**CASE STUDY 1**

**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?**

In my view, the primary causes of financial distress at Flow Management (“**FM**”) were organisational and psychological factors. Environmental and ecological factors may have played a part as seen from the sustained poor turnover despite steps being taken for 3-4 years (i.e. by 2016, FM was still suffering operational losses of nearly €9m). But as Mellahi & Wilkinson astutely observed, “*corporate calamities are calamities created by men*”.

First, we see a failure of leadership by FM’s CEO & CFO.

These two individuals paid themselves large management bonuses by having regard to numbers which were completely blown out of proportion. It is not clear whether this was done fraudulently, negligently or whether they were simply misinformed about the true financial status of FM.

As Mellahi & Wilkinson suggest, there are a number of factors that may have contributed to the CEO and CFO’s failure of leadership. For instance, they could have been narcissistic in their behaviour. When faced with threats, they isolated themselves from the advice of others, ignored words of caution, interpreted criticisms as threats and became myopic in their views. Their behaviour fostered hubris and caused them to stick to the knitting, which was not appropriate in changing market conditions. Alternatively, they could have cognitive inertia. By being in place for an extended period of time, they ignored internal causes of failure and subsequently exacerbated the problem. Their rigidity and commitment to standardized practices, reliance on restricted sources of information, management cohesion and entrenchment, meant that they did not spent sufficient time analysing the threats and opportunities facing them. They were unreceptive to change. Failure at the top cascades downwards.

Second, FM had poor financial systems and controls. We see this from various factors.

One, FM’s failure to periodically check real costs against the results of cost price calculation. As a result, prices were set too low and FM had to go to its customers to seek a sustained increase in prices across the board. This would hurt FM’s reputation.

Two, FM’s wrongful reporting and forecasting of its revenue and profit to the extent that a significant consolidated loss was reflected as a profit, and FM failed to detect that its subsidiaries had made significant losses of €6.3m in 2013.

Three, FM’s poor accounting practices where it made a wrongful booking of a €1.6m contingency gain in 2012 when it would only crystallise in 3 years.

As a result of the poor financial systems and controls, FM’s management team was completely misinformed and they suffered from a completely erroneous understanding of how well FM was doing in the market. This in turn led to management’s failure to diagnose the true causes of financial distress, which in turn led to wrong choices being made in a bid to fix the problems.

Finally, FM had poor workflow and processes.

This is apparent from the fact that (a) steps taken to improve loss recovery, reduce high excess premiums and find savings on car repairs was expected to yield savings of €3.9m and (b) it was possible to make 5% of its total workforce immediately redundant which would yield an annual saving of €3.3m.

Based on the above, I do not think that FM’s financial distress could have been prevented. The structural issues plaguing FM were systemic and went to the core of its operations and finance. Even when the banks replaced FM’s CEO and CFO, we still see that its profit forecasts were way off the mark to the tune of millions of Euros. There is evidently a deep-seated rot within FM that could not be fixed despite the efforts of the CRO and an activist creditor and shareholder team. It is also not clear what is FM’s long-term market strategy to generate greater and more sustained revenue. Other than short-term cost-cutting measures, there was no meaningful attempt to gain market share and establish greater operational profitability. That is why the ultimate restructuring plan which the parties settled upon was to “clean up” the corporate structure of FM and sell it as a going-concern to one of its competitors.

**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*?**

**Advantages of workout versus formal bankruptcy**

First, debtor companies have greater autonomy to find a way out of the distressed situation without having to get Court sanction at each stage.

One recent example was the successful and highly-publicized restructuring of shipping company Pacific International Lines (“**PIL**”), the largest shipping carrier in South-East Asia. This involved a US$3.3 billion debt restructuring process where US$1.1 billion was put through a formal scheme of arrangement while the remaining US$2.2 billion debt was restructured via an informal workout process.

In the workout process, PIL negotiated key terms with a core group of principle creditors and secured a standstill on enforcement action and a principal and interest holiday from PIL’s bank lenders, without the filing of any court proceedings. An informal steering committee was then formed to represent the large pool of unsecured creditors so that it was easier for PIL to negotiate with a representative group rather than with the entirety creditor pool. Finally, PIL secured a court order to give ‘super priority’ to a US$112 million facility injected by a white knight known as Heliconia. As a result of these actions, PIL’s operations were stabilised and Heliconia eventually became the majority shareholder in the PIL group.

Second, a workout process is less disruptive to on-going operations. If matters are not in court, the debtor is able to enjoy greater privacy and confidential material (e.g. list of creditor claims, assets and liabilities of debtor) will not be required to be filed publicly. As a result, there will be no undue publicity that may result in adverse market movements, further commercial pressure being put on the debtor company as a result of negative press and reputational damage to its brand image and customer’s perception of the company. Sometimes, undue publicity can lead to business partners viewing the debtor negatively and take steps to compromise existing business lines. Current employees may also look to go elsewhere to leave the ‘sinking ship’.

Third, it is less costly. Court costs can be hefty. Additionally, under Singapore’s civil procedure code, even if the debtor company succeeds in obtaining an order for a moratorium, it may still have to account for the party-to-party costs of objecting creditors who engage lawyers to resist the debtors’ application. This is typically about 50% of the actual costs paid by creditors to their lawyers. As a result, if an amicable solution is reached via a workout process, there is potential for greater recovery for the debtors and its creditors.

Finally, it is also potentially less time-consuming as court processes will need to accommodate creditor objections and side complications. Any creditor who wishes to address the Singapore Courts will be given leave to file written submissions and will be allocated time to be heard at the substantive hearing of the debtor company’s application.

**Disadvantages of workout versus formal bankruptcy**

First, there is no formal Court protection from creditors’ attempts to collect on their debts as the debtor cannot avail of the ‘automatic stay’ provision once the filing is made to the Court where creditors are legally restrained from continuing their collection efforts through litigation threats or any other sorts of harassment to the debtor. Such moratoriums are available under Singapore’s Insolvency, Restructuring and Dissolution Act (“**IRDA**”). As a result, the debtor company will have to deal with ongoing litigation from creditors. This is a large burden on debtors who may be distracted from the restructuring process in its bid to ‘fight fire’.

Second, there is no clear timeline for the restructuring to be carried out as compared to court-supervised processes under the IRDA where courts typically set certain target milestones, failing which the automatic stay will be lifted. Based on prior experience, the Singapore Courts tend to issue either renewable or non-renewable moratoriums of between 3 – 6 months for debtor companies to put together and get a scheme of arrangement passed by the requisite percentage of creditors.

Third, suppliers could refuse to work with the debtor as there is no incentive for them to accept the risk of doing business with the debtor where receiving compensation is in doubt. Even if suppliers are willing to continue to work with the debtor, they may cut down on trade credit and require payments to be made upfront in cash (often at unfavourable, above-market rates)

Fourth, it is difficult to reach a compromise with every single creditor without being able to make use of cram-down mechanisms. The holdout problem by a single antagonistic creditor becomes a greater concern. The fact that the creditor is the minority and an outlier does not matter as the debtor is required to receive all creditors’ approval before proceeding. Further, asset sales require unanimous approval and the liens on the assets and certain liabilities remain.

Finally, there is no or limited access to financiers as lenders often avoid distressed borrowers without court protection; DIP lenders often want to get “super priority”.

**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.**

Yes, the turnaround approaches presented in most of the reading material were applied in FM’s case.

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| **Author & Approach** | **Explanation** |
| *Pajunen*: Stakeholder Management Approach) | FM’s primary stakeholders (i.e. the Banks and the shareholder) actively participated in the reorganisation process to ensure that FM survived as a going concern. Amongst other initiatives, the Banks refinanced FM’s working capital, provided additional working capital, waived default interest and wrote off some of FM’s debt. The shareholder provided loan financing to FM, and actively worked together with FM’s new CEO and CFO to implement a new operational and marketing strategies for FM. |
| *Adriaanse & Kuijl*: Business & Financial Restructuring Approaches | For the financial restructuring, the Banks voluntarily committed to revised terms that allowed FM to continue as a going concern despite some hiccups along the way where some of the Banks threatened to exit from the reorganisation process.  The Banks revised the working capital repayment schedule, refinanced working capital and other loans, waived default interest, permitted repayment when liquidity permitted, cancelled certain loans and/or provided haircuts.  For the business restructuring, FM’s shareholder and management took steps to implement concrete strategic, operational and financial plans to reach a level of healthy and sound management. The objective was to restore confidence in the company and its management amongst interested parties.  FM first took steps to *stabilise* the business by identifying the critical problems which required immediate attention in order to stabilise the situation. They visited FM’s main clients and got them to agree on price increases, made redundant 130 staff members and streamlined the process of loss recovery, checked on the excess premiums and saved on car repairs.  FM then took steps to *analyse* the situation to determine the prospects of FM in the long term. For example, P&L and balance sheet analysis was conducted on FM’s Dutch subsidiary which led to a profit forecast of €9-10m and €200 – 250m turnover. This allowed parties to consider that FM could be sold as a going concern to a financially healthy party. By October 2014, FM had come up with four scenarios: (i) running FM as a going concern if the financiers are willing to grant the necessary indulgences, (ii) selling FM if viability is not sufficiently proven, (iii) debt-equity swap and (iv) filing for a moratorium and then using the breathing space to achieve a controlled sale of FM.  FM subsequently sought to *reposition* itself by appointing a Chief Restructuring Officer after determining that the going concern option was the best one. This eventually resulted in a Restructuring Agreement being signed on 4 July 2015 which provided for (i) FM’s operational subsidiaries being accommodated in a new special purpose vehicle (“**NewCo**”), (ii) NewCo’s shares being held by the various financiers proportionately according to their contributions, (iii) liquidating the old FM holding structure, (iv) cancelling all prior intercompany debt, and (v) some of the banks to cancel certain portions of their debt or provide a haircut. |
| *Schmitt & Raisch*: Retrenchment & Recovery Approaches | FM implemented the retrenchment approach initially. This was done by FM approaching its main clients and getting them to agree to price increases, making redundant 130 staff members and streamlining the process of loss recovery, checking on the excess premiums and saving on car repairs. This was intended to provide a stable base from which recovery strategies could be successfully undertaken.  FM subsequently implemented various recovery initiatives to improve its market position through sustained growth and profitability. Plans were drawn up to increase turnover, re-evaluate the entire business mix, and sell off the shares of companies outside the Benelux countries as well as non-Benelux foreign branches to streamline its corporate structure. |
| *Sundarsanam & Lai*: Management, Operational, Asset and Financing Restructuring | FM implemented the various types of restructuring approaches raised in Sundarsanam & Lai.  First, FM implemented top management change by replacing its CEO and CFO and hiring a CRO. The various interested parties may have been ascertained that FM’s old ways of operating needed to undergo drastic change, and that it was proving difficult for incumbent top management to change their habits and institute radical reforms. This was also something which the Banks wanted before they continued their financial support, as they needed a confidence boost to know that FM’s management team could manage the crisis at hand.  Second, FM implemented operational restructuring by seeking to stabilize operations and restore profitability by pursuing strict cost and operating-asset reductions. It raised prices, cut staff and improved its asset utilisation at the operating level.  Third, FM implemented asset restructuring and divestment by selling the shares of companies outside the Benelux countries as well as non-Benelux foreign branches to streamline its corporate structure. This was intended to streamline the corporate structure and focus on its core products in profitable countries rather than being spread too thin.  Finally, FM implemented financial restructuring strategies by getting additional shareholder loans and negotiating with the Banks to obtain additional working capital, waive default interest, provide haircuts or waive certain debts. |

**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?**

One or more of the following reasons may have influenced Banks C and D to decide to behave in a difficult manner at certain stages of the workout process:

* They wanted to hold out for better terms. Perhaps they may have been initially unwilling to drop default interest payments, refinance for a longer period and extend repayment schedules and commit further working capital without Banks A and B doing the same. We note that they eventually capitulated as a result of self-interest.
* They wanted to force a different reorganisation strategy. For example, they may not have agreed with Bank A’s proposed Chief Restructuring Officer or in providing additional working capital given that it was putting further good money after bad.
* They had no confidence in FM considering the failed promises and profit projections, and the lack of reliable management information despite steps being taken to rationalise the internal information collection systems.
* They wanted to compel Banks A and B to see through their proposal to buy them out at a 15-20% discount so that they could cut their losses and exit from the potentially long drawn-out restructuring process.
* They wanted to compel the shareholder to put further funds into the debtor company to have greater skin-in-the-game.

If I were acting as Bank A and B’s advisor, I would recommend to them to hold without prejudice conversations with Bank C and D to find out what are the reason(s) for their cause of action. There is usually key underlying interests that would be pushing others to act in ways which appear to frustrate a consensus-led process. Once the interests are identified, steps can be taken to address their concerns and find a compromise that everyone is agreeable to live with to ensure as great a recovery on their investments as possible.

**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)?**

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| **Principle No.** | **Present?** | **Explanation** |
| 1 | Yes | The Banks granted an informal standstill period to the debtor in the initial period which subsequently culminated in the Restructuring Agreement dated 4 July 2015. This allowed:   1. the appointment of an external accountancy firm to investigate into the debtor’s finances and processes; 2. the debtor to have an opportunity to address the deficiencies in their financial and operational systems and give a more accurate picture of the actual costs and turnover each month; 3. the appointment of an independent turnaround consultancy agency to ascertain whether the debtor is viable and to come up with a turnaround strategy which included measures such as increasing prices (yielding a €7.8m increase), making 130 staff redundant (yielding annual savings of €3.3m) and improving operational and financial processes (yielding annual savings of €3.9m); |
| 2 | Yes / No | The Banks did not take steps to enforce their claims against the debtor during the standstill period even though Banks C & D threatened to cancel their credit in June 2014.  However, if is not clear whether there were steps taken to address any conflicts of interest in the creditor group. It was simply assumed that as the banks and shareholder had no security rights or subordinated security rights (i.e. for the banks, there were problems with their respective pledges on the assets), their respective interests in keeping the debtor company as a going-concern were aligned. |
| 3 | Yes | The debtor company did not take any action which would prejudice the creditors during the informal standstill period. Instead, it appeared to cooperate with the creditors’ efforts to turn it around by replacing its CFO, making room for the appointment of a CRO on its board, and taking steps to improve the accuracy of its financial reporting. However, despite the efforts taken, there continued to be problems with the provision of accurate financial information at most material times. |
| 4 | Yes | The banks and clients largely accommodated the debtor company’s restructuring process.  Clients generally agreed upon price increases.  The banks agreed early that action must be taken jointly and in a controlled manner. This culminated in the following steps being taken:   1. Re-organising the management team, in particular the CFO and CEO 2. Getting the shareholder to put in additional shareholder equity / loans 3. Re-looking at the entire market strategy of the debtor company 4. The appointment of a CRO 5. Providing additional working capital financing, deferring repayment schedules and cancellation of default interest 6. Getting waivers for certain non-fulfilled contractual obligations |
| 5 | No | The debtor’s financial forecasts throughout the restructuring period were extremely inaccurate:   1. For 2013, the expected profit of €8 million was in reality a €36.4m loss 2. For 2014, the expected loss of €5.4m grew to €39m 3. For 2015, the expected profit of €30 million turned into a €9m loss 4. For 2016, the expected slight profit turned into a re-adjusted forecast of a slightly negative or break even result |
| 6 | Yes | Generally, creditors proceeded on if they were all ranked equally. This was also because the banks had also ascertained that there were problems with the pledges on their assets and the contracts concluded in this respect were not foolproof. |
| 7 | Yes | Generally, the debtor’s financial status was provided to the bank creditors at all material times so that they could assess the situation at each relevant juncture |
| 8 | Yes | In January 2015, €25 million was paid bank to the parties who provided additional working capital to the debtor. However, it is not clear that the entirety of the additional working capital that remained unpaid would have priority. |

**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?**

Yes, it is possible.

As I understand it, soft law instruments are non-binding instruments developed by standard-setting agencies that straddle inter-governmental efforts (e.g. UNCITRAL and World Bank), international organisations (e.g. INSOL International, International Insolvency Institute, Asian Business Law Institute) and inter-judiciary efforts (e.g. Judicial Insolvency Network) (Wessels & Boon 2019).

In Singapore, the current Chief Justice of Singapore Sundaresh Menon[[1]](#footnote-1) has opined extra-judicially that soft laws are “*powerful instruments*” for driving legal convergence in areas where states may have significant defensive interests and the consensus necessary for the conclusion of a treaty may be hard to come by. Soft laws (i) allow progress to be made on the basis of broadly agreed principles, (ii) encapsulate a vision of what the law ought ultimately to look like, and in that way exert a powerful normative pull over the shape of future developments, even when states do not fully adopt their provisions, and (iii) promote interstitial law-making through judicial gap filling and the publication of instruments of guidance by think tanks and professional bodies.

Examples of the latter include the Asian Business Law Institute’s ‘Asian Principles of Restructuring’ project, which aims to formulate common principles for in and out-of-court restructuring for use in Asian jurisdictions and the Judicial Insolvency Network’s Guidelines on Communications and Cooperation Between Courts in Cross-Border Insolvency Matters.

These efforts have recently culminated in the implementation of a protocol on court-to-court communication between Singapore and Malaysia on cross-border corporate insolvency matters[[2]](#footnote-2). The protocol provides for each court to initiate a request for court-to-court communication with the foreign court concerning certain types of corporate insolvency cases. The foreign court may respond directly to the request and engage in court-to-court communication. The confidentiality of any documents, information and other data exchanged in court-to-court communication will be maintained and will be used for the purposes and objectives of the protocol concerned. Such protocols can be terminated by notice from either court, and it will not affect the validity, implementation and completion of any court-to-court exchange already initiated under the relevant protocol prior to termination.

**7. Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015 (“RA”).**

The RA contemplates a sale of the entirety of the debtor’s business in a going-concern situation. This is achieved by way of:

1. the transfer of the debtor company’s operating subsidiaries to a new holding company whose shares are held by the Banks and a number of board members (“**NewCo**”);
2. the reorganisation of all debts by (i) having all creditors waive their debts against the debtor company and (ii) the debtor company waiving their debts against NewCo;
3. the eventual sale of NewCo in a going-concern situation.

The objective of the RA is clearly to “*clean up*” FM’s corporate structure and liabilities so as to present FM on a clean slate to potential buyers. It would also give the Banks and board members more direct control over NewCo and FM’s business rather than leaving it in the hands of the existing shareholders and board members who may not be totally in line with the turnaround strategy. That would allow the Banks to control the sale process better.

**8. Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?**

First, there may be a need to refresh regulatory approvals in the respective jurisdictions where FM is operating as a result of change of shareholding, particularly since the banks and some of the management team will be holding direct equity in NewCo after the RA is fully implemented.

Second, the board of directors of each FM subsidiary needs to ensure that they have not breached any of their fiduciary duties in permitting significant assets of the company to be disposed to NewCo when a significant portion of the debt (i.e. €240m) remain. Also, it is not clear that the prior wrongdoings of FM’s CFO and CEO have been satisfactorily resolved so it is incumbent on the management team to close off these issues.

Third, the shareholders of NewCo should enter into a formal agreement to regulate the terms of their engagement until such time that NewCo is sold as a going concern. It cannot be assumed that the sale will happen soon, or that it will happen in a manner that is satisfactory to all parties. Hence, a suitable holding pattern and exit mechanism for each of the parties should be contemplated and put down in writing to avoid future litigation as a result of uncertain rights and obligations of the parties.

Finally, there may be significant transfer taxes when migrating operating subsidiaries to NewCo unless reliefs can be obtained in the respective jurisdictions. However, it may be possible to mitigate the effects of these taxes by applying for reliefs or exemptions in the respective jurisdictions. For example, Singapore has stamp duty reliefs for amalgamations and reorganisations.

**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]**

I agree that it was not a good option to call for a moratorium at the time.

If a moratorium was called, then there would be a hard timeline towards getting a restructuring process going because the courts are involved and they want to see results in a definite amount of time. In Singapore, if a moratorium was successfully applied for, it would typically last between 3 – 6 months before the court will expect the debtor company to file a formal scheme of arrangement proposal for the creditors’ consideration. That would put significant time pressure on FM.

Further, FM’s finances would be revealed to the public because of the requirement for the debtor company to be transparent about its insolvency situation. Under Singapore’s Insolvency, Restructuring and Dissolution Act (“**IRDA**”), the debtor company must:

* publish a notice of the application in at least one English local daily newspaper;
* file in an affidavit a list of every secured creditor of the debtor and a list of all unsecured creditors;
* provide sufficient financial information to enable the creditors to assess the feasibility of the intended scheme of arrangement on a regular basis.

As a result, debtor companies often have to deal with negative press which would put additional pressure on it to achieve a turnaround sooner than later.

The Court may also impose additional conditions, as permitted under the IRDA, such as to make certain rental payments to certain creditors or provide additional information to creditors. That would again put additional pressure on FM to achieve a faster turnaround.

In light of the above, I agree with FM’s approach not to call for a moratorium. The creditors were not hostile at that point in time, so there is no need for a moratorium to hold off litigation. The Banks were satisfied with the debtor’s new management and there is some improvement due to the reorganisation. Moreover, turnaround options were not sufficiently clear due to the lack of reliable information, so the reorganisation plan still needed some time to germinate.

By allowing the restructuring process to go through a consensual process with its creditors, the time and publicity pressure was not as significant and the workout could be rolled out without undue haste.

1. “*The Future of Cross-Border Insolvency: Some Thoughts on a Framework Fit for a Flattening World*”, Keynote address at the 18th Annual Conference of the International Insolvency Institute 2018 (<https://www.supremecourt.gov.sg/Data/Editor/Documents/(III%20Conference%202018)%20Keynote%20address%20by%20Sundaresh%20Menon%20CJ.pdf)> [↑](#footnote-ref-1)
2. “*Media Release: Malaysia and Singapore implement protocols on court-to-court communication and cooperation in admiralty, shipping and cross-border corporate insolvency matters*” (<https://beta.judiciary.gov.sg/news-and-resources/news/news-details/media-release-malaysia-and-singapore-implement-protocols-on-court-to-court-communication-and-cooperation-in-admiralty-shipping-and-cross-border-corporate-insolvency-matters>) [↑](#footnote-ref-2)