**GLOBAL INSOLVENCY PRACTICE COURSE 2021/2022**

**CASE STUDY 1: FLOW MANAGEMENT**

**Overview**

1. This case study concerns the financial distress of Flow Management Holdings BV (**FMH**) in the period 2013 to 2015. FMH operates a global business leasing trucks and private cars, with a fleet of over 200,000 cars. It also had other interests in short leasing, real estate and truck repairs. FMH is based in the Netherlands, has six operating subsidiaries in the Netherlands and abroad, and employs over 3,000 people.
2. In 2013, FMH was a wholly owned subsidiary of Lease Group Holding United Kingdom Ltd (**LGH)**, and had banking facilities with four banks (A, B, C and D) (**Banks**) for €360m for working capital and €55m in other loans. Of these other loans, €35m was originally due for payment in December 2013.
3. In November 2013, FMH revealed to the Banks that prior years had been loss-making, and a series of revisions were made to prior year accounts. This precipitated a process of greater scrutiny by the Banks of FMH, which resulted in the appointment of a Chief Restructuring Officer (**CRO**) in June 2014, the entry into a Standstill Agreement in October 2014, and a Restructuring Agreement in July 2015.
4. Underpinning these activities was a belief by the Banks that a going concern sale was the best outcome, with the risk that a liquidation would reduce recoveries to 55% of the debt. In relation to a potential sale, there were three industry parties that were potential purchasers of the business, but were seeking to buy it in a liquidation scenario.
5. Under the Standstill Agreement, LGH contributed short-term liquidity funding, and the Banks postponed various repayment dates of their debts. Under the Restructuring Agreement, the Banks swapped all but €240m of their facilities for equity in a new entity, Flow Management II BV (**FM2**), which acquired all the operating assets and businesses of FMH, with FMH being liquidated.
6. Subsequent to the restructuring, the Banks and LGH were carefully optimistic about the future, although a further refinancing was postponed from November 2016 to July 2017. The Case Study does not provide details of the final outcome for the business or the Banks. A series of questions have been posed in relation to this Case Study, which are answered below.

**Question 1 – Financial Distress: Causes and Prevention**

1. The interaction of several factors caused FMH’s financial distress, which can be analysed using the integrative framework developed by Mellahi and Wilkinson (2004). The most obvious of these were internal organisational and psychological factors. However, the causes may also have included external, ecological, factors, and it was the interaction of the internal and external factors that led to the firm’s distress in 2013. Given the presence of these external factors, better management may have delayed, may not have prevented FMH’s financial distress from occurring.

*Causes*

1. Mellahi and Wilkson identify two main approaches traditionally applied to analyse the causes of financial distress: the ‘Deterministic’ view, which focuses on industry and external factors, and the ‘Voluntaristic’ view, which concerns internal factors to the firm. They argue in favour of an integrative framework, that emphasises the interaction of these different factors, and conclude that ‘typically management actions alone do not yield an organisational failure.
2. In any analysis of causation, it is necessary to distinguish between symptoms and causes. The initial symptoms of FMH’s distress became apparent in November 2013 with the writedown of the 2012 and 2013 profits, the acknowledgment of accounting errors in relation to contingency gains in 2012 and book profits not realised in 2013. The decline in the solvency rate from 5% to 3.9% was also symptomatic of underlying financial distress. At least superficially these may reflect internal, organisational factors under the OS/OP theories of distress referred to by Mellahi and Wilkinson.
3. Another notable fact, which may be indicative of management failure was the payment by FMH of €3m in bonuses to the CEO and CFO, at a time when the announced profit for 2013 was €8m. While the details of the bonus scheme are not provided, these bonuses suggest that management and accounting decisions may have been skewed in favour of producing short-term benefits for management, rather than focusing on longer-term profit and FMH’s business fundamentals.
4. The possibility that FMH’s accounting errors were symptomatic of causes such as groupthink, ‘upper echelon theory’ and management rigidity, may be seen in the improved busines results under the CRO. However, there were still significant losses in 2014, as well as a further big writedown for the 2013 results - likely due to accounting write-offs at the instigation of the CRO. Nevertheless, losses remained in 2015 and a slight profit only was forecast for 2016, suggesting other causes were involved.
5. Of particular significance was the discovery of a ‘formula error’ in the cost pricing spreadsheet which resulted in FMH’s prices being too low. A simplified business model for FMH involves revenue from car leasing, less employment and other operational costs, to produce an operating profit, from which financing costs and overheads must be deducted. Although FMH’s group turnover is not provided, the announced profits in 2011 of €9.4m, 2012 of €3m and 2013 of €8m suggest that FMH’s business was operating on relatively small margins to its turnover. Some indication of those margins is apparent in Dutch subsidiary forecasts in February 2014, of a €9-10m profit on a turnover of €200-250m, suggesting a best case profit margin of about 4-5%.
6. Thus, it may be simplistic to blame a ‘spreadsheet’ error for prices being too low. More likely, prices were set by market forces, noting that there were three other operators in this market, and FMH’s ability to influence prices may have been very limited. Evidence that supports this hypothesis is that FMH needed to visit its main clients to advise of price increases, although the contrary evidence is that very few negative responses were received. This evidence tends to suggest that important causes of FMH’s distress were ‘ecological factors’ such as market density, and potentially market size. FMH may have been the weakest of the 4 participants, and financial distress may have been part of a natural selection process in the global car rental market.
7. Based on the facts available, the Case Study lends support to the view of Mellahi and Wilkinson that it was the interaction of the exogenous and endogenous factors that caused FMH’s financial distress. That is, in a highly competitive market, as potentially the smallest player, FMH’s poor management and organisational factors crystallised its vulnerability to failure. This process accelerated as a consequence of its high level of gearing (low solvency rate) that slipped to -9.5% in June 2014, and was only resolved finally by rebalancing debt and equity through the Restructuring Agreement.

*Prevention*

1. Whether FMH’s financial distress could have been prevented depends upon the final conclusions that are drawn about the causes of that distress. An important insight from Mellahi and Wilkinson is that Deterministic Factors, external to the firm, cannot be addressed by the firm’s strategic choices. Here, FMH initially sought to make different strategic choices in 2013/2014 by its operational decisions to increase prices and reduce employee costs. Whilst these initiatives appear to have stabilised profits/losses in 2015 and 2016, the business remained loss-making, with limited control over its operating margin. It is also unclear what the medium term impact may have been of reducing employee numbers.
2. Similarly the debt for equity swap assisted in addressing the leverage and solvency rates, and may also have had a positive impact upon financing charges. The presence of the Banks as holders of equity may also enable them to have greater control over any excesses of management, such as the payment of untoward bonuses. However, the predictions for the future of the business do not inspire confidence that FM2 had a more positive future than FMH, even despite these restructuring measures.
3. The combined effect of these observations is that any earlier introduction of these measures – prices, employee reduction, debt restructuring – is unlikely to prevented FMH’s financial distress. It is also notable that, in March 2014, several plans were drawn up that involved more fundamental changes to the business of FMH, including evaluating and changing the entire product mix, as well as selling off various foreign branches and concentrating the focus of the business on the Benelux countries. These strategic changes do not appear to have been developed or pursued during the subsequent restructuring process, which also suggest that FMH’s strategic options were constrained by external market factors over which it had very limited control.
4. Thus, it is difficult to say that the causes of FMH’s financial distress could have been prevented. Having FMH better managed may have delayed the onset of that distress, possibly for many years, but the core problem remained that it may have been the weakest participant in a crowded market with limited strategic options. If so, financial distress could only have been avoided by a fundamental change in strategy, such as growth by way of takeover, investment in increased market penetration, or by sale.

**Question 2 –Out-of-Court Restructuring**

1. Out of court restructuring, also called ‘informal reorganisation’ occurs ‘outside the statutory framework’, and in the ‘shadow of the law’ (Adriaanse and Kujil, 2006). There are two essential differences between a formal and an informal reorganisation: first, who is control; and, secondly, the process by which the reorganisation is conducted. In many respects these two forms of reorganisation, and their advantages and disadvantages, complement each other. However, as demonstrated by my jurisdiction, Australia, the different models for reorganisation exist on a spectrum, with several options for reorganisation being available.

*Advantages and Disadvantages of Out-of-Court Restructuring*

1. It is convenient to start with formal reorganisation, as the default method of reorganisation under the bankruptcy or insolvency laws of a jurisdiction. As companies are an artificial legal creation, their dissolution is also a function of the law. In the case of companies, liquidation is the formal process provided by the law for the collection and realisation of the company’s assets, the recognition of the claims of creditors, and the distribution of those assets to the creditors and shareholders, in order to permit a deregistration or dissolution of the company. This process occurs will generally be subject to supervision or control by the courts, where the rights of the company or claimants can be finally determined, according to law.
2. A business may be restructured as the result of a liquidation, but that is not usually the role of the liquidation, or a restructuring can be a consequence of a sale of the business by the liquidator. Different jurisdictions may have other forms of ‘formal restructuring’, as denoted by Adriaanse and Kujil. All of these ultimately involve oversight or involvement by a court and the creation or recognition of rights of interested participants – usually owners/shareholders, creditors, employees and the government, in respect of taxes. The specific Australian options, in this regard, are set out below.
3. Very little attention appears to have been given to a formal restructuring, either through a moratorium or possible liquidation, in the Case Study. The specific considerations in relation to a moratorium are discussed in answer to question 9 below. However, the more general point to be made at this stage is that the Banks that only expected to receive about 55% of their debt in a liquidation scenario. Also, the Banks faced possible legal problems with their pledges, that made Court scrutiny of their security position an undesirable option. For either or both of these reasons, the Banks preferred instead to pursue the ‘informal reorganisation, ultimately through the Restructuring Agreement, which involved taking a risk on the possibility of a higher return in the future, rather than the reduced return available through a liquidation.
4. The main advantages of an informal reorganisation, as seen in the case of FMH, are those identified by Adriaanse and Kujil, of flexibility, silence and control. Here, the flexibility allowed the Banks to negotiate a Standstill Agreement, which allowed them time to resolve concerns about their securities, appoint a CRO, and create FM2 as the new operating entity, in preparation for the Restructuring Agreement. This seems to largely occurred in private, although, in this case, FMH issued press releases from time to time about the progress of the reorganisation. It is not entirely clear why this was done, although it is possible that FMH, LGH and the Banks were seeking to manage third party expectations about the reorganisation process.
5. On the question of control, the Case Study demonstrates a key advantage of the informal reorganisation. Here, the Banks were able to manage the reorganisation process without any obvious interference from other creditors or government interests. As discussed later, the Banks’ control of the process was slow to start, relying on the blunt instrument of default interest rates to put pressure on management. However that situation changed once the CRO was appointed, and LGH signalled its willingness to provide short-term equity funding. It might also be said that the Banks exercised a negative form of control which may have been deliberate, to slow down the restructuring, so that they could address the legal problems with their pledges, that may not have been possible under a court process.
6. Several disadvantages of informal reorganisation can also be seen in the FMH Case Study. Specifically, an informal reorganisation depends upon maintaining trust between key stakeholders, obtaining an injection of new capital to facilitate the reorganisation, and having a sound reorganisation plan with appropriate measures to address the operational and financial weaknesses in the business. Each of these matters ultimately depends upon the key participants being willing to compromise their rights in the expectation that the reorganised entity will provide them with a better return than a liquidation, forced sale or formal reorganisation process.
7. One issue not addressed in the Case Study was the impact of the reorganisation on unsecured and trade creditors, as well as customers. In a formal reorganisation, these parties would have had more influence over the fate of the business, through their standing and rights to be heard in any court controlled process. However it is not clear from the Case Study whether the interests of those parties would have been better or worse off under a formal reorganisation process. If the Banks were only likely to receive a 55% return on a liquidation, it is likely that unsecured creditors would receive nothing, although priority creditors, such as employees may have received benefits. The ultimate liquidation of FMH and the transfer of the business to FM2 may not have changed the outcome for unsecured creditors, unless they were ongoing trade creditors or employees, who benefited from the survival of the business. This issue is addressed in more detail in answer to question 6 below.
8. Another disadvantage of an informal reorganisation process, as seen in the FMH Case Study, was the lack of any external accountability for the time it took to complete the reorganisation process. In particular, the operation of the business during the period November 2013-May 2014 seems to have largely drifted without any clear sense of direction or control. By March 2014 this had resulted in friction between the Banks, and between the Banks and management, which was only resolved by the replacement of the CEO and the advance by LGH of €10m in unsecured loans. This loss of 5-6 potentially vital months in the case of financial distress illustrates a clear potential weakness of informal restructuring, in that the business may quickly go from a recoverable ‘bad’ situation, to an irrecoverable ‘worse’ situation, to the disadvantage of unsecured creditors and other stakeholders who do not have any court protection against potentially self-interested dealings by the Banks.
9. As it turned out, the situation at FMH did not become irrecoverable, and progress was made once the CRO was appointed. However, it is not clear whether the Reorganisation Plan will achieve long-term success, as the future of FM2 remained unclear, as at 2016. That is, the Case Study demonstrates how an informal reorganisation may be more effective at creating the conditions for the future survival of a distressed business, than a formal reorganisation, in appropriate circumstances. However, whether that business ultimately returns to financial strength is a different matter, and is a matter addressed in answer to question 3 below.

*Australian Perspective*

1. In Australia, a major reason for restructuring in cases of potential or actual financial distress is the insolvent trading regime under ss.588G, 588J and 588M of the *Corporations Act* 2001. These provisions impose criminal and civil liability upon a director in relation to insolvent trading by a corporation. These provisions extend to the incurring of debts where the company is insolvent, or where there are reasonable grounds for expecting insolvency.
2. Australian law provides a number of options for dealing with financial distress and restructuring. Consistently with earlier comments, the *Corporations Act* provides for the winding up of insolvent companies, and their ultimate dissolution by deregistration under Part 5A.1. Of more particular interest to the present question are the options for reorganisation before a winding up commences. There are essentially two ‘formal’ restructuring processes and one ‘informal’ process recognised by the *Corporations Act*. The essential feature of both ‘formal’ processes is that they provide a mechanism for objecting creditors to be bound by a decision of the relevant majority of those in favour of the proposed reorganisation.
3. The first of the ‘formal’ processes is that of a Scheme of Arrangement under s.411 of the *Corporations Act*. Although this is a traditional way in which distressed companies entered into reorganisation plans, it is less frequently used for distress companies now than the administration route, discussed in the next paragraph. A scheme for reorganising the interests of members and creditors of a company, may be proposed by the company or by a liquidator. It is fully supervised by the Court, which has an overriding discretion to approve or disallow the scheme. The Scheme process is generally considered to be costly and very process driven, although management does retain control of the process. Most contemporary schemes are used in merger and acquisition contexts, and the reorganisation of companies not in distress. A scheme is unlikely, therefore, to have been an option for consideration in a situation like that experienced by FMH in this case.
4. The second ‘formal’ reorganisation process available in Australia, which would have been an option for directors in a situation like that of FMH in November 2013, was the appointment of an independent administrator under Part 5.3A of the *Corporations Act*. The role of the administrator is to consult with creditors with a view to restructuring the company through a Deed of Company Arrangement (DOCA). The administration process is intended to allow the underlying business to continue and be restructured, under the management of an insolvency practitioner, whilst placing a moratorium on creditor actions. The FMH plan is one that could have been achieved by means of a DOCA, for example, by extinguishing some debts and continuing others as part of the establishment of FM2.
5. Although the DOCA process occurs out-of-court, it is still subject to court supervision and interested parties have the right to seek court intervention at any time. Anecdotal experience about restructuring by means of a DOCA is mixed. It is often seen as being very costly, benefiting insolvency practitioners at the expense of creditors generally, often becomes mired in court challenges, and frequently ends in liquidation. Whilst it has the theoretical benefit of flexibility, it lacks the other two benefits highlighted by Ariaanse and Kujil of silence and control. The other issue which arises in relation to the Administration provisions is the interaction of secured creditors and the administrator. Under Part 5.3A, Div 7, secured creditors may still enforce their rights over secured property, although this is subject to the possibility of limitations being placed on them by the Court. The provisions governing the interaction between secured creditors and the administration process give rise to a range of complex alternatives, and highlights the general undesirability of this process for addressing an FMH-type situation.
6. There is now an ‘informal’ process recognised in s.588GA of the *Corporations Act*, since 2017. This is known as the “safe harbour” defence and allows directors to retain control of the restructuring process, and obtain protection from the insolvent trading provisions. This is classified as an ‘informal process’ because it does not involve either the Court, or the definition of any legal rights on the part of interested parties. Rather, it creates a defence to any potential risk of liability for insolvent trading during a period of financial distress. The critical issue for the directors is that they must follow a ‘course of action’ that has the aim of producing a ‘better outcome’ for the company than the appointment of a liquidator or administrator. As a new provision, it has only been referred to in passing in a handful of judgments, and its actual effectiveness is not yet known.
7. However the conduct of FMH, the Banks and the shareholder LGH in the Case Study is precisely the sort of action to which the ‘safe harbour’ defence would apply in Australian law. Specifically, control of FMH remained in the hands of its directors, a reorganisation plan was developed and put into effect, and this was done in a flexible and private manner. Even though the FMH plan could have been effected through a formal administration of the company, it is doubtful whether an insolvency practitioner would have achieved the same plan as occurred by the informal means used in the Case Study. It seems clear from the Case Study that the directors of FMH would have been potentially exposed to a risk of liability for insolvent trading, particularly by June 2014 when FMH’s solvency ratio fell to -9.5%. This would therefore have been a paradigm case for the use of the “safe harbour” provisions, had Australian law applied.

**Question 3 – Application of Turnaround/Reorganisation Approaches**

1. The literature in in the reading material contains a range of view in relation to various factors that contribute to a successful turnaround or reorganisation. The FMH Case Study appears to have been successful, to the extent that a Restructuring Agreement was adopted in July 2015. However, the future of FM2 is unclear, raising issues about the long-term effectiveness of the reorganisation. In addition, as noted above, the FMH restructuring is also open to the criticism that it took too long, being over 18 months, and the future objectives for the new entity, FM2, other than a sale, were unclear.
2. As already considered, the FMH restructuring was conducted as an out-of-court restructuring, exhibiting the two distinct phases described by Adriaanse and Kujil (2006). First, there was a business restructuring that involved emphasis on improving business cash-flow by the use of price increases, staff redundancies and operational savings on matters such as loss recovery and car repairs. This also involved a process of ongoing analysis by turnaround consultants, and stabilisation by means of a standstill agreement in August 2014. The second phase involved a financial restructuring under the Restructuring Agreement in July 2015, by the replacement of a significant portion of the bank debt with equity capital to restore the 5% solvency ratio in FM2.
3. There is an important distinction drawn by Adriaanse and Kujil about the four phases that will ideally occur during a business restructuring. Here, FMH engaged in the first of these phases, which involved stabilisation by the taking of actions to increase cash flow in the short term, such as cutting back expenditure and increasing prices. Some attempt was made to conduct an analysis, which is part of the second phase, by considering future options. However, there was no clear analysis undertaken of the longer-term viability of the business, or of specific parts of the business, and no real attempt to identify measures to restore long-term profitability. By February 2014, it is clear that the Dutch business was expected to be profitable, and there was some suggestion of selling off foreign parts of the business, but nothing concrete appears to have been done about this in the Reorganisation Agreement. To the contrary, all of the foreign businesses were transferred to FM2, which suggests a lack of any longer-term plan in relation to them. The same might be said about product mix, which was identified as a matter for consideration, but without any follow up occurring.
4. The absence of any long-term strategic changes meant that the third and fourth phases identified by Adriaanse and Kujil, of repositioning and reinforcing, did not occur. What one is left with, in the case of FMH, is a partial business reorganisation for short-term stabilisation, and a financial restructuring. Such a reorganisation is, according to Adriaanse and Kujil, sub-optimal. The rational explanation for this occurring is that the Banks were limiting their objectives to dressing up the FMH business for sale to a trade rival, rather than suffer a forced sale and associated losses through a liquidation process. Viewed in this light, it is at least arguable that FM2 does not represent a true turnaround, in the sense of its business having long-term viability. Given the nature of the Case Study, this might be an unduly harsh assessment, but there is a strong sense of there being a missed opportunity to do more during the reorganisation process, even if that was limited simply to the sale of unprofitable foreign subsidiaries.
5. Another useful perspective to analyse FMH’s turnaround is the stakeholder analysis of Pajunen (2006). According to Pajunen, there is an important relationship between organisational survival and engagement with influential stakeholders. In the case of FMH, there were three main influential stakeholders who had control over critical resources: the Banks, LGH as the shareholder, and the CRO as the apparent controller of management decisions. The more peripheral stakeholders, who exerted limited if any influence of the restructuring process, included other creditors, customers, directors and other members of the management team.
6. One criticism that could be made about the restructuring process, as previously noted, is the length of time it took from November 2013, when the initial problems emerged, to the implementation of a standstill agreement in October 2014. It is not entirely clear who, if anyone, was actually controlling the process during this period other than the CEO, who was removed in April 2014, and whether anyone had done a critical stakeholder analysis. Although the Banks had a position of power to call a default, as a result of the expiry of certain of their facilities in December 2013, this was matched by an apparent weakness in their security position. The lever used by the Banks to exert control was the indirect measure of charging default interest. This does seem to have ultimately focused the mind of LGH, resulting in the replacement of the CEO in April 2014 and the provision of short-term financial support. However, vital time was lost during this process, and the financial situation of the business worsened.
7. The appointment of the CRO in May 2014 was a clear turning point in FMH’s reorganisation, not unlike the case study used by Pajunen, where progress was made by the removal of the CEO, Elving. It is clear that, by the time of the appointment of the CRO, the Banks and LGH had recognised the need for mutual cooperation and trust, and it is a reasonable assumption that the CRO stepped into the role exemplified by Pajunen’s second to fifth propositions, of establishing communication and building personal relationships between the Banks, LGH and the company, brokering agreements and building consensus between them. Thus, from about the time of the CRO’s appointment onwards, the key stakeholders appear to have worked together – initially on the Standstill Agreement and subsequently on the Restructuring Agreement – and made the prospect of FMH’s organisational survival more likely.
8. However, long-term survival of a financially distressed entity requires more than attending to short term problems. What is needed, and what was missing in the case of FMH was future strategic vision. This is the difference between two apparently paradoxical approaches to a turnaround, which Schmitt and Raisch (2013) label ‘retrenchment’ and ‘recovery’. The ‘retrenchment’ mindset is concerned with establishing stability, control and efficiency within an existing business model. On the other hand, a ‘recovery’ mindset requires the embracing of change, flexibility and an emphasis on effectiveness of the business operations. Traditional approaches to turnarounds often see ‘retrenchment’ and ‘recovery’ as distinct, and sequential phases. This appears to be the approach adopted by FMH and its stakeholders. The initial actions of management involved ‘retrenchment’ activities, such as cutting staff, saving on car repairs and increasing prices. Stability was initially achieved through the Standstill Agreement, and control through the debt to equity swap in the Restructuring Agreement, resulting in the restoration of the solvency ratio.
9. What was missing throughout the entire restructuring process of FMH from 2013-2015 was any sense of a recovery mindset, with emphasis upon strategic changes, such as improved market penetration, product launches or other structural variations. These possibilities were raised in May 2014, but as previously noted, were not apparently advanced as part of the Restructuring Agreement in July 2015. In terms of the analysis of Schmitt and Raisch, this represented a missed opportunity for FMH and its stakeholders. That is, FMH lost the opportunity to drive change as a result of learning from experimentation, seeking breakthroughs and participation by employees or management of foreign subsidiaries. It is therefore unsurprising that the situation of FM2 remained critical in 2016, and one is left to wonder whether the optimistic predictions of a better future will be realised.
10. This somewhat pessimistic prediction for FM2 is consistent with the broad-based study of successful strategies pursued during the turnaround/restructuring process by Sudarsanam and Lai (2001). These authors examine ex post facto success of recovery strategies in the two years following the onset of financial distress, and classify entities into ‘non-recovery’ and ‘recovery’ firms, depending on whether or not their turnaround strategies exhibited success in those immediately following years. It would be fair to place FMH/FM2 into the ‘non-recovery’ category, by comparing the situation of these businesses in 2015 after the Restructuring Agreement, compared to the onset of financial distress in 2013. The FMH experience conforms closely to the Sudarsanam and Lai analysis, in which the emphasis was the intensity of internal strategies, rather than external facing strategies which involved a ‘strategic refocusing of their asset and business portfolio’. As previously noted, FM2 resembles the original FMH, other than with respect to the debt/equity structure, management personnel and relatively minor organisational changes.
11. A better strategy for restructuring FMH, adopting some of the suggestions made by Sudarsanam and Lai, would have been asset restructuring, involving the sale or divestment of loss making aspects of its business, and use of the proceeds to invest in more profitable or efficient businesses or parts of the business. For example, the Dutch business was apparently profitable, with the confirmation of overseas losses in late 2013. It is not clear why the loss-making subsidiaries were not sold or closed and the capital invested elsewhere, such as in improved management information systems. It is also not clear why these options, which were on the table as at May 2014, were not pursued or incorporated within the final Restructuring Agreement. The short point is that, by failing to adopt these strategies, FM2 runs a serious risk of becoming a ‘non-recovery’ firm, despite the success of achieving the Restructuring Agreement.

**Question 4 – Dissent from Banks C & D**

1. Three months after the first signs of financial distress of FMH became apparent, the unanimity between the four banks broke down. In mid February 2014, C&D ceased cooperating, and friction arose between A&B on the one hand, and C&D on the other hand. The apparent source of this friction was the banks’ general lack of confidence in the management of FMH, and the slow pace of the restructuring measures. Whether causally related or not, in April 2014, LGH replaced the CEO of FMH, who appears to have been a major impediment to the restructuring, as it was in case study by Pajunen.
2. At about the same time, Banks A&B investigated the possibility of buying out C&D at a 15-20% discount, although this did not proceed. By June 2014, C&D were threatening to cancel FMH’s credit, which would have likely forced FMH into a ‘formal’ restructuring. It later emerged that this threat was intended as a signal to FMH to hurry up, rather than being an intended action in serious contemplation by C&D. Ultimately C&D fell into line with the other banks, and entered into the Standstill Agreement and Restructuring Agreement. The participation shares between the Banks in relation to the various facilities is not entirely clear from the Case Study, other than to note that C&D were responsible for the €32.5m facility, which appears to have been the first facility due in December 2013. Ultimately this facility was cancelled, suggesting it might have been a junior facility to the main €360m working capital facility, part of which remained as debt financing under the Restructuring Agreement.
3. It is self-evident that an ‘informal’ restructuring ultimately depends upon the consent of all major affected parties. At one level this reflects the parties’ legal position, in that a party with legal rights – such as the right to enforce a loan and security – can force the restructuring into a ‘formal’, court controlled process. More broadly, however the importance of cooperation is also reflected in Pujanen’s fifth proposition, which highlights the need for ‘consensus on long term goals among governing stakeholders’ to increase the likelihood of survival and a successful organisational outcome.
4. The dissent from Banks C&D can be analysed in economic terms of “game theory”, the application of the ‘prisoner’s dilemma’ and the desirability of achieving a ‘Nash equilibrium’ (Kishtany 2017) In essence, a decision by any Bank to force the restructuring into a formal liquidation process would have resulted in value destruction for all Banks, in the sense that the recovery in a liquidation would be only 55% of the outstanding debts. Such a situation is equivalent to a nuclear war, which is disastrous for all participants. What one participant seeks to achieve, by raising the possibility of a mutually assured destruction, is to hold the other participants hostage to that outcome, in the hope that they will give the first participant a benefit or advantage.
5. In other words, by raising the possibility of destruction, the active participant seeks to create leverage that does not otherwise exist. This is a rational strategy for Banks C&D if they have less at risk from a destruction scenario than Banks A&B. Here, Banks A&B at least contemplated buying out C&D at a 15-20% discount. Thus C&D created three options for themselves: first, continue to participate in the restructuring; second, pursue legal recovery means and suffer a certain 45% loss; or thirdly, engineer a buy-out at a 15-20% loss. Their financial outcomes are greatly improved by having the availability of option three over option two (15-20% loss being better than a 45% loss).
6. The prisoner’s dilemma posits that if C&D threaten to force a ‘formal’ restricting process, and A&B don’t yield to C&D’s threats, then C&D will forced to accept a sub-optimal outcome of liquidation, when a Restructuring Agreement provides the possibility for a 100% recovery. Thus the ‘Nash equilibrium’ is one that is reached by cooperative behaviour of C&D with A&B, not competitive behaviour – ie. entering into the Restructuring Agreement, as occurred. Whether cooperation is the best outcome for C&D will depend upon a range of factors not disclosed in the Case Study about their individual positions, tolerance for losses and appetite for future risk. However, as a general proposition, the advantages of cooperation will generally outweigh mutually assured destruction as the ‘Nash equilibrium’ posits.
7. The correct advice to give to A&B in response to C&D’s threats, as indicated by game theory, is to demonstrate to C&D that the ‘Nash equilibrium’ is that of cooperation, and participation in a restructuring agreement. In other words, the threat of liquidation by C&D should be met with a matching threat of liquidation by A&B, just as nations arm themselves with matching nuclear weapons. However, this can be a risky strategy for A&B, if C&D do not recognise the benefits of cooperation, and are determined to accept the write-offs that a liquidation would entail. In that case, the next best strategy for A&B is to seek to buy out C&D at a discount to offer them an incentive not to bring out about the destruction scenario of liquidation. In doing so, A&B effectively pay a premium to minimise their downside risk of loss. However, experience generally indicates that one set of banks is usually reluctant to pay out another set of banks, even at a discount, unless the debt owed to the exiting banks is very small or there is some other strategic benefit in doing so. One of the reasons for this reluctance is that it risks setting a precedent for other distressed companies, and no bank wants to have a reputation of being a soft target for a takeout threat, such as here with the threats by C&D.

**Question 5 – INSOL Principles**

1. The eight INSOL Principles, second edition (INSOL 2016) provide guidance to facilitate multi-creditor workouts in relation to financial distress of corporate entities, such as FMH. As noted in the Commentaries to the Principles, their main aim is to facilitate a collective, coordinated and cooperative approach by creditors to debtors in financial distress outside formal insolvency processes. Although generally directed at Banks and financial institutions, the Principles are capable of being applied to all creditors. However, consistently with Panjunen’s analysis, the Principles are of most relevance to the ‘governing’ stakeholders, which in this case were the Banks, LGH and management.
2. Most of the eight principles were put into effect in the FMH reorganisation to a greater or lesser extent, although one of the criticisms that can be made about their implementation was the lack of timeliness, particularly during the period November 2013-May 2014. Even though timeliness is not a distinct principle, INSOL notes that ‘delay prolongs commercial uncertainty, increases the cost of the process and potentially erodes value.’ Here, as noted above, a fracturing between the Banks occurred in early 2014, as a result of the uncertainty created by FMH’s management in relation to the lack of progress in relation to the working out of FMH’s financial distress. Whilst this uncertainty was resolved by the removal of the CEO and the appointment of a CRO, it is possible that the opportunity to improve value through the restructuring process was lost, by the lack of attention to FMH’s strategic options at an earlier stage.
3. The first principle requires the establishment of a standstill period to enable information to be obtained and proposals to be formulated and assessed for resolving FMH’s financial difficulties. This principle was mostly satisfied, informally by the deferral of the December 2013 repayment obligation, and formally by the entry into a Standstill Agreement in August 2014. The ‘all relevant creditors’ requirement in relation to FMH appears to have been satisfied by the coordinated action on the part of Banks A, B, C & D, and the absence of any other creditor being mentioned as a threat to the ongoing attempts to respond informally to FMH’s financial distress. However, what was missing was the lack of attention to the requirement that the standstill be in place for a ‘limited time’, and the lack of apparent urgency from November 2013 to August 2014 in formulating and assessing proposals for restructuring FMH.
4. The second to fourth principles were all essentially satisfied by the Banks. None of the Banks took any action to enforce their claims against FMH, although they had the right to do so (second principle). Nor did any of them take any action to adversely affect the prospective return to the Banks collectively, by proceeding with a liquidation or ‘Fallissement’ (third principle). There also appears to have been a coordination of response by the Banks in relation to FMH’s financial distress (fourth principle). It is true that C&D threatened to break ranks, but they did not do so, and their actions appear to have been driven by a desire to force a change of management, which occurred. Further, the end result of the process, namely the Restructuring Agreement, was said to reflect the relative positions of the financiers involved, which is one of the objectives of the standstill period under the second principle.
5. The major criticism that could be made in this case arises under the fourth principle. The Banks do not seem to have had a coordinating committee at the start, and appear to have acted in somewhat detached and reactive manner, relying on default interest to put pressure on FMH to change. It is true that the Banks met in December 2013, appointed an Investigating Accountant and received a report from an independent turnaround consultancy agency. However the fracturing of the relationship between the Banks in the period January-May 2014 suggests that there was no effective coordination mechanism at this time. This seems to have been resolved by Bank A taking the lead in May 2014 to push for the appointment of a CRO, which was done. It is reasonable to assume that, from that point on, coordination efforts improved, with the CRO acting as the coordinating person between the Banks, LGH and management.
6. The fifth and seventh principles concern the provision of information to creditors, and the treatment of that information as confidential, respectively, to facilitate the reorganisation process. It would seem that information was made available to the Banks by means of at least the Investigating Accountant and the turnaround consultancy in December 2013. It is also reasonable to assume that the CRO was open and forthcoming with the Banks about any information they required for the purpose of developing the Restructuring Agreement. To this extent the fifth principle was satisfied. However, for reasons already expressed, it is not clear how that information was used, or the extent to which it was considered, in formulating strategic options for the longer term success of the business. The fifth principle is essentially one of process, and relies upon creditors to make business decisions based on that information as they see fit, rather than mandating the use of the information provided. In relation to the seventh principle, there is no evidence that the Banks breached any confidentiality obligations in respect of the information provided. It is not entirely clear why FMH issued press releases about its ongoing financial difficulties, as it was not a listed company, but that did not involve any breach of principle seven by the Banks.
7. The sixth principle raises an interesting issue in this case. It requires restructuring proposals to reflect ‘applicable law and the relative positions of relevant creditors at the Standstill Commencement Date’. Here, the ultimate Restructuring Agreement was said to reflect the Banks’ relative positions, by implication as at November 2013. The ‘Standstill Commencement Date’ is noted in the commentary to the first principle, as being potentially problematic. Here, it is reasonable to treat 16 November 2013 as the relevant date, as this was when the Banks were invited to a meeting with the board of FMH at which they were told about FMH’s financial distress. As noted above, the first action of informal standstill occurred shortly thereafter, with the deferral of the December 2013 debt repayment. However, as at November 2013, the Banks had potential legal issues with the enforceability of their pledges, with the prospect that their proceeds would be substantially lower or even worthless in a liquidation. The result of the standstill, from November 2013 to July 2015, was that the Banks apparently rectified these pledges. As between the Banks themselves, the Restructuring Agreement reflected their ‘relative positions’ in terms of their pre-existing debts and securities. However, to the extent that the Banks improved their security position, the Restructuring Agreement did not reflect the Banks’ ‘relative position’ as against other creditors under ‘applicable law’. The Case Study does not indicate whether these other creditors were actually disadvantaged by the Restructuring Agreement, although it does appear that the liquidation of FMH consequent upon the Restructuring Agreement may have had that effect, unless the other creditors – employees and trade creditors – were transferred as part of the business transfer to FM2, or their interests were otherwise addressed, as discussed in answer to question 7 below.
8. The final, eighth, principle was also addressed in the FMH restructuring. This principle is concerned with additional funding being provided during the Standstill Period, and according it priority for repayment. In April 2014, LGH provided a €10m unsecured loan to FMH, and in June 2014 offered to provide €27.5m for the purpose of restructuring. It appears that this was reduced to €25m which was provided in connection with the signing of the Standstill Agreement in August 2014. In October 2014, LGH also provided additional security over €10m of tax refunds, although it is not clear whether any additional funding was provided, as opposed to the granting of this additional security. The €25m additional funding was repaid in January 2015, which accords with the eight principle. The original €10m unsecured loan appears to have been cancelled, without repayment, in the Restructuring Agreement. This is arguably not in breach of the eighth principle if the €10m is considered as being an action by the shareholder to provide financial support independently of any reorganisation effort, rather than funding negotiated with the Banks. In any event, the eighth principle is conditioned by the words “as far as practicable”. Thus, allowing for some part of the rescue funding to not receive priority, may be understood as the shareholder sharing the pain of having some of its debt cancelled in consideration for the entry into the Restructuring Agreement.

**Question 6 – “Soft Law” Instruments**

1. The focus of this question concerns the role of ‘other creditors’, meaning creditors other than Banks A, B, C & D, or loans from the shareholder, LGH. There is very little information in the Case Study about the ‘other creditors’, although these creditors will generally fall into four groups: employees, suppliers and trade creditors, government creditors, and other or general creditors. It appears reasonable to assume that if the secured creditors, namely the Banks, are unlikely to recoup more than 55% of their debts on a liquidation, the ‘other creditors’ will receive nothing from a liquidation. In other words, any reorganisation in which the business of FMH survives offers a potentially better solution than liquidation; or, put in the negative, the ‘other creditors’ will be no worse off by a restructuring of the type ultimately entered into by the Banks and LGH with the transfer of the operating assets into FM2.
2. The challenge with the ‘other creditors’ is akin to the dissention between the Banks, in relation to C&D’s threat to breakaway from a coordinated solution in early 2014. That is, as formal liquidation proceedings are likely to be open to ‘other creditors’, the practical question for the Banks is how to avoid one or more of the ‘other creditors’ seeking to leverage the possibility of liquidation to improve their prospects of being repaid their debts. Of course, not every creditor will have a debt of sufficient size to generate that leverage. In the case of individual employees, or trade creditors, for example, it will be easier for FMH to payout the debt rather than engage in disputation. LGH appears to have understood this business logic with its €10m unsecured loan in April 2014, and its subsequent advance of €25m as part of the Standstill Agreement in August 2014.
3. In dealing with the ‘other creditors’, “soft law” instruments provide a useful resource for the major stakeholders (here the Banks, LGH and management through the CRO) to bring the ‘other creditors’ on the informal reorganisation journey with them. The question is how this should be done in the context of an informal restructuring of FMH, without the certainty provided by insolvency laws or the protection of the Courts in the reorganisation process.
4. The reference to “soft law” is a reference to instruments that are not legally binding and can be found outside the precision or delegated power of “hard law” instruments (Wessels and Boon 2019). Typically, those authors note, “soft law” instruments are developed by ‘informal standard-setters’, by groups of interested parties or practitioners to reflect best practices. The INSOL Principles discussed in answer to the previous question are a paradigm example of a “soft law” instrument, developed by INSOL as a ‘standard-setter’ for global best practice.
5. Wessels and Boon note that, as at 2018, there were 55 identifiable “soft law” instruments, issued by a range of both inter-governmental bodies, such as UNCITRAL and the World Bank, and non-governmental bodies, such as the Asian Development Bank, the European Law Institute, the International Bar Association and the Judicial Insolvency Network. Some of these “soft law” instruments are directed specifically at filling gaps in areas such as international cooperation and communication between courts and insolvency practitioners, or in the interpretation or implementation of international texts such as UNCITRAL’s Model Law on Cross-Border Insolvency, which has been adopted into the domestic law of 53 jurisdictions (UNCITRAL 2021).
6. In the present case, the “soft law” of relevance, are those instruments which address the means by which an informal restructuring ought be done, and how the interests of parties – in this case the ‘other creditors’ – should be addressed, in the absence of any definition of the rights of those ‘other creditors’ by a ‘hard law’ solution. That is, it is easy in the case of a formal procedure for creditors and stakeholders to know exactly where they stand, and to make rational decisions about the course of action which maximises their individual interests, based on their expressly articulated legal rights. However, as the preceding analysis of a ‘Nash equilibrium’ demonstrates, a party’s actual best interests may be served by cooperation, rather than seeking to better oneself at the expense of other participants. That is, the certainty provided by a ‘hard law’ solution may come at the cost of destroying the value that can be created by negotiation and cooperation, in an informal restructuring.
7. In a review of the principles and practice of creditor participation in insolvency proceedings, Tomasic (2006) notes that creditor participation is an important aspect of ‘confidence in the fairness of an insolvency system’. Quoting Professor Good, he argues that creditor participation in insolvency should reflect the *pari passu* principle, namely that all creditors of a particular class should be treated equally, and receive an equal return on their debts. This principle is, of course, supplemented by the principle of risk and return, which gives rise to a hierarchy of priorities, with secured creditors placed before unsecured creditors, who in turn are placed before shareholders. Complexities can the arise within each of these classes, with statutory modifications altering the order of priorities amongst unsecured creditors being one of the complexities of formal insolvency laws. Thus, for example, in s.556(1) of the Australian Corporations Act, there are 14 sub-classes of priority payments for unsecured creditors, reflecting a general hierarchy favouring insolvency debts and employee debts, although taxation debts are no longer given priority status.
8. If, as Tomasic suggests, the question of creditor participation is one of confidence in procedures, even if those procedures yield a nil dividend, the challenge in the FMH restructuring is how to devise a process that includes participation by the other creditors. The answer to this question is provided by the most recent of the ‘soft law’ principles, the 2021 World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes. In particular, principle C7.1 provides, as follows:

“The role, rights and governance of creditors in proceedings should be clearly defined. Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors’ committee as a preferred mechanism, especially in cases involving numerous creditors.”

1. This principle is also embodied in, and gives effect to, Recommendations 126-136 of the UNCITRAL Legislative Guide on Insolvency Law, Part II (2004). These Recommendations are not limited to formal insolvency proceedings, with paragraph 84 noting that the input of creditors was ‘both useful and necessary’, on the basis that creditors would generally be asked to approve the reorganisation plan. However, the UNCITRAL Guide does not spell out the point made earlier, that approval of the ‘other creditors’ can also comprehend implicit approval by the non-commencement of formal insolvency proceedings, which might otherwise derail the informal restructuring process.
2. The more difficult question, particularly, in an informal procedure concerns the role and operation of the creditor’s committee, particularly in an informal restructuring. The UNCITRAL Guide contains a comprehensive analysis of a detailed range of factors that can be taken into account in striking a balance between under- and over-involvement of creditors and creditor committees in the insolvency or restructuring process. World Bank Principle C7.2 seeks to address this in terms of outcomes, rather than specific mechanisms – such as indicating that the committee ‘should have the right to request relevant and necessary information from the debtor’ and be the ‘conduit’ for disseminating that information to creditors.
3. Notably Principle C7 follows immediately after C6, which concerns ‘the appointment of an insolvency representative with authority to administer the estate in the interests of creditors’. In the Case Study, this role was fulfilled by the CRO, who appears to have played an important role in generating confidence with the Banks and ultimately producing both a Standstill Agreement and a Restructuring Agreement. Although the Case Study does not say so, it is probable that the CRO was also conscious of the need to consult with and inform the ‘other creditors’ of the progress of the reorganisation. This may explain why information about FMH’s difficulties were published by way of press release, perhaps as the CRO’s solution to the ‘prisoners dilemma’ – ie. to demonstrate the folly of a formal insolvency proceeding to any of the ‘other creditors’ tempted to seek to leverage formal insolvency proceedings to improve their prospect of repayment.
4. The better course for FMH, as part of its informal restructuring process, may have been to use the World Bank Principles, or an alternative equivalent ‘soft law’ instrument, as a basis for engaging with the “other creditors” to involve them in the restructuring process. This may have led to the formation of a ‘creditors committee’, with a structure and rules of operation appropriate to the nature of the case, guided by a consideration of the factors identified in the UNCITRAL Guide, or other appropriate publication. Although the Case Study does not indicate that the ‘other creditors’ posed a specific risk to the restructuring process, it is also not clear whether a better process or outcome may have ensued if the ‘other creditors’ had been more directly involved in the restructuring.

**Question 7 – Essence and Result of the Restructuring Agreement**

1. The Restructuring Agreement on 4 July 2015 essentially involved a reorganisation of the Bank debts in FMH to provide a foundation for selling the assets of the business on a going concern basis. As previously noted, this was not a reorganisation of the business for future growth as a turnaround. The reason for this approach was two-fold. First, on a formal liquidation, the Banks would only have received a 55% return on their debts; and, secondly, the three likely purchasers of the business were apparently waiting for a liquidation to purchase the business or its assets. That is, the restructuring was a rational response by the Banks to seek to generate higher returns from the sale of the business by forcing the prospective purchasers to recognise that the business could only be purchased on a ‘going concern’ basis.
2. There were four specific aspects to the Restructuring Plan. The first, and foundational, factor was the decision to use FM2 as a new holding company for the business. The Case Study does not reveal whether there were any taxation or structuring advantages behind this decision, or whether it was done to eliminate any legacy risks inherent in FMH. Nevertheless, the use of a shell company permitted a share register to be created, and a corporate constitution or shareholder agreement to be developed, which was forward looking and reflected the agreement between the restructuring parties – namely the Banks, LGH and management.
3. An important part of the implementation of the Restructuring Plan will be the transfer of all of the operating companies from FMH to FM2. At its simplest level, this should simply involve the transfer of shareholdings in the various subsidiaries from FMH to FM2. However, where FMH owns assets or business directly, these will need to the subject of a business or asset sale agreement. The complexity of the documentation involved may depend upon the extent to which any cross-collateralised obligations or guarantees need to be unwound or redocumented. There will also be a range of taxation and regulatory considerations that may need to be addressed in each of the jurisdictions where assets and businesses are located. In general, specialist legal and accounting advice will be required to enable these changes to occur smoothly and with a minimum of cost or risk. It will be of assistance that the Restructuring Plan has the support of the Banks, LGH and management. However, as noted in answer to the previous question, there are risks associated with the potential disruption by ‘other creditors’, including employees and governments, which will need to be addressed or at least neutralised in the details of the implementation of the plan.
4. The second factor, which follows from the first, was the establishment of a new shareholding structure. Where previously, LGH had been the 100% owner of the business, the Banks and management became the owners of the business. The removal of LGH from the share register reflected the fact that, on a liquidation, its shareholding would have been worthless. Although the Case Study does not say so, it is probable that LGH agreed to write-off its shareholding interest in return for a release of parent company guarantees given by LGH for the Bank debts. LGH also received a €25m repayment in January 2015 of the €35m extra funding it provided during the restructuring process, meaning that LGH’s out-of-pocket loss was limited to €10m in addition to the loss of its shares.
5. Management was also provided with shares in FM2 most likely as a reward for their continued commitment to the business, or in the case of the CRO for consummation of the Restructuring Agreement, and as an incentive to achieve a ‘going concern’ sale of the business. This was a rational decision by the Banks, as co-equity owners, to create an incentive for management to maximise the likely sales returns, as well as to ensure a longer-term commitment by management to the success of the business prior to any sale occurring. Management’s equity stake in FM2 would also send an additional signal to prospective purchasers that they should discount the possibility of an early liquidation to acquire the business cheaply, thereby encouraging earlier interest from them in a ‘going concern’ sale.
6. The third and critical factor was the restructuring of the Bank debt by a partial debt for equity swap, to ensure FM2 had the required solvency ratio and could thereafter continue as a solvent entity. At the time of the Restructuring Agreement, the total Bank debt was €425m, comprising the €360m working capital facility due in November 2016, €55m in other working capital (€35m of which was originally due in December 2013 and €20m due in 2017) and a further €10m that appears to have emerged during the reorganisation process, either as capitalised interest or as short-term funding.
7. This debt was restructured by retaining a core debt of €240m in FM2, and converting the balance into equity. The €240m represents 56% of the Bank debt at the time of the Restructuring Agreement, which is consistent with the expected payout to the Banks on liquidation – thus indicating an overall fairness in the Restructuring Agreement, consistently with Professor Good’s observation about the *pari passu* principle. The balance of the Bank debt of €185 was written off by the Banks and cancelled as against FMH and its subsidiary FMW. From the Banks’ point of view, any improvement in the sale value of the business will provide a repayment of that €185, and in the very best case an equity premium for the risks involved, if the sale value exceeds the notional repayment amount plus interest. Although this arrangement can be described as a ‘haircut’, whether or not that turns out to be the case will depend upon the ultimate sale price for the business.
8. The fourth element under the Restructuring Agreement is the liquidation of FMH, which is said will be conducted in an unspecified manner. The important consideration for this part of the Restructuring Agreement is the treatment of the ‘other creditors’. The Case Study indicates that the operating companies, and presumably also businesses, were transferred to FM2. However, FMH may have had other assets that remained on its balance sheet, for example unrelated property assets or even insurance claims. The second important aspect of the cancellation or waiver of the Bank debts owed by FMH and FMW is that the liquidation balance sheet of FMH would be free of secured debt, so that some money would be available to meet liquidation costs, any priority debts, with the balance available for unsecured creditors, and potentially LGH. There is insufficient information in the Case Study to analyse this position any further. However, it is likely that this potential outcome represented an improved scenario for these ‘other creditors’ than a liquidation of FMH without the restructure. For this reason, the support of the ‘other creditors’ for the restructure was implicitly achieved without the risk that the restructure was derailed by a formal liquidation application.
9. It might also be noted that the ‘other creditors’ of relevance to the FMH liquidation are only likely to be the direct creditors of FMH, or of any non-operating subsidiaries that were not transferred to FM2. That is because the position of the creditors of the operating subsidiaries will not change as a result of the change in shareholding, unless those creditors had guarantees from FMH. To the extent that there might be employee debts in FMH, it is likely that these would be transferred with the employees who transition from FMH to FM2. The same might be true of other debts where the creditor of FMH continues to engage with the businesses through FM2. In short, the list of creditors remaining in FMH after the restructure is likely to be relatively contained, and it can be expected that the CRO took their interests into account in determining the final details of the Restructuring Agreement.
10. Thus, without knowing all the details, the Restructuring Agreement represented an opportunity for all participants to achieve an outcome that offered the possibility of a better return, from a ‘going concern’ sale, than a liquidation. The risk in relation to this possibility was taken by the Banks, who took an immediate ‘haircut’ on their existing loans, by converting part of their interest into equity in FM2. The possibility of getting an enhanced return in the future through this equity holding was the Banks’ compensation for taking that risk. As at May 2016, the possibility of this enhanced return remained uncertain, and the next major decision point for the Banks was a potential refinancing scheduled for November 2016, but postponed to July 2017. Whether or not a better return does eventuate, unless the business of FM2 performs worse than FMH, at a minimum the Restructuring Agreement was a better alternative than liquidation because of the possibility which it offered. On the other hand, if FM2’s performance declines and the business is ultimately placed in liquidation, then the Restructuring Agreement will be seen with the benefit of hindsight of a potentially costly delaying of the inevitable. The difference between the two outcomes is the key to understanding the true commercial decision being made by the Banks, and the risk they were prepared to take, in supporting the reorganisation of FMH.

**Question 8 – Legal and Non-Legal Cross-Border Issues**

1. Although FMH was based in the Netherlands, it had operating subsidiaries in five foreign jurisdictions, Australia, France, South Africa, Spain and the USA. One of the key aspects of a cross-border enterprise group, such as FMH, is that the global nature of its operations poses a range of potential challenges in a liquidation scenario. These challenges have been addressed partly through the work of UNCITRAL, and relevantly in this case through the European Union, in seeking to coordinate insolvency proceedings involving more than one jurisdiction. In addition to the formal legal mechanisms that exist within the laws of a jurisdiction, there exist a range of non-legal issues that can also arise in relation to transnational entity or group such as FMH. The main non-legal actors concerned are typically governments and regulators, on the one hand, and employees and unions on the other hand. However there may also be other major national and transnational actors who can have a significant influence on issues involving cross-border financial distress.
2. An important preliminary observation to be made in relation to FMH’s subsidiaries is that three of the subsidiaries are subject to the European Union Regulation 2015/848 on insolvency proceedings, the Netherlands, France and Spain; whilst three subsidiaries are located in Model Law countries, Australia, South Africa and the USA. The two instruments are said to provide a complementary regime, in that the EU Regulation applies to cross-border insolvencies with the EU member-states, whereas the Model Law applied to non-member states (UNCITRAL 2014). It may also be noted that the Model Law is not confined in its operation to the recognition of insolvency proceedings only in other Model Law countries.
3. The core concept in both the EU Regulation and the Model Law is that of the ‘centre of main interests’, or COMI. Determination of the COMI is key to determining which court will be responsible for conducting and/or supervising any insolvency proceeding. Under Article 3 of the EU Regulation, the COMI is presumed to be the organisation’s principal place of business, in the absence of proof to the contrary. In the Case Study, this is the Netherlands, which would bring any insolvency proceeding under the EU Regulation. If such a proceeding were to be commenced, the Model Law would recognise that court to be a “Foreign main proceeding” under Article 2, which provides the cornerstone of the recognition and cooperation procedures set out in the Model Law.
4. There is, however, an important difference between the EU Regulation and the Model Law, that is relevant to the present case. FMH is an enterprise group, with overseas subsidiaries being separately incorporated in each jurisdiction. The EU Regulation, Chapter V, makes provision for “group coordination proceedings”, where separate insolvency proceedings exist in different EU Member States. The priority rule in Art 62 appears to accept that the first court to accept jurisdiction will have jurisdiction over the coordination proceeding, which may or may not be the COMI of the group, subject to a choice of court rule in Art 66. On the other hand, the Model Law does not address enterprise group insolvency, which led to a further UNCITRAL Model Law on Enterprise Group Insolvency in 2019. The latter Model Law has introduced a similar concept of a “planning proceeding”, in which a “group insolvency solution” can be developed. However, this more recent Model Law has not yet been adopted, and therefore does not arise for consideration in this Case Study.
5. Returning to the EU Regulation, its relevance in the present case is that it provides the ‘shadow of the law’ against which the informal reorganisation of FMH took place. As there was no formal insolvency proceeding commenced, the EU Regulation did not apply. However, if there had been a liquidation, then it would have taken place in the Netherlands. The main possibilities would then have been, first, the liquidator would have taken control as shareholder of the affairs of the subsidiaries and placed them into an insolvency situation had the liquidator wished to do so; or, secondly, a creditor may have taken action to place the subsidiaries into liquidation. In the worst case, there might have been multiple liquidators in multiple locations. For the EU countries, this would have led to a ‘group coordination proceedings’. For the non-EU countries, interesting questions may have arisen before the courts of those countries as to how they should treat the various foreign liquidations as a matter of public policy and comity, as these multiple liquidations would be outside the scope of the Model Law. Such a situation occurred, for example, with the collapse of Lehmann Brothers, demonstrating the limits of insolvency proceedings in relation to cross-border enterprise groups.
6. The potential complexity of the legal cross-border issues for FMH created a risk for the Banks in terms of loss of value through any liquidation process, having regard to the costs and complexity involved. However these issues also reveal that a premium attaches to cooperation in reaching an informal reorganisation solution. As the sum of the parts on liquidation will usually be less than the ‘going concern’ value of the business, entry into the Restructuring Agreement was a rational strategy for the Banks. This assumes that the Restructuring Agreement can deliver upside value from a ‘going concern’ sale. However, as previously observed, if liquidation was inevitable, then the best that can be said is that cross-border risks were always inherent in lending decisions made by the Banks to a transnational group such as FMH.
7. Alongside the complexities of legal cross-border issues are a range of potential non-legal issues. These are more difficult to define on the information presented in the Case Study. The core facts about FMH’s business is that it operated in six countries, three different continents, employed 3,000 people, had over 5,000 customers and had 200,000 cars in its fleet. Viewed in this light, FMH had multiple stakeholders who were affected directly or indirectly by its existence and operation. Indirect effects could include, for example, the landlords who rented premises to its outlets, regional communities who depended upon the availability of car rental at their local airport, technical facilities that existed to service and repair the cars, and other businesses that depended on the buying and selling cars as the car fleet was refreshed and renewed.
8. The ripple effect of a collapse in the business of FMH therefore had the potential to cause substantial problems for a vast number of people in locations throughout the world. Viewed from the perspective of the subsidiary businesses, the collapse is one that can easily be portrayed as a foreign problem caused by executives and bankers in a remote location, namely the Netherlands. Both business and politics tend to be viewed in local terms, and it is easy for disaffected creditors or displaced employees to seek to blame outsiders as the cause of the local problem, and seek local protection for their perceived interests. In the case of employees, this could involve actions by labour unions. Alternatively, other stakeholders might seek action or intervention by domestic governments to protect the local constituents.
9. The difficulty that these non-legal actors pose to FMH and the Banks is the potential to disrupt any reorganisation efforts, with a view to a ‘going concern’ business sale. The risk to the CRO and those involved in the restructuring process is similar to the ‘prisoner’s dilemma’ problem mentioned earlier. That is, if a foreign actor seeks to avoid a risk of loss from a liquidation by taking some form or non-legal action, be it a union ban or an extra government regulation, the risk of a liquidation may increase. The analytical difference between these non-legal actors, and say ‘other creditors’, is that the solution to the problems of the non-legal actors is not necessarily resolved in strict financial terms. That is, stakeholder management and the provision of assurances to the non-legal actors about the future of FMH may be more important than the specific financial outcomes. Thus, for example, operators and consumers at a regional airport may be more worried about continuity of service than the rental price of the cars.
10. In summary, the more that can be done by the Banks, LGH and the CRO to ensure continuity for FMH’s business during the informal restructuring process, the less risk there will be of a non-legal disruption to the reorganisation. FMH seems to have been conscious of these risks, as far as can be gleaned from the Case Study: only 130 of the 3,000 staff members were made redundant, there is no evidence of any closures, and even the car repair savings appear to have been an incremental change. In addition, the provision of the emergency funding of €35m by LGH will have been an important signal of support and continuity to governments, unions and other non-legal actors, during the restructuring process.

**Question 9 – Possibility of Moratorium**

1. In August 2104, the Banks entered a Standstill Agreement with FMH and canvassed four options for the future. One of those options was a moratorium procedure under Dutch law. This procedure is one that involves an application to the Court by the debtor. It is not available to creditors. A judge and receiver (bewindsvoerder) is appointed by the Court to oversee the moratorium. The role of the receiver is to manage the enterprise and negotiate payments with creditors, whilst the aim of the process is to restructure the business and create the opportunity for the business to continue whilst the restructuring is taking place (EMCC 2021).
2. There are both advantages and disadvantages of moratorium procedures for dealing with companies in financial distress. In Australia, a similar type of procedure exists under Part 5.3A of the *Corporations Act*, for the appointment by the company of an administrator, as previously mentioned. In the case of FMH, a Restructuring Agreement was achieved without entering a moratorium, which indicates that it was a good idea not to proceed down the moratorium route.
3. In general, the main problem with a moratorium, or administration procedure in Australia, is the loss of control by the key stakeholders over the restructuring process. As mentioned, the moratorium procedure involves both court supervision and a court appointed receiver. In Australia, the debtor gets to choose the administrator, and typically administrators are pre-vetted by the directors as persons who are likely to be sympathetic to them. However, the result is likely to be the same in both jurisdictions. That is, a third party enters into management under the direct or indirect supervision of the Court. Complexity and fees are added to the already difficult task of managing a business in distress. One of the major complaints about the administration procedure in Australia is that the fees accumulated by administrators can often tip a company into liquidation where it was capable of being saved.
4. The other disadvantage that may be seen in the case of FMH is the risks associated with the cross-border issues discussed in answer to question 8. Commencing an insolvency proceeding, even one for a moratorium, can trigger downstream consequences for FMH’s subsidiaries of both a legal and non-legal kind, which make a liquidation more likely to occur as individual actors and stakeholders seek to maximise their individual positions, rather than cooperate to maximise the overall position – in other words, the ‘prisoner’s dilemma’ problem. In the Case Study, the Banks appear to have avoided this possibility by undertaking an informal restructuring approach, as discussed in answer to question 2 above.
5. One downstream legal consequence of a moratorium, that may be of significance for a business like FMH, which is likely to have a significant number of property holdings associated with its car leasing business, is the triggering of automatic default clauses in contracts and leases. These clauses, also known as ‘ipso facto’ clauses, allow counterparties to terminate contracts where an insolvency event occurs within a corporate group. Depending on the drafting, the institution of a moratorium proceeding in the Netherlands is likely to enable landlords, credit providers and suppliers to terminate obligations if they had contractual clauses allowing them to do so. This could lead to the potential loss of business critical assets such as property leases or licences to operate at major airports, for example, or the repossession of vehicles under finance, that may in turn trigger downstream insolvency proceedings or business collapse.
6. Australian law now specifically addresses the harm that can be done by ‘ipso facto’ clauses, by a series of amendments to the *Corporations Act,* but only in a formal insolvency proceeding. In explaining the need for these changes, the Australian government noted that such provisions can ‘reduce the scope for a successful restructure’, ‘destroy the enterprise value of a business’ and ‘prevent the sale of the business as a going concern’ (Australian Government, 2017, para 2.4). Given the equivalence between a Dutch moratorium, and an Australian administration, the Australian government correctly characterised such provisions as ‘defeating the purpose of a voluntary administration’. The decision by the Banks to avoid the moratorium option avoided these potential legal consequences.
7. There are, of course, benefits of a moratorium in an appropriate case. In the Case Study, there were four Banks which generally managed to maintain alignment in relation to the restructuring, facilitated by the appointment of a CRO and supported by capital injections from LGH. Not every distressed group will have such an opportunity. Where the key stakeholders are numerous, or disparate, or where serious disputation exists between those stakeholders, a moratorium procedure may be the best option to progress a restructuring, despite the risks previously identified. In such a situation, the presence of an independent receiver and court supervision, may permit the restructuring to occur in an orderly way, despite the conflict or divergence of interests. The other circumstance in which a moratorium, or administration, procedure may be useful is where the claims or interests of specific parties are in dispute or doubtful. Given the concerns of the Banks about their pledges at the start of FMH’s restructuring process, it was likely to their advantage that they retained control of the process, so that they could fix any deficiencies; although unsecured creditors may have been better served if the court process had allowed some of these problems to come to light.
8. In Australia, the shortcomings of the Part 5.3A administration procedure were noted by the Australian government in 2017 and led to the introduction of the ‘safe harbour’ provisions mentioned above in answer to question 2 above. The rationale for this change to the law, involved a recognition of the potential for value destruction by the appointment of an administrator, where a reorganisation by the directors was possible, and in particular (Australian Government, 2017, para 1.9):

Even where a company may actually be solvent or could be turned around, the appointment of an administrator has the potential to result in the company being liquidated because of the loss of confidence amongst its suppliers, credit providers and employees and the general public.

1. This observation is equally applicable to the possibility of a Dutch moratorium. It also reflects a more widely held perspective in support of debtor-in-possession style options, of the type found in Chapter 11 of the US Bankruptcy Code. In January 2021, after the dates relevant to the Case Study, the Netherlands introduced a new debtor-in-possession proceeding, which is said to combine the features of the US Chapter 11 procedures and the English Scheme of Arrangement (Jones Day 2021). A key feature of the Dutch procedure, according to Jones Day is that it allows restructuring plans to be imposed on ‘dissenting creditors’ to avoid the problem mentioned earlier of recalcitrant who seek to ‘monetise nuisance value’, that was a disadvantage of traditional informal reorganisations. It may also be noted that the EU Regulation, Article 76, extends its cross-border protections, where appropriate to debtor-in-possession situations.

**Conclusion**

1. In conclusion, the entry into the Restructuring Agreement may be considered as a partial success by the Banks. Commercially they have taken the risk that FM2 will achieve a higher payout than a liquidation of FMH. Apart from the time it took to get started, the reorganisation process largely followed INSOL Principles, and avoided some potential cross-border insolvency pitfalls. The major criticism that can be made of the restructuring was the loss of an opportunity to bring about strategic change to the business, in favour of preparing it for a ‘going concern’ sale. Even at 2016, it was too early to tell whether this will give rise to a successful solution for the Banks and the other affected stakeholders.

31 October 2021 **Tim Castle**

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