Case Study I

INSOL Global Insolvency Practice Course 2021/2022

Module A: Case Study I

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1. *What were in your opinion the causes of financial distress at Flow Management (see e.g. Mellahi & Wilkinson, 2004)? Could the financial distress have been prevented? If yes, explain how. If no, why not?*
2. According to Kamel Mellahi and Adrian Wilkinson,[[1]](#footnote-1) “*[d]espite the lack of a precise definition of failure, there is a broad consensus on the meaning of failure. Cameron et al. (1988, 9) define it ‘as a deterioration in an organization’s adaptation to its microniche and the associated reduction of resources within the organization’*”.[[2]](#footnote-2) Certain signs point to an organization’s failure, such as diminishing financial resources (in Flow Management Group’s case, solvency reached 0.1%) and negative profitability (the group incurs losses in the years 2012, 2013, 2014 and 2015).[[3]](#footnote-3) The authors introduce the different causes of organizational failure according to diverse schools of thought:
3. The Deterministic View. For this perspective of organizational failure, environmental and external factors play a more important role in explaining the organization’s failure, meaning that “*failure is caused by external factors over which management has little or no control*”.[[4]](#footnote-4) There are two theories within the deterministic view:
   1. industrial organization (“IO”) assumes that (1) the external and environmental factors put pressure on the organization that leads it to fail, (2) organizations in the same industry adopt similar business strategies, and (3) decision-makers (i.e., management) are rational and act on the organization’s best interests, meaning that the burden of failure does not befall on them. For this school of thought, causes that lead to organizational failure include “*turbulent demand structure due to brand switching by core customers, changes in consumer tastes, cyclical decline in demand, strategic competition due to rivalry among existing competitors or new entrants* (…)”, as well as “*technological uncertainty due to product innovations and or process innovations*”;[[5]](#footnote-5)
   2. organization ecology (“OE”), according to which the failure of the organization is evidenced by its dissolution, a “*state at which an organization ‘ceases to carry out the routine actions that sustain its structure, maintain flows of resources, and retain the allegiance of its members’*”.[[6]](#footnote-6) This school of thought suggests that there are four factors that account for the success or demise of a firm: (1) population density (i.e., the number of organizations within a certain population), (2) industry life cycle (i.e., failure caused by demand saturation, supply issues or new technologies), (3) organization age (i.e., younger firms are more likely to fail), and (4) organization size (i.e., smaller firms are more likely to fail);[[7]](#footnote-7)
4. The Voluntaristic View. For this perspective of organizational failure, “*managers are the principal decision makers of the firm (…), and their perceptions of the external environment have a strong effect on how they (mis)manage the firm*”.[[8]](#footnote-8) Failure of the organization is, therefore, caused by internal inadequacies and poor decision making by management, in light of “*external* *threats*”, such as impulsive decisions, difficulty adapting to change, bad information, and unnecessary risk-taking. There are two theories within the voluntaristic view:
   1. organization studies (“OS”), which suggest, in addition to the aforementioned item (ii), that successful firms may fail due to over confidence and arrogance, because, over time, successful routines may become embedded in an organization and make it more difficult for management to change its ways and adapt in light of internal shortcomings and inadequacies, as well as external and environmental changes. Top management tenure, top management homogeneity, management successions and past performance are all factors that may lead to a firm’s demise;[[9]](#footnote-9) and
   2. organizational psychology (“OP”) argues, among other things, that managers faced with external threats to the organization will not shift their focus to respond to such a crisis and will act as if it does not exist, due to their managerial perceptions/cognitions. Psychologically speaking, the “*(mis)behaviour of managers*” might be explained “*by ego defences that tend to push managers toward a regressive retreat from a changing reality*”, what is called *cognitive inertia*.[[10]](#footnote-10) Once managers are able to overcome such cognitive inertia and actually notice the changes to the business, it may be too late to avoid the organization’s failure.
5. After examining these different views, Mellahi and Wilkinson conclude that “*any attempt to explain organizational failure will not be complete unless the interplay between contextual forces and organizational dynamics is taken into account*”. In other words, the reasons why organizations fail range from external and environmental factors, as proposed by the IO and OE theories, as well as internal and managerial factors, as proposed by the OS and OP theories.
6. In Flow Management Group’s case, a few causes of financial distress may be singled out, though others have certainly played its part in the group’s decline. These causes were made apparent in November 2013, the beginning of the group’s financial distress, and throughout the following years during negotiations for a workout agreement with Banks A, B, C and D (henceforth, the “Group of Banks”):
7. November 2013. Faults in the annual accounts of 2012 that reversed a € 3 million profit to a € 5 million loss, and a reported pre-tax profit of € 8 million in September 2013 that actually turned out to be a € 23.1 million loss. These losses and negative corrections were caused by (a) large management bonuses of € 3 million that were wrongfully awarded to Flow Management Holding BV’s Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), (b) a contingency gain received in 2012 was wrongfully booked as a result in 2012, which required a negative correction of € 1.6 million, (c) an expected € 2.8 million book profit was not realized in 2012 or 2013, and, what may be the gravest of all mistakes, (d) the group charged prices that were lower than their costs, due to a failure to periodically check the cost-price calculation – which was later attributed to a formula error in a spreadsheet (!).

The incorrect financial information provided to the group’s management could have also led them to take unnecessary risks, such as investing in different lines of business (non-core) and increasing the group’s indebtedness. The lack of trustworthy information may have also prevented management from detecting early warning signs of financial decline.[[11]](#footnote-11)

The mistakes that sparked Flow Management Group’s decline into financial distress may have also been caused by poor management, both at the top levels (i.e., CEO, CFO) and at the middle and lower management levels, which failed to take the necessary steps to avoid such mistakes in the first place (i.e., audit financial statements and projections, periodical checks on the cost-price calculation).

This could be due to the fact that the Flow Management Group may be family-run, as it is indirectly owned by the Johnson Family, perhaps without the adequate expertise to identify and address relevant issues that arise in the day-to-day business.

Therefore, organizational factors (as posited by the OS theory), such as top management tenure, top management homogeneity, management succession and past performance, may have clouded the managers’ judgment and made it more difficult for relevant changes to be implemented in the group’s internal controls and business in general. Cognitive inertia (postulated by the OP theory) may have also played a role in delaying the managers’ reaction to the incoming financial distress.

1. Post-November 2013. After the initial shock and the first talks with the Group of Banks, Flow Management Group’s financial distress only worsened, which could be attributed to the poor quality of control over the group’s financials: (a) the 2013 results vary wildly from an expected profit of € 3 million to an actual loss of € 36.4 million, with 2012’s result once again adjusted from a loss of € 5 million to a loss of € 6.1 million, (b) the forecast for 2014 initially points to a € 5.7 million loss, which was later revised to a € 39 million loss (as of October 2014), and (c) the forecast for 2015 initially suggested a € 30 million profit, while it actually turned out to be a € 9 million loss.

The case description does not provide any environmental factors (i.e., technological uncertainty, regulatory, demographic or economic changes, as formulated by the IO theory) for such decline in the Flow Management Group’s financials, which would indicate that internal factors such as poor management, incorrect managerial perception, operating inefficiencies, high operating costs and inadequate financial control may have had a greater role in the group’s downfall.

The lack of reliable financial information also made it more difficult for top management to implement restructuring measures throughout 2014 and 2015. And the apparent low level of specialization and professionalization of the top management, and perhaps the controlling shareholder’s (indirectly, the Johnson Family) stubbornness, led to a sluggish response in replacing the CEO and the CFO and in appointing a Chief Restructuring Officer (“CRO”).

Once the issues began piling up and the Group of Banks started negotiations for a workout, another cause to the group’s financial decline may have been the delayed capital contribution by the controlling shareholder, and in a smaller amount than requested by the Group of Banks.

Overall, due to the bad and unreliable information provided to the Group of Banks, as well as the group’s slow response time to address pressing matters (i.e., the management’s cognitive inertia), negotiations for a workout agreement may have taken longer than in a scenario of real-time access to reasonable and trustworthy information, thus reducing the parties’ informational asymmetries.

1. These are a few of the causes that may have led to Flow Management Group’s financial distress, as surmised from the case description, but could the group’s financial distress have been prevented (or at least swiftly resolved)? The answer is *possibly* yes, and for the following reasons:
2. Preemptive measures. It is very clear that one of Flow Management Group’s main issues is the *quality* of information that is provided to its management. The investment in a better accounting system, as well as more robust audit and internal controls, could have provided managers with better information regarding the group’s financials. Access to up-to-date and reliable information in real-time could have allowed managers to take swift actions to address any solvency issues, divest in non-core businesses, downsize, among other measures.

The *quality* of management also seemed to be a problem in the present case, possibly due to unskilled and unspecialized managers appointed by the Johnson Family, one of the indirect shareholders. Management training (or even the replacement of managers) to better understand the business and process the financial information may have allowed them to quickly pinpoint the issues with the business and promptly remedy them. It could also have prevented the grave error in the cost-price calculation, with periodical checks on the numbers that could have identified the formula error in the spreadsheet very early on.

1. Restructuring measures. Once the signs of financial distress were identified by the Flow Management Group and the Group of Banks was made aware of the group’s situation, management could have quickly reacted and implemented certain measures, such as (a) the replacement of the CFO and the adoption of more strict financial controls, aimed at improving the quality of information, (b) establishing a direct line of communication with the Group of Banks to provide reasonable and reliable information in real-time, to minimize informational asymmetries and aid in the negotiations for a workout agreement,[[12]](#footnote-12) (c) the appointment of a CRO in November-December 2013 (instead of May-June 2014) might have helped in gaining the Group of Banks’ confidence in the top management’s goal of effectively turning the group around, (d) the controlling shareholder engaging in a more active role and injecting new money into the business to address the solvency issues early on, and (e) reaching a standstill agreement in the beginning of negotiations and the quick proposal of deep-cutting restructuring measures, with a clearly defined schedule to implement such measures.
2. These actions might have reduced the lengthy period of negotiations until a workout agreement was finally reached by the parties and possibly allowed a quicker turnaround of the business. And according to Jan Adriaanse and Hans Kuijl, “*informal reorganizations are especially successful when the company is able to reorganize its business operations quickly and adequately and, thereby, to restore profitability*”.[[13]](#footnote-13)
3. *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?*
4. According to Jan Adriaanse and Hans Kuijl, important advantages of informal reorganizations “*can be summed up with the terms flexibility, silence, and control*”.[[14]](#footnote-14) Notwithstanding, out-of-court restructurings and formal bankruptcy proceedings both have its advantages and disadvantages, and usually one’s advantage is the other’s disadvantage, as can be seen in the table below:

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| --- | --- |
| Out-of-court restructuring | Formal insolvency proceeding |
| Advantage: An informal reorganization allows the debtor and creditors more flexibility when drafting restructuring proposals and reaching an agreement. According to Jan Adriaanse and Hans Kuijl, the informal “*reorganization process is less rigid than is the case with(in) formal procedures*”.[[15]](#footnote-15) The parties have a greater array of possible solutions at their disposal, which would better suit their needs, without (i) being bound to the legal constraints of bankruptcy law and the legal framework, (ii) court supervision, (iii) legal deadlines, and (iv) overall legal formalities.  An unsuccessful negotiation for a workout agreement does not end in the debtor’s liquidation. Rather, there is still the option of a formal insolvency proceeding to try to restructure the company’s indebtedness.  Although Brazil does not have a specific legal framework regulating out-of-court restructurings, article 167 of the Brazilian Bankruptcy Law (Federal Law No. 11,101/2005) allows workout agreements outside of formal insolvency proceedings. | Disadvantage: A formal insolvency proceeding (reorganization, restructuring, or any other in which a viable company is restructured) is (i) bound by the legal constraints and legal framework provided by the insolvency legislation, (ii) overseen by the court and a court appointed examiner (or trustee), (iii) subject to legal deadlines, (iv) subject to an order of priority of claims (e.g., absolute priority rule), (v) subject to a specific set of proceedings, among other formalities.  And if the restructuring attempt is unsuccessful, the debtor may be declared bankrupt and subsequently liquidated.  Specifically in Brazil, in a judicial reorganization proceeding (*recuperação judicial*, in Portuguese), the Public Prosecutor’s Office is called to oversee and participate in the proceedings (and may even challenge court orders). A judicial administrator (*administrador judicial*)is also appointed to supervise the proceedings and aid the court by giving opinions on certain matters, although the debtor remains in possession. |
| Disadvantage: An out-of-court restructuring may be the way to go when there is a small, concentrated and homogenous group of relevant creditors (such as the Group of Banks in the Flow Management Group’s case), but it does not work as well with large numbers of creditors that are heterogeneous and spread across different jurisdictions.  Notwithstanding, even with a small group of creditors that are privy to the negotiations, if just one of the creditors does not agree with the terms and conditions of the workout agreement (a holdout), negotiations may break down and all may be for naught. A workout agreement cannot bind a dissenting creditor. | Advantage: Unlike a workout, a formal restructuring proceeding is designed to work with any number of creditors, whatever the nature of their claims and wherever they may be situated.  In case one creditor or a group of creditors do not agree with the restructuring proposal, insolvency laws usually have ways to bind the dissenting creditors (according to the majority rule) and even cramdown classes of claims that have not fulfilled the requisite quorum for approving the restructuring proposal.  Brazil is one such jurisdiction, wherein the majority rule applies and, if need be, a cross-class cramdown may be used by the court to confirm the judicial reorganization plan, as long as the legal requirements are met. |
| Advantage: An informal reorganization causes less reputational damage on the debtor. Although the debtor’s financial distress will be known by the relevant creditors that are invited to the negotiations, the parties often sign a non-disclosure agreement. “*Furthermore, informal reorganizations take place in relative silence. That is to say, the procedure is not made public; this is opposed to formal reorganizations, which are public.”[[16]](#footnote-16)*  The debtor’s stakeholders (consumers, suppliers, employees etc.) and even competitors may remain unaware of the debtor’s financial distress.  The debtor may continue to seek financing in the market, without the hurdles imposed by a formal insolvency proceeding – although a poor credit score due to the worsening financials might affect the terms and conditions of any loan agreement.  Furthermore, the less people know of the restructuring talks, the lower the chances that enforcement proceedings or collection suits may be filed to start a race for the debtor’s assets.[[17]](#footnote-17) | Disadvantage: The filing for a formal insolvency proceeding usually sends shockwaves across the market in general and, specifically, the debtor’s stakeholders.  Consumers may become wary of the quality of goods and services and may flee to competitors (or may be outright poached by the competition). Suppliers may stop offering credit and may demand upfront payments for goods and services, or even take their business elsewhere.  Specifically in Brazil, due to Central Bank regulations, any lenders to debtors undergoing judicial reorganization must provision 100% of the balance owed, and any future loans also require 100% of the amount to be provisioned, which means that credit from regulated financial institutions dries up. |
| Disadvantage: The negotiations toward an informal reorganization may sometimes reach a standoff, by which certain creditors may not budge and accept the debtor’s restructuring proposal. To stop these creditors from accelerating their contracts and filing enforcement or collection suits, it is important for the negotiating parties to agree to a standstill for a specific period of time, during which the parties cannot enforce or collect their claims.  Without a standstill agreement, if negotiations break down, any of the participating creditors may race for the debtor’s assets to satisfy their claims. | Advantage: A formal restructuring proceeding usually provides for a stay of proceedings, contingent upon a court order, or simply automatic from the moment the debtor files their petition.  During the stay period, creditors are not allowed to initiate enforcement proceedings or file collection suits.  Due to this legal impediment, creditors are “forced” to sit at the negotiating table and discuss the terms and conditions of a restructuring proposal that is acceptable to all parties involved.  In Brazil, the stay period is not automatic and depends on the court’s acceptance order of the judicial reorganization proceeding and lasts initially for 180 days. The stay may be extended for another 180-day period if the debtor has not contributed to delay the proceeding. If creditors reject the debtor’s reorganization plan and decide to submit an alternate plan, the court may extend the stay for another 180 days, in a total of 540 days. |
| Advantage: The debtor’s management remains in charge and in control of negotiations for the out-of-court restructuring agreement, as “*they can continue to fully run the company independently*”.[[18]](#footnote-18)  Though relevant creditors might pressure for a change in the top management, or the appointment of a CRO, the debtor’s management is still calling the shots.  The debtor’s management may also decide to sell assets or divest as part of the workout agreement, without the need for outside confirmation (except as provided by security, pledge or collateral agreements). | Disadvantage: In certain jurisdictions, the debtor remains in possession (like a judicial reorganization in Brazil), but other jurisdictions may appoint an examiner, trustee or administrator to run the debtor’s affairs, or at the very least co-manage the debtor alongside its management (like a suspension of payments, in the Netherlands).  Specifically in Brazil, after filing for judicial reorganization, though the debtor remains in possession, the company’s management is restricted from selling noncurrent assets without court authorization. |
| Advantage: An out-of-court restructuring may represent lower costs when compared to formal insolvency proceeding.  Such costs are limited to the financial, accounting and legal advisors to all parties in the negotiations, often times even expert opinions, and any fees and costs necessary to implement the restructuring measures agreed by the parties. | Disadvantage: Besides the same costs with financial, accounting and legal advisors that are present when negotiating an informal reorganization, a formal insolvency proceeding also requires the payment of court fees and costs, any expert fees and costs, as well as any fees and costs from the court appointed examiner, trustee or administrator.  There is also the opportunity cost of all business the debtor may miss out, due to the fact that it is undergoing a formal restructuring proceeding.[[19]](#footnote-19)  Specifically in Brazil, the court appointed judicial administrator, who performs a supervisory role and aids the court in the verification of claims, among other matters, is paid up to five per cent (5%) of the company’s indebtedness that is subject to the judicial reorganization proceeding. |

1. *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.*
2. A few of the turnaround and reorganization approaches presented in the supporting materials were applied in the Flow Management Group’s restructuring. The following analysis uses as a starting point the seminal paper “*Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions?*”,[[20]](#footnote-20) by Jan Adriaanse and Hans Kuijl, and works from there to incorporate reorganization approaches offered by Kalle Pajunen,[[21]](#footnote-21) Sudi Sudarsanam and Jim Lai,[[22]](#footnote-22) and Achim Schmitt and Sebastian Raisch.[[23]](#footnote-23)
3. The aforementioned paper focuses on informal reorganizations, which are not bound by statutory insolvency legislation (*in the shadow of the law*, as the authors put it), that are aimed at rescuing the debtor from financial distress. Informal reorganizations, therefore, may consist of a business restructuring and a financial restructuring:
4. Business restructuring. Also known as turnaround, a business restructuring is “*a comprehensive plan the aim of which is to restore the (operational) profitability of a company in financial difficulties*”,[[24]](#footnote-24) and can be divided into four (4) phases:
   1. Stabilizing, whereby management is tasked at identifying the crucial issues and critical problems that need to be immediately resolved to stabilize the debtor’s situation, to promote an increase in their cash flow and consequently allow the debtor to satisfy impending financial obligations. A few actions may be carried out by management to further this end, such as (1) cutbacks in expenditure, (2) optimizing the stock situation (i.e., selling off excessive stock), (3) optimizing turnover times of the accounts receivable, (4) divestment of excessive assets and (5) optimizing financing arrangements (i.e., extending payment schedules).[[25]](#footnote-25)-[[26]](#footnote-26)

In the Flow Management Group’s case, in December 2013, shortly after the first indications of financial distress in November 2013, the debtor carried out cutbacks in expenditures, laid off 130 employees and independent contractors, implemented extra savings and raised prices, to reflect a correct cost-price calculation. The Group of Banks have also implicitly agreed to allow the debtor to miss a scheduled repayment of € 35 million on 31 December 2013 – as governing stakeholders,[[27]](#footnote-27) as defined by Kalle Pajunen, the more secure their continuing support “*in an existence-threatening crisis, the more probable is organizational survival*”.[[28]](#footnote-28)

These seem to be retrenchment strategies, as defined by Achim Schmitt and Sebastian Raisch,[[29]](#footnote-29) through which the debtor sets out to improve operational efficiencies by reducing operational costs through layoffs and process improvements.

* 1. Analyzing, through which management shall draft a reorganization plan indicating the debtor’s short and long-term objectives in order to reorganize the company, with (1) a strategic and financial analysis tracing the causes of financial distress, (2) an examination of the actual financial position and an assessment of the company’s viability, (3) proposed restructuring measures and long-term projections, (4) short and long-term cash flow projections showing that the debtor can perform their obligations, and (5) cash flow projections showing a future improvement on liquid assets.[[30]](#footnote-30)

The reorganization plan should also provide the measures the debtor will implement to restore long-term profitability, such as (1) adjusting strategy and marketing, (2) cutting overhead costs, (3) dismissing excessive personnel, (4) rationalizing product assortment, (5) improving purchasing processes, (6) improving management information systems, (7) improving working capital and cash flow management, (8) closing loss-making business units, (9) capitalizing excessive fixed assets, or (10) selling profitable operations that are non-core.[[31]](#footnote-31)

All of these measures are necessary to restore the stakeholders’ confidence in the company in distress, and it is also quite common to retain professionals that are specialized in turnaround processes (i.e., an advisor, an accountancy firm, a CRO).[[32]](#footnote-32)

That being said, in the Flow Management Group’s case, any attempt at identifying the causes of distress, the group’s current financial situation, and future cash flow projections is hindered by the poor quality of financial information that the debtor has provided during the negotiations for a workout with the Group of Banks.

As asserted by Kalle Pajunen, “*open and active communication with governing and potential stakeholders has a positive effect on their support for organizational survival*”,[[33]](#footnote-33) which did not seem to occur with the Flow Management Group. Had the group employed this strategy after improving its information systems, negotiations with the governing stakeholders (the Group of Banks) might have led to a quicker turnaround.

However, inaccurate and insufficient information regarding the business and its financials delayed the drafting of a final reorganization plan for the Flow Management Group – from November 2013 to the conclusion of the restructuring agreement in July 2015, there were five (5) different proposals (some more extensive than others).[[34]](#footnote-34) In the end, the main proposals by the debtor involved cutting overhead costs and dismissing personnel, which led to an informal reorganization that ultimately transferred the operating subsidiaries to the Group of Banks and cancelled most of Flow Management Group’s indebtedness.

* 1. Repositioning, according to which the debtor’s management implements the measures outlined in the reorganization plan – what is called by the authors as the “*value recovery process*”.[[35]](#footnote-35) Management must also report the progress of the restructuring process to the interested parties “*in an open and timely manner*”.[[36]](#footnote-36)

In the present case, the relevant creditors (the Group of Banks) ended up as the shareholders of the new entity holding the operating subsidiaries (alongside a few board members), while the old controlling shareholder gave up any interest in the new entity. After this change in control, the case description mentions that the new and reorganized company has had losses of nearly € 9 million in 2015 and expect a slightly negative or a break-even result in 2016, and although there seem to be no interested parties in purchasing the new company from the Group of Banks (at least no one seriously interested), “*a better future is forecast and the parties are carefully optimistic about a good result*”.

* 1. Reinforcing, according to the authors, means that management will be reinforced (i.e., replacing old managers, changing management positions) as well as the debtor’s balance sheet, which can be achieved by the transfer of the company to a new owner that would be able to meet any future obligations (this is closely linked to the financial restructuring).[[37]](#footnote-37)

In the Flow Management Group’s case, the CEO and the CFO were replaced and a CRO was appointed prior to the signing of the restructuring agreement. Though the change in top management (a managerial restructuring, according to Sudi Sudarsanam and Jim Lai[[38]](#footnote-38)) represented a breath of fresh air, and helped overcome the previous management’s cognitive inertia,[[39]](#footnote-39) it could have been carried out much earlier in the negotiation process in order to show the controlling shareholder’s commitment to the turnaround process and bolster the governing stakeholders’ confidence in the debtor.

Furthermore, the new and reorganized company was transferred to the Group of Banks and a few board members, which ought to ensure the payment of future obligations. Although it might have been less traumatic if the old controlling shareholder had made capital contributions early in the negotiations, to ensure that the group could meet its obligations, thus reducing the tensions and stress surrounding the negotiations for the group’s informal reorganization.

1. Financial restructuring. An informal reorganization often requires financial restructuring, which can mean that, “*on the one hand, the relevant creditors voluntarily commit to revised terms with regard to the funding they made available (…) and, on the other, if so required, new funding is made available by providers of risk-avoiding capital (debt) and/or risk-bearing capital (equity)*”.[[40]](#footnote-40)-[[41]](#footnote-41) Some examples of financial restructuring measures are (a) reducing the repayment obligations and/or reducing current debts, (b) reducing interest obligations, (c) deferring repayments, (d) deferring interest obligations, (e) debt-to-equity swap, (f) generating new-risk avoiding financing, and (g) generating new risk-bearing financing.[[42]](#footnote-42)-[[43]](#footnote-43)

In the present case, the final restructuring agreement provided for a debt-to-equity swap through which the Group of Banks and a few board members exchanged their debts for shares in the new and reorganized company, to which the shares of the operating subsidiaries were transferred, and cancelled a substantial portion of their indebtedness, thus strengthening the new company’s balance sheet.

1. Furthermore, in the Flow Management Group’s case, it is possible to visualize how the management employed a retrenchment strategy (i.e., reducing expenditures, layoffs, increasing internal process efficiencies) followed by a recovery strategy (i.e., structural change to the firm via the transfer of ownership), in a sequential manner, instead of attempting to implement both short-term and long-term strategies in a complementary manner, as suggested by Achim Schmitt and Sebastian Raisch.[[44]](#footnote-44) This could have contributed to a quicker turnaround process, perhaps even with a different outcome, with the controlling shareholder retaining a piece of the new and reorganized company.
2. *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?*
3. There may be a few reasons for Banks C and D to walk away from negotiations in mid-February 2014, which are summarized as follows:
4. From the beginning of the conversations between the Group of Banks and Flow Management Group, although the debtor attempted to keep an open channel of communication regarding its financials, most, if not all, the information passed on to the Group of Banks was inaccurate and/or insufficient to allow them to properly assess Flow Management Group’s situation of distress. The *poor quality* of information made it more difficult to draft an adequate restructuring proposal, and this might be the reason Banks C and D decided to take a step back in the hopes that the debtor might see this as a threat and start providing more reliable information.
5. Another reason for Banks C and D to stop cooperating might be the sluggish attitude assumed by Flow Management Group and its controlling shareholder when taking measures to address the debtor’s financial distress. From the start, some problems are clearly noticeable in Flow Management Group’s business, such as (a) poor management overall, (b) wrongful issuance of management bonuses, (c) incorrectly booked profits, (d) formula error in a spreadsheet regarding cost-price calculations, (e) solvency issues that are not remedied by the controlling shareholder, to name a few.

To address these issues, Flow Management Group raised its prices, laid off 130 employees and independent contractors and implemented savings in certain areas, such as car repairs, but nothing was done to improve the debtor’s solvency (the controlling shareholder proposed selling 350 cars instead of making a capital contribution, though the case description does not confirm this ever happened) and by December 2013, the debtor’s solvency reached 0.1% and it would only have enough cash to fulfill its obligations until April 2014, without taking into account a € 35 million repayment by the end of December 2013 that the Group of Banks implicitly postponed.

The measures Flow Management Group undertook thus far may have been seen by Banks C and D as not enough to address the debtor’s level of distress, especially the lack of a capital contribution by the controlling shareholder.

1. It may also be inferred that Banks C and D walked away from negotiations to try to ascertain the weakness of their pledges and sort out any problems that would lead a lower-than-expected recovery in case of Flow Management Group’s liquidation. The case description points out that the contracts providing the pledges are not foolproof, which could have led Banks C and D to confer with their attorneys and look for ways to improve their position and gain leverage in the negotiations with the debtor and the other banks.
2. Furthermore, Banks C and D could have tried to halt conversations to pressure Banks A and B to buy out their claims, which was actually considered at the end of March 2014, but did not move forward.
3. In light of Banks C and D’s reluctance to cooperate to a consensual solution to Flow Management Group’s financial distress, an advisor to Banks A and B may take a few steps to continue negotiations aiming at a satisfactory conclusion for the banks they represent, which are described below, in order:
4. First, it would be advised that Banks A and B attempt to reach an inter-creditor agreement with Banks C and D, which would regulate how the Group of Banks would approach the debtor and carry on negotiations. This inter-creditor agreement would provide for a voting mechanism, risk sharing, and ensure that the banks’ original credit agreements be observed when proposing restructuring measures. A third-party coordinator may be appointed, one of the banks could be chosen as coordinator or a committee could be formed, serving as a focal point for negotiations with Flow Management Group and showing a united front – this is actually suggested by the Fourth Principle provided by INSOL International’s Statement of Principles for a Global Approach to Multi-Creditor Workouts II.[[45]](#footnote-45)
5. Second, if an inter-creditor agreement cannot be signed, and Banks C and D decide to remain uncooperative, it would be advised for Banks A and B to continue negotiating with Flow Management Group. Restructuring proposals could be drafted that would best suit Banks A and B’s best interests, whilst ensuring that Banks C and D would be treated equally and without prejudice. Furthermore, ongoing negotiations with Banks A and B could pressure Banks C and D to come back to the negotiating table to try to avoid a less-than-optimal recovery given the debtor’s circumstances and Banks A and B’s interests.
6. Third, if a consensual workout solution cannot be reached due to Banks C and D acting as holdouts, Banks A and B could consider (a) buying out Banks C and D with a discount (according to the case description, this was actually considered, with a 15-20% discount), (b) financing a third-party specialized in debt trading to buy out Banks C and D, and subsequently signing an inter-creditor agreement with the successor, or (c) financing Flow Management Group’s repayment of Banks C and D’s debt.
7. *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)?*
8. INSOL International’s Statement of Principles for a Global Approach to Multi-Creditor Workouts II (henceforth, “Statement of Principles II”) may be regarded as a “soft law”, i.e., a body of guidelines, principles or declarations that are not legally binding, such as “hard law”. Andrew T. Guzman and Timothy L. Meyer define “*soft law as those nonbinding rules or instruments that interpret or inform our understanding of binding legal rules or represent promises that in turn create expectations about future conduct*”.[[46]](#footnote-46)
9. Considering that formal insolvency proceedings are not always expeditious or cost-effective, and considering that it may somewhat tarnish a firm’s reputation with its suppliers, consumers and the market in general, informal workouts may be the best alternative when the conditions are right – that is, when a group of relevant creditors, such as financial institutions, are willing to negotiate “*an orderly and expeditious rescue or workout*” in order “*to avoid the social and economic impact of major business failures where viable alternatives exist*”, as expressed in the Commentaries to the Statement of Principles II.[[47]](#footnote-47)
10. And an important tool to guide informal workouts is precisely a soft law that embodies principles the parties can agree to abide by throughout their negotiations, such as the Statement of Principles II, which provide eight (8) principles that have been thought to encourage discussions in a safe environment and directed toward a common goal, the rescue of the business in distress. If the consensual approach does not bear fruit (e.g., due to a hold-out), a formal insolvency proceeding may be the solution, perhaps even with a restructuring support agreement outlining the principal measures to be undertaken during the formal proceeding, or even a prepackaged bankruptcy, which is quite common in the United States and is starting to gain traction in Brazilian judicial reorganizations.
11. That being said, in Flow Management Group’s case, the principles set forth by INSOL’s Statement of Principles II may be observed throughout the negotiations carried out by the debtors and the Group of Banks, which will be discussed as follows.
12. First principle. At first sight of the debtor’s financial difficulties, relevant creditors (usually financial institutions, but bondholders and any other important creditors may be included herein) should come together and cooperate toward a satisfactory solution that would avoid a formal insolvency proceeding, and the first step to do so would be to reach a standstill agreement, whereby creditors halt their enforcement actions, in exchange for information from the debtor that would allow for restructuring proposals to be drawn up considering the debtor’s specific situation.
13. The standstill period, although for a limited time, is important to avoid the common pool problem, as explained by Thomas Jackson[[48]](#footnote-48), in which each individual creditor of a debtor in financial distress tries to collect their claims through the “grab” rules of nonbankruptcy law and the debtor’s assets are allocated on a first-come, first-served basis, thereby hindering a global solution to the debtor’s crisis. Rather than using a formal insolvency proceeding to solve this collective action problem, a standstill agreement among relevant creditors may have the same effect as an automatic stay period, allowing all the relevant creditors to assess the situation and formulate proposals for an out-of-court workout, as well as avoiding a formal insolvency proceeding.
14. In Flow Management Group’s case, in January 2014, the Group of Banks realize that they should cooperate toward a global solution to the debtor’s financial distress and suggest a standstill agreement may be important to reach this goal. However, months went by before the Group of Banks and Flow Management Group actually reached a standstill agreement for 120 days, signed in the middle of August 2014 – approximately nine (9) months after the first signs of financial trouble.
15. Although it took a while to agree on a standstill, from November 2013, Flow Management Group initiated conversations with the Group of Banks to communicate their situation of distress and provide information on the business, even if at times such information was incorrect. The Group of Banks also seemed to cooperate and try to coordinate in search of a restructuring proposal from the outset, in December 2013, though Banks C and D had their moments of disbelief in the debtor’s management (and shareholders) and its ability to effectuate the necessary turnaround measures, causing them to momentarily leave the negotiations.
16. Second principle. For the standstill agreement to actually be effective, creditors must not initiate collection suits or enforcement proceedings seeking the repayment or the improvement of their positions against the debtor. On the other hand, creditors are encouraged to “*allow utilisation of existing credit lines and facilities*”.[[49]](#footnote-49) The objective of the first and second principles is to achieve the stability needed to negotiate restructuring proposals without the threat of imminent bankruptcy. In Flow Management Group’s case, it is not clear if the standstill agreement disallowed such actions by the Group of Banks, but it is possible to infer that the creditors agreed to not press for repayment or to try to improve their individual positions, considering there is no information regarding such actions.
17. Third principle. In exchange for the creditors’ cooperation and the standstill of collection and enforcement actions against the debtor, “*the debtor should agree not to take any action which will disadvantage relevant creditors during the Standstill Period, apart from paying employees and trade and other (non-relevant) creditors in the ordinary course of business*”.[[50]](#footnote-50) This means that the debtor should not offer security to non-participating creditors, transfer assets or value away from the company or undertake any action that might adversely impact the prospective return of the participating creditors. This seems to be the case with Flow Management Group, as the debtor did not perpetrate any such action, apart from the payment of € 25 million, in January 2015, to the providers of the additional working capital (Banks C and D, it would seem), apparently after the end of the 120-day standstill.
18. Fourth principle. Alongside a standstill agreement, it is important for relevant creditors to come together and coordinate their efforts toward a consensual solution for the debtor’s financial distress. This coordination may be done through a committee or the appointment of a main coordinator, to take on the role of facilitating the negotiation with the debtor, as well as mediating discussions among relevant creditors.
19. In Flow Management Group’s case, it does not look like the Group of Banks appointed a coordinator or a coordination committee, but it seems as though the Banks have tried to coordinate their approach to the debtor’s restructuring, at least until Banks C and D decided to step away from an active role in the negotiations. Perhaps if a coordination committee had been appointed in this case, then any disagreements among the Banks and between the Banks and the debtor could have been more easily resolved.
20. Fifth principle. Any attempt at an out-of-court restructuring requires high quality information from the debtor and transparency regarding its operation and business. Informational asymmetries only make negotiations more difficult, considering the relevant creditors will not be able to properly assess the debtor’s condition and draft proposals to remedy the situation.[[51]](#footnote-51) Reasonable and timely access to relevant information, therefore, is the foundation upon which a workout agreement is built. If the relevant creditors do not have access to the debtor’s information, or if the information that has been provided is not accurate, such unreliable information may delay negotiations and may even push creditors away from the negotiating table.
21. In Flow Management Group’s case, although the debtor and its principals have tried to maintain an open channel of communications with the Group of Banks, much of the information that has been passed to the relevant creditors has proven to be incorrect assessments of the debtor’s financial situation, have been based on inadequate premises and, ultimately, has shown to be untrustworthy. This may very well be the reason why Banks C and D, at a certain point, decided to walk away from the negotiations, after subsequent misrepresentations of the debtor’s financials and projections.[[52]](#footnote-52)
22. Despite Flow Management Group’s efforts, it seems that reasonable and timely access to all relevant information was hampered by the *quality* of such information, which, in turn, made it more difficult for the parties to draft adequate restructuring proposals.
23. Sixth principle. The objective of sharing all of the debtor’s relevant information with its principal creditors is to allow them to evaluate the debtor’s financial position and assess any restructuring proposals submitted by the debtor, or draft counterproposals, which would entail equitable treatment to all relevant creditors. When assessing or drafting these proposals “*creditors will need to compare the outcome they could expect from any proposals made to them against the returns they might expect to achieve in a formal insolvency process or from other options available to them*”.[[53]](#footnote-53)
24. The Group of Banks made such a comparison in Flow Management Group’s case when drafting the restructuring proposals, and found that a formal insolvency proceeding (i.e., bankruptcy) would negatively affect their recovery, particularly due to an issue with the pledges that would cause a substantially lower return than expected in an out-of-court workout.
25. Seventh principle. Pursuant to the seventh principle, all relevant information exchanged between debtor and creditors should be treated as confidential, and any successors to the original creditors (due to debt trading) should receive the same information as all other relevant creditors.
26. From the description of the Flow Management Group case, it is not possible to conclude that the parties agreed to confidentiality or signed a non-disclosure agreement, although it may be inferred that the information was transmitted in confidentiality. The case did not involve debt trading, though Banks A and B considered buying out Banks C and D in order to better carry on the negotiations – in which case the successors would already be on par with all relevant information.
27. Eighth principle. New money is fundamental for firms in distress to emerge from the depths of financial crisis and reorganize/restructure its business. Therefore, any attempt at an informal workout should consider the influx of new money to the debtor as a crucial element to the restructuring efforts.
28. However, unlike debtor-in-possession financing provided during a formal insolvency proceeding (e.g., Chapter 11), any new money provided during the negotiations for an out-of-court workout should specify that the lender shall have priority over other claims of relevant creditors. This priority of repayment could be achieved through security or, if all of the debtor’s assets are encumbered or subject to negative pledges, through loss-sharing arrangements between the relevant creditors.
29. In Flow Management Group’s case, although it mentions an additional working capital facility by Banks C and D in the amount of € 35 million, the case description indicates that such amount should have been repaid by the end of 2013, shortly after the first signs of distress, in mid-November 2013.Thus, from the available information, it is not possible to affirm that the Group of Banks, or any other relevant creditors, provided new money in the out-of-court workout, or that it was afforded priority in case of a future formal insolvency proceeding.
30. Notwithstanding, it should be mentioned that Flow Management Group’s controlling shareholder provided € 10 million in an unsecured loan in mid-April 2014. In early June 2014, the shareholder proposes a € 27.5 million contribution, and by the end of June 2014 the shareholder proposes a € 10 million contribution in the short term, followed by a € 25 million contribution in September/October 2014, but there is no evidence that such capital contributions were actually carried out. However, this is not new money provided by the relevant creditors, but capital contributions from a shareholder that is not afforded priority.
31. *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?*
32. If creditors do not agree to follow the guidelines set forth by the Statement of Principles II, there are other soft laws that could help steer the negotiations toward an out-of-court workout agreement, such as
33. The UNCITRAL Legislative Guide on Insolvency Law.[[54]](#footnote-54) Item II of Part One of the UNCITRAL Legislative Guide on Insolvency Law provides guidelines for a voluntary restructuring without (or before) resorting to a formal insolvency proceeding, such as (a) commencement of negotiations, either by initiative of the debtor or any of their relevant creditors, (b) coordination between creditors, through a committee or the appointment of a coordinator, (c) a standstill agreement, to “*allow business operations to continue and to ensure sufficient time is available to obtain and evaluate information about the debtor and formulate and assess proposals to resolve the debtor’s financial difficulties*”,[[55]](#footnote-55) (d) hiring of independent experts and advisors, (e) the provision of new money to ensure adequate cash flow and liquidity, (f) access to “*complete, adequate information on the debtor*”,[[56]](#footnote-56) for creditors to properly evaluate the debtor’s financial positions and structure adequate proposals for an out-of-court workout agreement, and (g) the debtor should try to involve relevant creditors in the negotiations for a voluntary restructuring agreement, and, if not possible, a formal reorganization proceeding could be used to bind dissenting creditors using the workout agreement as a pre-packaged plan or a plan support agreement).
34. The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes.[[57]](#footnote-57) “*Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability.*”[[58]](#footnote-58) The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (“World Bank Principles”) suggest that jurisdictions should create a framework to enable informal workouts as a means for resolving financial distress.

According to the World Bank Principles, and similarly to the Statement of Principles II, a framework enabling an informal workout should encourage, for instance, (a) the disclosure of reliable and accurate information in timely manner, (b) the lending of new money, (c) any number of restructuring alternatives, such as asset sales, divestment, debt write-offs, debt rescheduling, discounted debt sales, and exchange offers, (d) allow creditors the ability to enforce their claims, utilize a formal reorganization or resort to liquidation, if an out-of-court workout proves unsuccessful.[[59]](#footnote-59)

1. The Insolvency and Creditor Rights Standard.[[60]](#footnote-60) The World Bank and UNCITRAL, with comments from the International Monetary Fund (“IMF”), devised the Insolvency and Creditor Rights Standard (“ICR Standard”) “*to represent the international consensus on best practices for evaluating and strengthening national insolvency and creditor rights systems*”.[[61]](#footnote-61) In this regard, the ICR Standard reproduces the World Bank Principles when it comes to addressing informal workouts, as mentioned above in item (ii).
2. The aforementioned soft laws may serve as guidance to informal workout negotiations whenever a certain jurisdiction does not have a body of rules (i.e., hard law) to govern out-of-court restructuring agreements.
3. Specifically in Brazil, there are no soft laws that would give directions or orientations as to how an informal workout restructuring would progress. However, article 167 of the Brazilian Bankruptcy Law (Federal Law No. 11,101/2005) allows for debtors and creditors to reach *other* restructuring agreements not regulated by the bankruptcy law. This makes way for all sorts of informal solutions to a situation of distress, as long as there is a concentrated group of relevant creditors that are willing to negotiate.
4. Due to the underdeveloped nature of Brazil’s capital markets, it is quite common for companies to finance their business through loan facilities from financial institutions. This means that a large portion of a company’s indebtedness is held by banks. In case of default, the longer the debtor takes to repay the bank, the more provisions the bank has to make in order to comply with federal banking regulations. And if the default lasts longer than a period of 180 days, the bank has to make a provision of 100% of the outstanding debt – the same provision is required when the debtor files for judicial reorganization, a formal insolvency proceeding pursuant to the Brazilian Bankruptcy Law.
5. This indirectly serves as an incentive for financial institutions in Brazil to negotiate with financially distressed companies (with significant bank indebtedness) and attempt to reach an informal workout agreement, that is, before the debtor is pushed to a judicial reorganization filing by other less relevant creditors. In this sense, even though there is no soft law in Brazil to help guide negotiations toward an informal restructuring, it is somewhat common for debtor and creditors to hire financial and legal advisors to guide the negotiations under a confidentiality agreement, with the debtor’s relevant information being made available to all parties in pursuit of a consensual solution (e.g., divestment of assets, spin-off and sale of non-core businesses, public offering of securities etc.).
6. *Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015*
7. After a long period of negotiations (and quite a few moments of uncertainty regarding the future of the debtor), Flow Management Group and the Group of Banks signed a restructuring agreement on 4 July 2015 that can be divided into two prongs: (i) a business restructuring and (ii) a financial restructuring, as categorized by Jan Adriaanse and Hans Kuijl[[62]](#footnote-62) – although both could be considered a financial restructuring through a debt-based strategy, according to Sudi Sudarsanam and Jim Lai.[[63]](#footnote-63)
8. On the business restructuring front, the parties agreed on the following measures:
9. Flow Management Holding BV would consolidate its six operating subsidiaries under a new company, called Flow Management II BV; and
10. The shares of Flow Management II BV would be transferred to the Group of Banks, according to their relative positions, and a few board members of Flow Management Holding BV, including the CRO. Through these measures, the company as a going concern was transferred in a similar manner as a debt-to-equity exchange offer, wherein the creditors become the new owners of the new and reorganized company, created in order to start anew and replace the old equity shareholders (although in some cases the old equity may remain as partial owners or even retain control in the new reorganized company) – such are business restructuring measures according to Jan Adriaanse and Hans Kuijl.[[64]](#footnote-64)
11. It should also be noted that even before the restructuring agreement was signed, Flow Management Holding BV’s top management was replaced, with the substitution of the CFO in January 2014, the CEO in mid-April 2014 and the appointment of a CRO still in 2014 – a management restructuring according to Sudi Sudarsanam and Jim Lai.[[65]](#footnote-65) A few other measures were also put in place during negotiations for a restructuring agreement, such as lay-offs, price raises and cost savings.
12. On the financial restructuring front, the parties agreed on the following measures:
13. Flow Management Holding BV would be liquidated in an undisclosed manner, after the transfer of its operating assets to Flow Management II BV, with the cancellation of all claims against the holding by the Group of Banks and by Lease Group Holding UK Ltd., the controlling shareholder;
14. Flow Management Holding BV and the controlling shareholder would cancel their claims against the newly formed Flow Management II BV and the operating subsidiaries;
15. Banks C and D would write-off the € 32.5 million debt arising from the additional working capital facility provided to Flow Management Work BV (one of the six operating subsidiaries transferred to the new company, Flow Management II BV);
16. The Group of Banks would waive an amount of € 97.5 million of the debt regarding the working capital facility provided to Flow Management Work BV, while a € 240 million claim against Flow Management Work BV would remain; and
17. The amount of € 55 million concerning loans made by the Group of Banks to Flow Management Work BV would be cancelled in full.
18. Through these restructuring measures, the operating companies were transferred to a new company and its shares were used to repay Flow Management Holding BV’s debts, with the exception of a € 240 million claim that would remain against Flow Management Work BV (one of the six subsidiaries), which should be refinanced in July 2017 (after an attempt at refinancing in November 2016 did not materialize).
19. Certainly, the Group of Banks do not intend to remain as shareholders of a company that leases trucks and private cars: the main objective of the corporate and financial restructuring carried out by the banks is to sell the new company, Flow Management II BV, as a going concern to interested parties in the same industry. However, according to the case description, the talks with three interested parties “*pass off with difficulty and management has the impression that the takeover candidates prefer to buy the company following liquidation*”. Although negotiations to take over the new company have not progressed, and it is still not making a profit, “*a better future is forecast and the parties are carefully optimistic about a good result*”.
20. A possible takeaway from the case description is that the restructuring proposal that the parties ultimately agreed upon was not the best outcome for the Group of Banks, that have not recovered their claims through the sale of the new company (as of May 2016) and may not recover any amount in the near future, at least not until the new company makes a profit and attracts the attention of potential buyers.
21. *Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?*
22. The Flow Management Group is comprised of a holding company in the Netherlands (Flow Management Holding BV) and six operating subsidiaries in different jurisdictions: (i) Flow Management Work BV, in the Netherlands, (ii) Flow Management Work Spain SL, (iii) Flow Management Work France SPRL, (iv) Flow Management Work Australia Ltd., (v) Flow Management Work South Africa Ltd. and (vi) Flow Management Work USA Ltd.
23. Flow Management Work Holding BV also has a controlling interest in Lease Cayman Real Estate Ltd. and Lease and Truck Repair Sweden Holding Ltd., in another two jurisdictions.
24. The holding company is wholly owned by Lease Group Holding United Kingdom Ltd., which shares are divided among the Johnson Family in the United States (30%), LLS Private Equity Fund Ltd. in the United Kingdom (40%) and Cinderella Investment Ltd. also in the United Kingdom (30%).
25. A group that has operations spanning over six jurisdictions and is owned by a company in a seventh jurisdiction is bound to face cross-border issues when trying to design a consensual solution to address their financial distress. Although the case description does not point out cross-border problems of any kind, it is possible to surmise a few that may stand out in an out-of-court restructuring of this magnitude (the first of which seems to be the most relevant):
26. If Flow Management Holding BV, in the Netherlands, has any creditors with outstanding debts other than the Group of Banks, the transfer of all of its assets to a new company (Flow Management II BV) and the subsequent debt-to-equity exchange, transferring all shares in the new company to the Group of Banks and certain board members, could be perceived as an attempt to defraud Flow Management Holding BV’s creditors.

In the scenario wherein the holding is liquidated in a formal bankruptcy proceeding in the Netherlands (*faillissement*), clawback actions may be filed by the bankruptcy trustee to invalidate any transactions that were detrimental to the estate, such as the aforementioned debt-to-equity swap and the cancellation of Flow Management Holding BV’s claims against Flow Management Work BV.[[66]](#footnote-66) A transaction like this would have been protected if carried out in a formal insolvency proceeding, but not in an out-of-court restructuring (unless otherwise provided by the governing law). This could be an issue before the Dutch court in a bankruptcy proceeding, but it is also possible for foreign creditors to file the *actio pauliana* before their own respective jurisdictions, if their contracts allow them.

If a clawback action filed by the bankruptcy trustee in the Netherlands is successful, then all six operating subsidiaries spread across six jurisdictions could be affected by the Dutch bankruptcy. In this situation, an assessment of the companies’ centers of main interest (“COMI”) might be needed for the recognition of foreign main and non-main proceedings before each jurisdiction (if their respective legislation allows it) and the Flow Management Group’s restructuring would dive into a multi-jurisdictional bankruptcy proceeding.

1. The change in ownership control in the six operational subsidiaries may also affect some of their relevant contracts, governed by different laws, and would need to be addressed before the restructuring agreement is complete, especially if Flow Management Holding BV and their controlling shareholder have offered collateral or are in any way guarantors of subsidiaries’ obligations.
2. The change in ownership may also have an impact on the relationship with certain clients, most notably if they era in any way connected (or loyal) to the Johnson Family, wherever they may be, affecting contracts governed by different laws.
3. These are just a few cross-border issues that may come up in an informal workout like the one executed by Flow Management Group and the Group of Banks. Despite the lack of information in the case description, it is likely that the restructuring agreement foresaw these problems and took steps to avoid them.
4. *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]*
5. Flow Management Holding BV is a company incorporated in the Netherlands and, therefore, subject to Dutch Law. When drafting the four different scenarios in October 2014, the Group of Banks and the debtor considered three (3) scenarios involving out-of-court restructuring measures (i.e., going concern with a new standstill or refinancing of the debt, along with a capital contribution by the controlling shareholder; sale of the company; or a debt-to-equity swap) and one (1) scenario in which a formal insolvency proceeding would be initiated, i.e., a moratorium followed by the sale of the company.
6. Under Dutch Law, a moratorium (*surseance van betaling*) is a suspension of payments that should provide an environment inducive to negotiations and that would ultimately allow the debtor to restructure their indebtedness, rather than resort to a liquidation. Such a moratorium may last as long as four (4) months and an administrator is appointed (*bewindvoerder*) that shall jointly run the debtor’s affairs alongside their management. Any and all acts must be carried out jointly by the court appointed administrator and the debtor’s management, which makes it all the more difficult to reach a negotiated restructuring arrangement and may lead to a bankruptcy liquidation (*faillissement*).[[67]](#footnote-67)
7. Recently, on 1 January 2021, the Dutch Bankruptcy Act was amended to provide for a Dutch Scheme, through which the debtor may request a stay of proceedings and may restructure their debts by any means available (e.g., debt-to-equity swap, debt rescheduling, debt write-offs, asset sales etc.), subject to a confirmation hearing before the court.[[68]](#footnote-68)
8. Considering the Flow Management Group’s case transpired before this recent change in Dutch Law, the debtor would only be able to utilize a suspension of payments, wherein the management and the Group of Banks would have a hard time negotiating a consensual solution that would be amenable to the court appointed administrator – at least a harder time than the parties would have outside of a formal insolvency proceeding.
9. Because of this, it is possible to deduce that a moratorium according to Dutch Law was always a last case scenario for the restructuring of the Flow Management Group’s indebtedness, considering it would take things out of the debtor’s control, and into the administrator’s hands, thus making it more difficult for the Group of Banks to reach an agreement that would avoid liquidation – the next step after a failed arrangement in a suspension of payments. In this case, an out-of-court restructuring agreement that provided for a debt-to-equity swap, with debt cancellations and write-offs, followed by a sale of the new reorganized company surely seems like a better alternative – even if it was rushed due to the end of the 120-day standstill agreement in mid-December 2014 and the subsequent repayment of € 25 million in January 2015 to the providers of additional working capital.
10. However, if the Dutch Scheme had been enacted prior to the Flow Management Group’s financial distress, perhaps it would have been a more viable alternative to a moratorium, which would allow more time for the parties to negotiate a restructuring agreement and even carry out the sale of the new company as a going concern. All of this without the administrator making negotiations more difficult and without the ghost of liquidation lurking around the corner.
11. On the other hand, if the case were under Brazilian jurisdiction, Flow Management Group would have three (3) different alternatives to effectuate a stay of proceedings before reaching the final terms of a restructuring agreement:
12. Mediation. Debtors in distress may commence an alternative dispute resolution proceeding, such as a mediation, in order to reach an agreement with a certain creditor (or even a group of creditors), prior to filing for a judicial reorganization. If the mediation is successful and the debts are renegotiated, a judicial reorganization may not be necessary. To encourage creditors to participate in such a mediation, according to article 20-B, §1, of the Brazilian Bankruptcy Law, allows the debtor to request a stay of enforcement proceedings and collection suits for the period of sixty (60) days, if they are able to prove the need for such a suspension.[[69]](#footnote-69)
13. Extrajudicial Reorganization. An extrajudicial reorganization is a formal insolvency proceeding, similar to a scheme of arrangement in the United Kingdom, in which the debtor and their creditors negotiate, gather support and submit a payment plan to the court for confirmation. If more than half the creditors in volume of claims support the plan, it shall bind any dissenting creditors – it is a great solution for an out-of-court workout agreement that could not achieve 100% of approval due to holdouts. If the debtor has not reached the threshold to approve the plan, but needs protection against enforcement proceedings or collection suits, pursuant to article 163, § 6 and § 7, of the Brazilian Bankruptcy Law, they may initiate the extrajudicial reorganization proceeding with at least one third (1/3) of the creditors in volume of claims and obtain the support from the remaining quorum within ninety (90) days, during which time a stay of proceedings will take place.[[70]](#footnote-70)
14. Judicial Reorganization. A judicial reorganization is a formal insolvency proceeding, similar to Chapter 11 in the United States, in which the debtor files for protection and then negotiates with their creditors a reorganization plan that shall be voted by a general creditors’ meeting and confirmed by the court. If, for some reason, the debtor has not yet gathered all the necessary documents for filing, article 6, §12, of the Brazilian Bankruptcy Law, allow the debtor to request the court to anticipate the effects of the stay in order to protect them from enforcement proceedings or collection suits. In a judicial reorganization, the law provides for a 180-day stay period that can be extended by an additional 180 days (and if creditors decide to submit an alternative plan of reorganization, the court may grant an additional 180-day stay period, for a total of 540 days).[[71]](#footnote-71)
15. All of these alternatives maintain the debtor-in-possession, without an administrator like the Dutch suspension of payments (in the judicial reorganization proceeding, the court appoints a judicial administrator that performs a purely supervisory role) and allow for the implementation of a debt-to-equity exchange, with a rescheduling of debts and the imposition of discounts. A judicial reorganization proceeding may even be a better forum for the sale of the company as a going concern, considering such a sale would be free and clear of any debts, obligations, liabilities, or contingencies of any kind, pursuant to article 60, sole paragraph, of the Brazilian Bankruptcy Law – which could allow for a better pricing by any interested buyers and ensure the maximization of the asset’s value (and the creditors’ recovery).

1. See MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, v. 5/6, issue 1, p. 21-41, 2004. [↑](#footnote-ref-1)
2. *Ibidem*, p. 22. [↑](#footnote-ref-2)
3. *Ibidem*. [↑](#footnote-ref-3)
4. *Ibidem*. [↑](#footnote-ref-4)
5. *Ibidem*, p. 23. [↑](#footnote-ref-5)
6. *Ibidem*. [↑](#footnote-ref-6)
7. See MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, v. 5/6, issue 1, p. 21-41, 2004, p. 24-27. [↑](#footnote-ref-7)
8. *Ibidem,* p. 27. [↑](#footnote-ref-8)
9. *Ibidem,* p. 30. [↑](#footnote-ref-9)
10. *Ibidem.* [↑](#footnote-ref-10)
11. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 148 (stating that “the presence of inadequate management information systems within the company” may result in the management missing important early signs of decline). [↑](#footnote-ref-11)
12. As proposed by Kalle Pajunen, in “an existence-threatening crisis, frequent and open communication between managers and governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organizational survival” (See PAJUNEN, Kalle. Stakeholder influences in organizational survival. *Journal of Management Studies*, v. 43, issue 6, p. 1261-1288, September 2006, p. 1280). [↑](#footnote-ref-12)
13. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 149. [↑](#footnote-ref-13)
14. *Ibidem*, p. 145. [↑](#footnote-ref-14)
15. *Ibidem*. [↑](#footnote-ref-15)
16. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 146. [↑](#footnote-ref-16)
17. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 146 (affirming that “in a public context, a race to collect can easily develop; creditors ‘tumble over each other’ as they seek to get paid in advance of their sister creditors. This frequently also involves petitioning for liquidation of the debtor (in order to enforce payment). However, these developments place the company in a(n) (even more) vicious circle. This phenomenon is, therefore, often seen as the self-fulfilling prophecy-effect of a public procedure. The negative effects upon management and the missed opportunities as a result of publicity of procedures can also be characterized as opportunity costs. In an informal reorganization, these costs are (considerably) less—especially because of the relative silence—than is the case in a formal reorganization”). [↑](#footnote-ref-17)
18. *Ibidem*. [↑](#footnote-ref-18)
19. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 146. [↑](#footnote-ref-19)
20. *Ibidem,* p. 135. [↑](#footnote-ref-20)
21. See PAJUNEN, Kalle. Stakeholder influences in organizational survival. *Journal of Management Studies*, v. 43, issue 6, p. 1261-1288, September 2006. [↑](#footnote-ref-21)
22. See SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. *British Journal of Management,* v. 12, p. 183-199, 2001. [↑](#footnote-ref-22)
23. See SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. *Journal of Management Studies*, v. 50, issue 7, p. 1216-1244, November 2013. [↑](#footnote-ref-23)
24. See ADRIAANSE; KUIJL, *op. cit.*, p. 140. [↑](#footnote-ref-24)
25. ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 140-141. [↑](#footnote-ref-25)
26. See also SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. *British Journal of Management,* v. 12, p. 183-199, 2001, p. 185 (affirming that “[t]he efficiency/operating turnaround stage aims to stabilize operations and restore profitability by pursuing strict cost and operating-asset reductions”). [↑](#footnote-ref-26)
27. See PAJUNEN, Kalle. Stakeholder influences in organizational survival. *Journal of Management Studies*, v. 43, issue 6, p. 1261-1288, September 2006, p. 1265 (stating that governing stakeholders have a direct influence on an organization’s survival). [↑](#footnote-ref-27)
28. *Ibidem*, p. 1279. [↑](#footnote-ref-28)
29. See SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. *Journal of Management Studies*, v. 50, issue 7, p. 1216-1244, November 2013, p. 1218. [↑](#footnote-ref-29)
30. See ADRIAANSE; KUIJL, *op. cit.*, p. 141. [↑](#footnote-ref-30)
31. *Ibidem*, p. 142. [↑](#footnote-ref-31)
32. *Ibidem*. [↑](#footnote-ref-32)
33. See PAJUNEN, Kalle. Stakeholder influences in organizational survival. *Journal of Management Studies*, v. 43, issue 6, p. 1261-1288, September 2006, p. 1280. [↑](#footnote-ref-33)
34. It seemed that the Flow Management Group failed to look ahead and propose long-term solutions from the outset, limiting their proposals to short-term measures that only delayed negotiations toward a long-term restructuring agreement. See SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. *Journal of Management Studies*, v. 50, issue 7, p. 1216-1244, November 2013, p. 1225 (stating that “[p]resenting a detailed recovery plan can thus convince stakeholders of the firm’s long-term potential for breakthroughs, which will help ensure their support for short-term retrenchment measures”). [↑](#footnote-ref-34)
35. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006,p. 143. [↑](#footnote-ref-35)
36. *Ibidem*. [↑](#footnote-ref-36)
37. *Ibidem*. [↑](#footnote-ref-37)
38. See SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. *British Journal of Management,* v. 12, p. 183-199, 2001, p. 184 (affirming that “[a] change in top management is tangible evidence to bankers, investors and employees that something positive is being done to improve the firm’s performance, even though the cause of poor performance may have been beyond management’s control”). [↑](#footnote-ref-38)
39. See MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, v. 5/6, issue 1, p. 21-41, 2004, p. 30. [↑](#footnote-ref-39)
40. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 144. [↑](#footnote-ref-40)
41. See also SUDARSANAM; LAI, *op. cit.*, p. 187 (stating that “[f]inancial restructuring is the reworking of a firm’s capital structure to relieve the strain of interest and debt repayments […]”). [↑](#footnote-ref-41)
42. See ADRIAANSE; KUIJL, *op. cit.*, p. 145. [↑](#footnote-ref-42)
43. Likewise, see SUDARSANAM; LAI, *op. cit.*, p. 185 (stating that a financial restructuring via debt restructuring means “a transaction in which an existing debt is replaced by a new contract, with one or more of the following characteristics: (1) interest or principal reduced; (2) maturity extended; (3) debt-equity swap”). [↑](#footnote-ref-43)
44. See SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. *Journal of Management Studies*, v. 50, issue 7, p. 1216-1244, November 2013, p. 1237 (affirming that “[r]etrenchment acts as a resource provider in the initial turnaround stage (Pearce and Robbins, 2008), but it is also essential to regain stability in the face of strategic change in the advanced turnaround stage. While recovery drives strategic change in the advanced turnaround stage (Barker and Mone, 1994), it is also an important means to direct retrenchment in the initial turnaround stage”). [↑](#footnote-ref-44)
45. See INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 18-23. [↑](#footnote-ref-45)
46. See GUZMAN, Andrew T.; MEYER, Timothy L. International soft law. *Journal of Legal Analysis*, v. 2, n. 1,p. 171-225, Spring 2010. [↑](#footnote-ref-46)
47. See INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 4. [↑](#footnote-ref-47)
48. See JACKSON, Thomas H. *The logic and limits of bankruptcy law.* Washington: BeardBooks, 2001, p. 12-14. [↑](#footnote-ref-48)
49. See INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 13. [↑](#footnote-ref-49)
50. *Ibidem*, p. 17. [↑](#footnote-ref-50)
51. George A. Akerlof gives the famous example of the used car market to show how informational asymmetries may cause assets to be undervalued, which, in Flow Management Group’s case, would lead to inadequate restructuring proposals that might impose a greater-than-necessary loss to the debtor’s controlling shareholder, or a lower-than-expected return for the Group of Banks, for instance. See AKERLOF, George A. The market for “lemons”: quality uncertainty and the market mechanism. *The Quarterly Journal of Economics*, v. 84, n. 3, p. 488-500, August 1970. [↑](#footnote-ref-51)
52. The fact that the information provided by Flow Management Group was later found to be inaccurate and insufficient signaled to the Group of Banks, especially to Banks C and D, that the debtor did not have their house in order and was not employing their best efforts to negotiate a consensual solution to their financial distress. Regarding the notion and importance of signaling, see SPENCE, Michael. Job market signaling. *The Quarterly Journal of Economics*, v. 87, n. 3, p. 355-375, 1973. See also GREENWALD, Bruce C.; STIGLITZ, Joseph E. Externalities in economies with imperfect information and incomplete markets. *The Quarterly Journal of Economics*, v. 101, n. 2, p. 229-264, 1986. [↑](#footnote-ref-52)
53. See INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 26. [↑](#footnote-ref-53)
54. See UNCITRAL. *Legislative Guide on Insolvency Law:* parts one and two. New York: United Nations, 2005, available at: https://bit.ly/3mEMBiB. [↑](#footnote-ref-54)
55. *Ibidem*, p. 24. [↑](#footnote-ref-55)
56. *Ibidem,* p. 25. [↑](#footnote-ref-56)
57. See THE WORLD BANK. *Principles for Effective Insolvency and Creditor/Debtor Regimes.* Washington-DC: The World Bank, 2021, available at: https://bit.ly/3bvAjCN. [↑](#footnote-ref-57)
58. See THE WORLD BANK. *Principles for Effective Insolvency and Creditor/Debtor Regimes.* Washington-DC: The World Bank, 2021, p. 7, available at: https://bit.ly/3bvAjCN. [↑](#footnote-ref-58)
59. *Ibidem*, p. 19. [↑](#footnote-ref-59)
60. See Insolvency and Creditor Rights Standard, 20 January 2011, available at: https://bit.ly/3q7ADjk. [↑](#footnote-ref-60)
61. See THE WORLD BANK, Principles for Effective Insolvency and Creditor/Debtor Regimes: brief. 19 November 2015, available at: https://bit.ly/3waCyoh. [↑](#footnote-ref-61)
62. See ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 136. [↑](#footnote-ref-62)
63. See SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. *British Journal of Management,* v. 12, p. 183-199, 2001, p. 185 (stating that “[f]inancial restructuring is the reworking of a firm’s capital structure to relieve the strain of interest and debt repayments and is separated into two strategies: equity-based and debt-based strategies. Equity-based strategies cover dividend cuts or omissions and equity issues, i.e. rights issue, public offer or institutional placing. Firms in financial distress tend to reduce or omit dividends due to liquidity constraints, restrictions imposed by debt covenants, or strategic considerations such improving firm’s bargaining position with trade unions (...). Debt-based strategies refer to the extensive restructuring of firm debt. Firms restructure their debt either to avoid financial distress or to resolve an existing financial distress. Gilson (1989, 1990) defines debt restructuring as a transaction in which an existing debt is replaced by a new contract, with one or more of the following characteristics: (1) interest or principal reduced; (2) maturity extended; (3) debt-equity swap”). [↑](#footnote-ref-63)
64. See ADRIAANSE; KUIJL, *op. cit.*, p. 145. [↑](#footnote-ref-64)
65. See SUDARSANAM; LAI, *op. cit*, p. 184. [↑](#footnote-ref-65)
66. See KUIPERS, Paul. Netherlands. In: NEWMAN, Peter K. (Editor). *The Restructuring Review*. 14 ed. London: Law Business Research, 2021, available at: https://bit.ly/3wk3m5S. [↑](#footnote-ref-66)
67. See HOOFF, Job van; NIJKAMP, Daisy. Netherlands. In: BAINS, Jat (Editor). *Restructuring & Insolvency.* London: ICLG, 2021, available at: https://bit.ly/3jXkqcT. [↑](#footnote-ref-67)
68. *Ibidem*. [↑](#footnote-ref-68)
69. See COSTA, Daniel Carnio; MELO, Alexandre Correa Nasser de. *Comentários à lei de recuperação de empresas e falência*. Curitiba: Juruá, 2021. See also SACRAMONE, Marcelo Barbosa. *Comentários à lei de recuperação de empresas e falência*. 2 ed. São Paulo: Saraiva, 2021. [↑](#footnote-ref-69)
70. See SACRAMONE, *op. cit*. See also BEZERRA FILHO, Manoel Justino. *Lei de recuperação de empresas e falência*: lei 11.101/2005: comentada artigo por artigo. 15 ed. São Paulo: Revista dos Tribunais, 2021. [↑](#footnote-ref-70)
71. See COSTA; MELO, *op. cit*. See also SACRAMONE, *op. cit.*, and BEZERRA FILHO, *op. cit.* [↑](#footnote-ref-71)