***INSOL INTERNATIONAL***

***GLOBAL INSOLVENCY PRACTICE COURSE (ONLINE)***

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***Case Study 1 – Tahirah Ara***

***1. Causes of financial distress. Was it preventable and if so or if not, why?***

Yes, preventable. The causes of financial distress at Flow Management (the "**Company**") stem primarily from poor or self-serving decisions of management and not from external market forces. The distinction between the two is set out in the article, Mellahi and Wilkinson, 2004.

Conceptually, there may have been external factors also causing distress at Flow Management, perhaps the rise of competition from internet on-demand cars and trucks services. However, according to the synopsis the reasons given for the change in financial condition did not stem from changes in the business environment or the demand for company's services, it arose primarily from management failure.

In particular:

(a) wrongfully issued bonuses;

1. serious accounting errors; and
2. mispricing of services.

The above factors were all preventable. Regarding possible malfeasance, we know that the Banks considered "legal action" though we are not certain of what sort, but there may have been suspicion of fraud or misappropriation, in particular in the case of wrongfully issued bonuses.

***2. Advantages and disadvantages of an out of court restructuring versus formal bankruptcy. Advantages and disadvantages in my country?***

The key factors for seeking court protection are (i) the debtor cannot reach a consensual restructuring and/or (ii) to cover enforcement risk. Reasons why (i) come into play include:

(a) the diverse group of creditors such that the debtor cannot get them to form a committee;

(b) inability to identify the creditors, for example if a company has issued New York law governed notes where fundamental changes require 100% consent, it would be impossible to identify all 100% of holders, especially when there are individual holders as opposed to institutional investors; and

(c) the relationship has totally broken down such that commercial sense no longer prevails, and it has become personal. Although it is rare, I have seen it happen in matters where the acrimony outweighs the commercial benefits to doing a deal.

Covering enforcement risk where there is a possibility of enforcement over key assets, there are uncooperating creditors or opportunistic funds are good reasons to seek court protection.

Whether an out of court or in court process is the best option depends on that matter. There is no one size fits all. The size of debt, the type of creditors, the governing law of the debt, the number of creditors, the assets to protect, the relationship of creditor group versus company, what the company can offer in a restructuring are all valid reasons to consider when deciding which route to take.

The benefits of out of court are as follows:

(a) reputational - I have worked with clients who would want to avoid any in court process purely because they perceive it would damage their brand or reputation. This is especially so for companies that are owned by the first or second generation;

(b) flexibility – up to the debtor and creditor to strike a deal that works for best and for most debtor, the concessions made (e.g., allowing board seats, control over operations, additional pledges, etc.) are kept confidential and not in the public domain (for private companies);

(c) bespoke - different deals can be done with different creditor groups, i.e., the debtor does not need to treat every creditor in the same manner. It can take into account that creditors debt size, instrument of debt, relationship before deciding a deal that works for that particular creditor which may not be the same deal it strikes for other creditors that have different debt profile;

(d) administrative - less cumbersome to implement and the timeline is also not dictated by a formal court process; and

(e) freedom – the debtor can continue to run its company independently.

The disadvantages are that it can be a long-drawn affair as the debtor shuttles back and forth between different creditor groups, it may need 100% consent to formally amend the documents, there is less rush (no mandated deadline to adhere to) to get a deal done.

The advantages of a court process:

(a) bypasses the need for 100% consent to make fundamental changes to the documents;

(b) quicker especially in certain jurisdictions where you have a limited time frame to vote on a plan, after which the debtor is liquidated e.g., 270 days in Indonesia;

(c) it prevents opportunistic funds taking advantage of the debtor or striking side deals for themselves; and

(d) it offers formal protection such that a creditor cannot enforce or allows the debtor breathing space to restructure/formulate a plan, e.g., in the absence of a consensual standstill, a moratorium has a similar effect and cannot be easily challenged once granted.

The disadvantages of a court process are that it is public, it can be more expensive and subject to challenge, with creditors and debtor fighting over moratorium and stays, and having the debtor bogged down by interlocutory applications instead of focusing on the way forward.

While based in Singapore, my restructuring focus is on Indonesia. The advantages and disadvantages in Indonesia are similar to what I have outlined above.

***3.*** ***Were the turnaround/reorganization approaches as presented in the reading material applied in this case? If yes, explain in what way. If no, detail what in your opinion should have been done differently.***

Some of the approaches presented in the reading materials were implemented, but many of those that were implemented were done incorrectly or in an untimely manner. As was covered by the article by Sudarsanam and Lai, 2001, some companies in distress initially engage in short term firefighting, putting off the necessary business changes that can lead to recovery, which they may adopt at a later stage, but then it may be too late.

In particular, the approaches implemented by Flow Management included:

(a) cost reduction – in December 2013, the Company reduced the number of employees netting annual savings of € 3.3 million and higher excess premium, savings on car repairs, netting another € 3.9 million. However, it was not clear from the fact pattern that spending cuts to labour were warranted at that time. There was a mispricing of services. The main clients indicated overall that they would be willing to pay the higher prices. So, there is a question of whether the labour cuts were necessary and if not necessary, if they negatively affected the ability of the company to provide services going forward. If they were necessary, would they have been sufficient given that laying off 130 staff was only 4% of the overall number of staff. Unfortunately, I think this is an example of operational restructuring designed in the short term for cash flow and profit improvement, as was discussed by Sudarsaman and Lai, 2001. However, the necessary changes to the Company's business were not tabled until mid-2014 when broader plans were proposed for a strategy to increase turnover, reassess the product range and selling off the foreign branches;

(b) raising new equity – this should have been done sooner. In the first instance, the CFO of the Company proposed to sell 350 cars to raise cash to improve the solvency rate instead of raising more funds from the shareholder. As we were not told of any drop off in demand, then selling the cars would negatively impact the company's business operations. I believe this is another example of the firefighting mentality that management had in the initial stages. There were also discussions in January 2014, for the shareholder to pump money into the company if a standstill agreement can be signed, which then was not signed because Banks C and D were purportedly not confident in the original management which was still in place. Finally, the former CEO pumped in some money as debt in April 2014 via a € 10million unsecured loan – which is not the same as risk bearing equity. There were suggestions that the shareholder would pump in further equity if truly needed and a standstill agreement is signed. As to whether these additional capital injections were eventually fulfilled is unclear. Tax refunds were given as additional security;

(c) negotiating with the shareholder – at all times, the Company's management and the corporate parent of shareholder (Lease Group Holding) were engaged with the Banks. This was good, but the Banks should have sought to involve other stakeholders, specifically the ultimate shareholders of the corporate parent, Lease Group Holding. Given the percentage of shareholdings amongst the owners of Lease Group Holding, none of the ultimate beneficial owners likely had the ability to independently control the business. We also do not know the dynamics amongst the three ultimate shareholders. Clearly these three ultimate shareholders were key "stakeholders" as were the Banks. The role of key stakeholders in a restructuring was discussed in the article by Pajunen, 2006. However, there is little known in this fact pattern regarding the ultimate shareholders. Were they aligned or was there infighting amongst them? What was the interplay between management of the company and the three shareholders? The relationship between management and key stakeholders is critical in an existential crisis for the company, as discussed by Pajunen, 2006. Was this a source of the problems at the Company? Very likely mismanagement at the Company may have stemmed from disagreements between the ultimate owners themselves. Arguably the Banks should have taken steps to identify key stakeholders early in the process, in this case the three ultimate owners of Lease Group Holding as key stakeholders and opened direct discussions with them as part of their discussions with management. The key propositions outlined by Pajuned, 2006, for organizational survival in an existential crisis all seemed to be lacking in this situation. The key propositions include having the support of key stakeholders, frequent and open communications between them and management, good personal relationships between stakeholders and management, and most importantly in this case, consensus on long term goals among key stakeholders (i.e., being the ultimate owners of the business and the creditors of the business). These all tend to increase the probability of organizational survival. In this case, key stakeholders – the owners – were completely absent from discussions with the Banks and we know little about the interactions between them and the Company's management;

(d) change in management – a change in CFO was announced in January 2014 and a new CEO in April 2014. Clearly this was way too late, and I think was probably the biggest mistake the Banks made. The Banks should have demanded a change in top management as soon as Company informed them of wrongfully paid bonuses (to CEO and CFO), serious accounting irregularities and mispricing services. As indicated in the reading materials of Sudarsanam and Lai 2001, "[t]op management change is widely regarded as a precondition for successful turnarounds". Clearly there was management incompetence, but there may also have been wilful misconduct. Because of the delay in changing management, Banks C and D were unwilling to move forward in the restructuring and sign the standstill agreement as they lacked confidence in management (or at least this was their purported reason for delaying the standstill agreement, though they may have had other reasons as discussed below);

(e) appointment of independent auditors – in December 2013 when trouble first surfaced, an accounting firm (not being the Company's auditors were called in). This was done correctly and timely. Likewise, with bringing in an independent turnaround consultancy. The Banks also pressed for a CRO to be appointed by Company, which is also good;

(g) approved financial control – from December 2013, the Company had to report on actual cost and turnover each month. This was one of the few things that we can say was done correctly and in a timely manner;

(h) standstill agreement – a formal standstill agreement was first raised by the Company in January 2014, but Banks C and D stopped cooperating, purportedly because they did not have confidence in management. In June 2014, the Banks proposed extending the maturity of the loans if the shareholder injects € 35m into the Company. However, by end of June 2014 the Company informs lenders that it will have a large loss for 2014 and a liquidity shortage is imminent. Its only after that time, when it is a crisis mode, that a standstill agreement is finally signed. A standstill agreement should have been reached much earlier. But of course, getting to the standstill agreement was dependent on agreeing an amount of equity that the shareholder would inject into the Company and a change in management. Also, there is some question of whether all the Banks really wanted a standstill agreement, this is discussed below; and

(i) asset sales / debt to equity – eventually, the operating companies are transferred to a new entity held by the consortium of Banks as well as a number of board members. Essentially, the result after years of negotiations is that the shareholder is wiped out and the Banks now own the equity in the new company and a significant portion of their loans cancelled. It may even be worse yet, as it is clear how much the Banks will eventually realize on its equity position even after significant write-offs of the debt. A poor result all around (for all parties) and an example of the non-recovery firm discussed by Sudarsanam and Lai, 2001 article, in that "the major difference between recovery and non-recovery firms is that, with the latter, ineffectiveness of restructuring in early years leads to more intensification of strategies". This is clearly what we have seen in this fact pattern. Both the shareholder and the Banks in the early years did not implement effective restructurings strategies. Early steps were relatively easy operational changes (labour reduction, sales of some assets) that proved ineffective. This led to an intensification of strategies much later (change in management, reassessment of the business strategy, debt write-offs and debt to equity conversion), but it was all too late.

***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?***

The purported reason was that Banks C and D were not confident in management. That may have been their overt rationale, but they also may have had other important reasons for acting independently of Banks A and B.

Banks C and D may have been in a weaker position than Banks A and B. It is mentioned that as part of the Restructuring Agreement that while all four Banks were part of the original consortium for the working capital facility, it was only Banks C and D which provided the additional working capital. Their additional working capital debt of € 32.5 million was written off which suggest that they could have been in an inferior position to Banks A and B.

In addition, the additional working capital provided by Banks C and D was on a different repayment timetable than the original working capital facility provided by the full consortium. It seems that the additional working capital was originally to have been repaid in 2013 but was rescheduled to be paid off in accordance with a repayment scheme starting in 2015. This was presumably earlier than the original working capital facility which was originally scheduled to be repaid in 2016 and then rescheduled to 2019. Hence, Banks C and D may have been less inclined to agree to a formal standstill agreement. In mid-2014 the Banks finally agreed to a formal standstill agreement, but it is limited to 120-days. They may have had the strategy to delay signing a standstill agreement and then only to sign a standstill agreement that would expire before payments become due on the additional working capital facility in 2015. As such they received a €25m payment on the additional working capital working facility in January 2015. So, the interests of Banks A and B differed from the interests of Banks C and D in part because of a difference in timing of repayment on the additional working facility (which only Bank C and D participated in) versus the original working facility.

Further, A and B were considering at one stage of buying out Banks C and D and this would be in a situation where C and D had smaller position than them such that it makes sense to buy them out. Bank A managed to appoint the CRO which suggest it had the might to do so. Banks C and D may feel that they have less "skin in the game" and less to lose by not being cooperative. They may have felt that perhaps as they had a smaller position it would incentivise the debtor to pay them out – why have a small creditor take the debtor into liquidation. They may have felt that their ask was not being met and that Banks A and B ask had more importance than theirs.

I would have tried to look for common ground so that all parties would feel incentivised to work together. For example, was there common security all parties shared. It would be better for all parties to be united so that the best possible outcome could be obtained. If one party chooses to take court action, it could lead to severe consequences for everyone, the amount obtained in a liquidation may not be as good as if it was consensual. I would also consider whether I could buy their debt at a discount so that I would be able to have more control in the process and that if there was a debt-to-equity swap, I would have more control of the debtor.

***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)?***

All of the eight principles can be identified.

(a) first principle - the creditors did work together and eventually signed a formal standstill agreement in mid-2014. However, there seemed to be an informal standstill agreement much earlier. We can tell this from the fact that the Banks were charging default interest in December 2013 (to put healthy pressure on the Company) so we know there was a default, but the Banks must have implicitly agreed amongst themselves not to accelerate the principal amounts of their loans. Also, it was decided early on by the Banks that action must be taken jointly and in a controlled manner. Notwithstanding it would have been better if that implicit standstill period was put to better use, to allow the Company to assess the business and put together an effective restructuring plan;

(b) second principle - it seems that during the implicit standstill period the Banks refrained from taking any enforcement actions. Unfortunately, conflicts of interest between the creditor groups were not identified early. Banks A and B and Banks C and D did not seem to be aligned. Banks C and D seemed to have a strategy to try to delay a standstill agreement until part of the additional working capital was to be repaid;

(c) third principle- it is not clear that this principal was followed. Following a short-term 120-day standstill agreement, the Company paid € 25m to Banks C and D as the additional working capital providers. While the formal standstill agreement expired, the company was still in significant distress. This payment was at the expense of other creditors, specifically Banks A and B;

(d) fourth Principle - unfortunately, creditors did not effectively coordinate their response to the debtor, regardless of their overt positions. No coordination committees were appointed and there was no appointment of professional advisors that we know of, except for the independent auditor and an independent turnaround consultancy in the early stages of the restructuring;

(e) fifth principle - this principle on financial information was followed. One of the few things that was done correct and timely was the early appointment by the Banks of an independent auditor to review the company's accounts, which the Company agreed to do;

(f) sixth principle - it is not clear that this principle was followed. The additional working capital seems like it would be subordinated following an enforcement event, but the timing of repayment of the additional working facility was earlier than the original working facility. However, the implicit standstill agreement did not seem to protect the relative positions of the creditors, specifically Banks A and B versus Banks C and D, and in January 2015 Banks C and D received a € 25m repayment on the additional working capital facility. In addition, the Banks collectively took into account the sixth principle when considering between an out of court versus an in-court process and realising that given the imperfect situation with their pledges, an out of court settlement would yield a better outcome;

(g) seventh principle - this principle was followed. There is no suggestion that the creditors leaked any confidential information; and

(h) eighth principle - it is not clear that this principle was followed. It seems that the former CEO of the corporate shareholder had made unsecured loans to the Company of €10m and possibly another € 27.5m. If money is coming the from the shareholder, then it should be injected as risk bearing equity capital. If it was however coming from someone other than the shareholder (i.e., a lender even if that lender was formally a manager), then it should be accorded priority according to this principle. In this case however, it is not clear whether the funds from the former CEO of the shareholder was somehow actually coming from the shareholder, but if it was not then it should have been given 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?***

The Statement of Principles covers a broad spectrum of behaviour, and I think most creditors can be persuaded to apply them in any given situation. I have worked on consensual and court restructurings and unless the relationship has totally broken down and become personal and acrimonious between parties, creditors usually would want to work with the debtor to find a solution so that their returns are realised to the best extent possible. The debtor would then have to find common ground between the various groups and keep a constant dialogue between them.

In the case of Indonesia, where I focus my practice, enforcement is very difficult for creditors, particularly in situations where most if not all the assets of the debtor are located inside of Indonesia. In these instances, creditors are wary of pursuing a strategy of enforcement or liquidation. Instead, there is a general preference of creditors work with the debtor and reschedule the debts.

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

In essence, the Banks have taken possession (ownership) of the Company and the original shareholders have been wiped out. They have ringfenced the valuable assets of the Company, moved these into a special purpose clean vehicle ("**SPV**") so that it can be sold.

More specifically:

(a) the consortium of the original working capital facility (Banks A, B, C and D) together with shareholders that were previously board members (perhaps the former CEO that lent money to the company, and the CRO) now hold all the equity in the SPV that owns the operating companies. Presumably the banks' equity position was "paid for" by the write-down of €97.5m in the original working capital facility;

(b) following the write-down of part of the original working capital facility as mentioned above, the consortium (Banks A, B, C and D) still retains part of the original working capital loan (€240m), owed by the Company.. Assuming that they have fixed their issues with the pledges, they would have first priority and will recover further amounts pursuant to liquidation;

(c) amounts owed under the additional working capital facility provided by Banks C and D have been wiped out. (Though they did receive a €$25m payment prior to the restructuring so perhaps not a terrible result for Banks C and D or at least not a complete loss); and

(d) this structure allows for the SPV to be sold as a going concern, meaning the consortium will be paid on the sale of the equity in the SPV (assuming it is solvent).

While Banks A and B have done best for themselves and they have the best deal, there is also no certainty whether the SPV can be sold and whether their equity in SPV will give them the returns they hope for. As such, it may not be a good outcome for any party when in reality there seems to be a good business case for the Company – the independent turnaround consultancy concluded that the Company is viable. The external environment is still positive for a business like the Company – leasing of cars and trucks.

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

The centre of main interests (COMI) for the business is the Netherlands. In addition, the banks have lent their money to the operating company in the Netherlands. It is likely therefore that any in-court restructuring would be in the Netherlands in respect of either the Dutch operating company or possibly the Dutch holding company. As noted in the fact pattern, there is an issue with pursuing bankruptcy in the Netherlands because of the negative impact it would have on the proceeds from any court action, and this is further impacted in legal deficiencies with the pledges. So, the question is whether it would be possible to pursue a scheme of arrangement in another country, the most likely candidate being the UK which is the domicile of the shareholder. It may not be feasible as it may not be possible to show nexus to the UK. The English court's jurisdiction is based on sufficient connection. English law documents and submission to English law courts for disputes are used to bring foreign companies within its jurisdiction based on the sufficient connection test. We assume that the governing law of the bank loans is that of Netherlands. If it were English law, then they could consider a UK scheme of arrangement.

Assume that either the Banks of the company commenced action in Netherlands, the principal issues would be of recognition and enforcement in the jurisdiction where the foreign subsidiaries are located. Spain, France and Netherlands have not adopted Unicitral Model Law making it hard for these countries to recognise proceedings commenced elsewhere. It may require taking out separate and multiple actions in each country. Further, even if recognised in those jurisdictions if the subsidiary companies had limited assets, then it might not be worthwhile if the proceeds from enforcement would be minimal when compared to the cost of proceedings.

Non-legal issues include control over the subsidiaries. It is fine for the Banks based in Netherlands to have control and appoint the CRO and independent auditor in the Company, but they have less visibility on the subsidiaries worldwide. There is no change in management that we know of in these foreign subsidiaries. We do not know how much these foreign subsidiaries contribute to the revenue of the Company though we were told that in the aggregate the foreign subsidiaries were losing money.

***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]***

Calling a moratorium would typically lead to an Event of Default and trigger cross default provisions across different facilities or contracts. Moratorium would also attract publicity and hamper any potential refinancing. It would also lead to a distress sale and reduce the purchase price if selling as a going concern was the preferred recovery route. In certain jurisdictions, a moratorium is not indefinite. It expires after a certain time and there is a limited number of times the debtor can extend it. This opens the debtor to a legal claim (e.g., liquidation or enforcement) if it is not ready with a restructuring plan to be voted on. Moratorium which is a formal legal process also forces the debtor to formulate a formal restructuring plan and it may force it to agree to terms in a rushed manner when taking the time to understand the underlying issues and formulating a realistic proposal would have been better.

In the case of the Company, a moratorium in October 2014 would not have been pressing as there is no signs that the Banks wanted to enforce on their security or have the Company put into a formal bankruptcy process.

In addition, there may have been disagreement amongst the creditors on a moratorium. Banks C and D, who had previously agreed to a short-term standstill agreement which recently expired, may have resisted a moratorium. It is not clear why, but in January 2015, the company paid back €25m to Banks C and D on the additional working capital facility, presumably from the proceeds of the sale of surplus assets. This could not have happened if a moratorium would have been in place. So, Banks C and D might not have agreed to the moratorium.

Also, given that a sale as a going concern was preferred by the creditors, it would make sense not to deter buyers who would use any formal bankruptcy process to depress the purchase price. It would have also attracted negative publicity.