The starting point here is that the shareholder contributes another € 30 million and the banks will transfer security rights of € 45 million to the shareholder;
2. selling Flow Management Holding BV if viability is not sufficiently proven. A buyer must be found soon;
3. a Debt equity swap (conversion of debts into shares) with or without the cooperation from the shareholder;
4. a moratorium [formal suspension of payments procedure] or restart following liquidation, with the company being sold in a ‘controlled’ manner. However banks must be willing to provide a bridging loan.

On 31 October 2014 it is announced in a press release that the expected loss for 2014 will rise to € 39 million, and that a € 10 million loss for 2015 is forecast, followed by a slight profit in 2016. Although the provision of information has improved, the banks are at that moment disappointed with the progress of the reorganisation. The company will provide € 10 million of tax refunds as additional security. As a result of the sale of surplus assets, sufficient incoming cash flows are expected so that additional deposits seem unnecessary.

Based on recent developments, the banks conclude that a going concern situation seems to be the best one. A study is held into the possibilities of a Debt equity swap. It is also scrutinised what the role of the current shareholder would be in that case.

In January 2015 a total of € 25 million is paid back to the providers of the (additional) working capital.

On 4 July 2015, a Restructuring agreement is finally signed. This is outlined as follows:

1. all operating companies of Flow Management Holding BV are to be accommodated in a shell subsidiary, called Flow Management II BV;
2. the shares in Flow Management II BV are transferred to the consortium of banks (A, B, C, D) which has financed the original working capital of Flow Management Work BV, as well as to a number of board members (including the CRO);
3. Flow Management Holding BV will be liquidated in an undisclosed manner. All claims against this BV will be cancelled by the banks and the shareholder of Flow Management Holding BV;
4. Flow Management Holding BV and its shareholder will cancel all claims against Flow Management II BV and its subsidiaries;
5. the banks (C and D) which in the past provided Flow Management Work BV with additional working capital will waiver an amount of € 32.5 million. In fact, the entire debt is written off (‘haircut’);
6. the consortium who in the past provided Flow Management Work BV with working capital will waiver an amount of € 97.5 million. A € 240 million claim against Flow Management Work BV remains;
7. the € 55 million loan in Flow Management Work BV is cancelled in full.

The contents of the financial restructuring agreement reflect the relative positions of the financiers involved. The providers of the original working capital posses pledges on most assets of Flow Management Work BV (the main partner in the group) and will receive part of their claim on liquidation. The other financiers (both banks and shareholder) have no or subordinated

security rights and will (most probably) receive nothing from their claims on liquidation. As a result of this restructuring, the foundation is laid for selling the company (now being 'Flow Management II') in a going concern situation.

In May 2016 it emerges that the 'new' company incurred operational losses of nearly € 9 million in 2015, despite (revised) forecasts of a break even result. However, as a result of the debt reduction, the net profit is positive and the equity capital is strengthened (solvency is higher than 5%). The expectation is that a slightly negative or break even result will be achieved in 2016. The reorganisation takes place without delay. Meetings are held with three parties active in the same industry. The talks pass off with difficulty and management has the impression that the takeover candidates prefer to buy the company following liquidation. The working capital which has been made available again on the transfer of shares should be refinanced in November 2016 according to the agreement. Taking into account the negative results and the troubled takeover talks, this refinancing is postponed until July 2017 in order to prevent liquidation.

Although the situation is critical, a better future is forecast and the parties are carefully optimistic about a good result.

Assignment questions

Answer the following questions in detail. Use as much reference material as possible (e.g. the reading material provided by INSOL and/or your own library) to explain and enrich your answers.

1. What were in your opinion the causes of financial distress at Flow Management (see e.g. Mellahi & Wilkinson, 2004)? Could the financial distress have been prevented? If yes, explain how. If no, why not?
2. What are in general advantages and disadvantages of an out-of-court restructuring (workout) as compared to a formal bankruptcy procedure? More specific, what are the advantages versus disadvantages *in your country*?
3. Were the turnaround/reorganization approaches as presented in the reading material (see e.g. Adriaanse & Kuijl, 2006, Pajunen, 2006, Sudarsanam, S, Lai, J., 2001, Schmitt, A., Raisch, S., 2013) applied in this case? If yes, explain in what way. If no, detail what in your opinion should have been done differently.
4. Banks C and D seem to frustrate the process at a certain point. What could have been the (rational and/or opportunistic) reason(s) for them to behave like that? What would you have done in that situation in your role as advisor of the other two banks?
5. Which of the eight principles of the 'Statement of Principles for a Global Approach to Multi-Creditor Workouts II' can be found in the workout process of Flow Management (explicit or implicit)?
6. Suppose it is not possible to convince other creditors to adopt the Statement of Principles in a given situation, are there any other possibilities for "soft law" to use (perhaps specifically in your country/region)? If yes, explain in what way. If not, do you see any alternative (informal) possibilities?
7. Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015.
8. Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?
9. In October 2014 four scenarios have been drawn up. Why *was* or *wasn't* calling for a moratorium (see scenario 4) a good option given the situation at that time? [you are allowed to give your opinion based on your own countries' Bankruptcy Act; be as detailed as possible]

Reading material [see course platform]

Adriaanse, J.A.A., & Kuijl, J.G. (2006). Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?, *Review of Central and East European Law*, *31*(2), 135-154.

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Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), 21-41.

Pajunen, K. (2006). Stakeholder Influences in Organizational Survival. *Journal of Management Studies*, 43(6), 1261-1288.

Sudarsanam, S, Lai, J., (2001), ‘Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis’, *British Journal of Management*, Vol. 12, 183-199.

Schmitt, A., Raisch, S. (2013). ‘Corporate Turnarounds: The Duality of Retrenchment and Recovery’, *Journal of Management Studies*, 50(7) p. p. 216-1244.