GLOBAL INSOLVENCY PRACTICE COURSE

(ONLINE)

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Case Study 1

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**REQUIRED**

Read and analyse the case provided and answer the questions that follow.

This case provides detail of the acknowledgement of poor trading results of a group of Companies known as Flow Management to its bankers in November 2013. Subsequently the

case records worsening events that call for a response from the various stakeholders affected by the effects of the trading outcomes.

The requirement is to respond to the issues through nine questions that reflect upon a distinct issue of the case providing opinion and recommendations in respect of that issue.

**QUESTION 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?

**ANSWER**

**Overview**

In a meeting convened for the purpose, the board of Flow Management Holding (FMH) advised the member banks that the earlier reported pre-tax profit, as of September 2013, of €8 million has, after adjustments, turned out to be a loss of €5.4 million. The revised outcome for the period is a spread of €13.4 million.

The board explains that the reason for the change in outcome is attributed to large management bonuses, wrongful appropriation of a contingency gain, failure to achieve an accounted for capital gain and inadequate maintenance of reconciling standard costing to actual costings.

**Suggested cause of the financial distress**

Although the reasons of why the overstatement of previously reported profit may be accurate, it does not accurately address the causes of the losses. The larger question to be considered is whether the newly reported result is caused by a failure of management.

There are three reasons which suggest that management has failed. The first is that it has taken more than one year to recognise that its 2012 accounts were overstated by €8 million. The second is that management contends that accounting shortcomings are the cause of its situation. The third is a proposition that the situation can be rectified by performing better in the marketplace.

Management failure has been defined by Cameron, Sutton and Whetton and as cited by Mellahi and Wilkinson[[1]](#footnote-1) “*as a deterioration in an organisations adaption to its microniche and the associated reduction of resources within the organisation*”. In the fact situation of this case, management has failed to accurately identify, and pointedly respond, to the underlying causes that have been picked up by accounting corrections. In addition, the proposed corrective measures (extract greater gross profit from the marketplace), bear no resemblance to the losses highlighted nor is any attempt made to infer a relationship with the causes and the solution. It is acknowledged that the implementation of price rises will be helpful, but no connection is drawn between the need for greater gross profit and the failure to reconcile standard costing to actual costing.

Importantly, management does not appear to be conscious of the reduced liquidity that should have been observed as a result of the losses in YE 2012. On that point, the work prepared by Mellahi and Wilkinson[[2]](#footnote-2) is relevant. The authors propose that schools of thought on business failure stem from determinism or voluntarism[[3]](#footnote-3) and that there is a divide between them. In more simple terms the theories suggest that causes of business failure are either external, or internal to the organisation.

The facts of the case suggest that management lacked the interpretive skills to comprehend the inevitable reduced working capital, compared to what should have existed if the reported profits from YE 2012 were to be believed. Such a failure is consistent with the idea that corporate failure is often underpinned by voluntaristic shortcomings.

The proposition is supported by Larsen and Clute (1979) as cited by Mellahi and Wilkinson[[4]](#footnote-4) where they say that “*the characteristics shared by failed firms are directly related to personal decision-based characteristics of managers*”. With that in mine, it is my view that the cause of the financial distress is directly related to the “*mental models*”[[5]](#footnote-5) that appear to be characterised in the stayed *(constrained by their existing commitments)[[6]](#footnote-6)* and blunt perspectives, that management held. This is illustrated by the proposed way for remedying of the situation was to be found in placing attention on sales and costs.

This view is supported when recognising that management paid out large management bonuses ostensibly on the basis that such payments would earn the business positive future outcomes. However, viewed retrospectively, the bonuses should not have been paid because they were not deserved – knowledge of which should have been known by management. This not only reveals a shortcoming in reporting requirements but a lacking in managements intuitive skills as to the business’s performance.

**Could the financial distress have been prevented?**

Management arguably misguides itself when predicting a profit will be made again in just two months. Although the correction from loss to profit is unrealistic, the expectation of an increase in sales does confirm that a market for the service delivery does exist. Information provided in the case records that competitors also exist in the marketplace. This provides further evidence that demand side is not an issue of concern.

On the presumption that competitors are financially sound, it would suggest that failure factors relating to Industrial Organisation or Organisational Ecology[[7]](#footnote-7) are not the reason for the failure of Flow Management. This supports the contention that failure arises from internal factors and accordingly rest with management.

To have been in a position to prevent the financial distress, management would first need to know, *ex ante,* what caused the issues that accounting has reported on. The explanation provided to the bankers - defining how the situation will be corrected, suggests that managements mind set is to do little more than what it has already been doing with perhaps some tweaking - increasing prices and running the ruler over expenses. Mellahi and Wilkinson contend[[8]](#footnote-8) that management will do the things that it has done in the past and *“reinforce well-earned past routines and procedures”*. In this fact situation, persistence of past practice, is likely to do little more than leverage the failing drivers already in place. This observation suggests that the financial distress would not be averted unless, and until, management turns a searching mind to the causal relationship of its financial situation.

**Conclusion**

The operating mandate of management is to efficiently engage the resources of the business to achieve the best possible outcome in all the circumstances. In this situation, there does not appear to be external factors that have caused the financial distress. The corollary is that internal factors are responsible, and the existence of those factors firmly rests with management. As a result it is suggested that the viability of the business will continue to be at risk until management engages in deeper analysis and broader insightfulness into its voluntarist approach to optimising outcomes.

**QUESTION 2**

What are in general advantages and disadvantages of an out of court restructuring (workout) as compared to a formal bankruptcy procedure? More specific, what are the advantages versus disadvantages in your country?

**ANSWER**

For this response, out of court restructuring is deemed to be a reorganising of the affairs of the company without reference or recourse to either the court for adjudication or enforcement. The process is said to be conducted in the shadow of the law. It is suggestive that any such process is an alternative to a procedure determined by a statutory framework. In this discussion, reference will be made to an article authored by Adriannse and Kuijl[[9]](#footnote-9) where appropriate.

**INFORMAL PROCEDURE**

The purpose of any recovery procedure is to restore the economic health of the company. The intrinsic value of conducting an informal procedure is captured in the three features of flexibility, silence and control.[[10]](#footnote-10)

**Flexibility**

Flexibility is a critical feature of any turnaround process. This on the ground that the parties that are responsible to achieve an effective outcome are able to use all their wiles without the constraints that typify a formal procedure. In this unrestricted landscape, a better outcome is expected to be achieved due to the malleability of persons involved, time efficiency in achieving outcomes and cost savings that are likely to result.

At all times, any agreements reached will need to meet a legal test of reasonableness, as well as ensuring settlement arrangements are not designed to defeat rights that would exist in formal proceedings. Provided restructuring arrangements are made in the faith of those requirements, parties can strike deals that will suit themselves and be structured to fit the desired outcome.

**Silence**

While disclosure is a vital requirement of formal recovery proceedings, there is a powerful negative impact that can land upon other service providers if there is a hint of loss that they may have to bear. In occasions of broad dissemination, all creditors affected will manifest heightened interest in their exposure and may proactively strive to achieve settlement by way of leverage or by means of self-help. An informal procedure can minimise that risk by keeping issues contained to the parties directly affected.

**Control**

Control is the manifestation of authority to deal with issues that are relevant to the turnaround process. The persons that will have the knowledge of the insolvent circumstances are usually the parties that are directly affected. A delegated authority to an independent person, as would be expected in a formal state of insolvency, will result in a knowledge gap within the appointed person, of the business resources that they have become responsible for.

The nuances and interpretations of business issues will rest with the persons that have been involved in the activities of the business. These subtilities are vital to achieving economically efficient outcomes. Moreover, the parties that are directly involved have more to win, or lose, and are expected to be more keenly interested in the outcome which should result in a more focussed view.

**ADVANTAGES AND DISADVANTAGES**

The advantages and disadvantages of an informal procedure are set out below.

**Advantages**

A significant advantage is flexibility – owners and affected parties can work out a solution that optimises their respective interests.

A second advantage is that, throughout the process, management remains in control of the business activity. This minimises the disruption that arises from the engagement of independent persons who are constrained by the rigors of statutory requirements.

Privacy is also a significant advantage. Keeping the issues confined to the affected parties minimises the risks of reaction from other parties that may not otherwise be affected.

Savings are also a big advantage. The process can be achieved in a much more time efficient manner with perhaps just the guidance of an independent specialist - compared with a full team of engaged people to conduct a formal process.

**Disadvantages**

A disadvantage will occur when management exhibits the will but does not have the knowledge or skills to hone down the issues, and to achieve the best result in the circumstances.

In a similar vein, management may have the desire, but does not have the inertia to strive toward an end goal. Consequently a disadvantage will occur in the form of unrealised outcomes.

A further disadvantage is that the aspiration to engage without formalities, leaves the process bare of any legal framework to fall back upon if negotiations do not proceed as desired.

A lack of reality may also exist within management, as to the ability of the business to return to viability. Keeping a business operating in a setting of little, or no hope, will cause a significant disadvantage to creditors if immediate liquidation would have returned a better dividend.

**Advantages and Disadvantages in New Zealand**

The advantages and disadvantages in New Zealand are similar to those identified above but scaled relative to the size of businesses in New Zealand.

In the corporate context there are three formal states of insolvency: Voluntary Administration, Liquidation and Receivership. Voluntary Administration is the legislative process that is designed to determine whether the business has the potential to survive or whether immediate liquidation would be better for creditors.

There is a relatively low uptake in New Zealand for Voluntary Administration despite the fact that it offers the potential for a safe harbour for directors as well as a structured process for business recovery.

This suggests that, electively, there are informal processes being conducted by and between the company and the suppliers of credit. The possible explanation for this is that business owners have a perception that formal processes spell a death knell for the company.

Some of the advantages of informally dealing with insolvency issues are as follows.

1. The issues can be resolved with the same flexibility, silence and control already addressed.
2. The internal economy of the business can be manipulated to focus on some suppliers while aging others.
3. Given the community aspect of New Zealand business, it is more likely that resolve can be achieved where personal relationships feature as an element of the proceedings.

Some disadvantages are listed below of when an independent person, with appropriate skills, is not involved.

1. Knowledge of insolvency processes are not well understood. This will often result in informal processes being conducted without reference to the priorities of preferential creditors and the rights of secured creditors.
2. Often informal processes will be embarked upon involving the introduction of new capital, without any reasoned justification for increased investment. Family and friends’ money is often exposed as a result.
3. Keeping the business going without any realistic hope of returning to viability will keep feeding the will of management but may very well diminish the value for creditors. Survival for survival’s sake is not a justification for continuing the business.

**QUESTION 3**

Were the turnaround/reorganisation approaches as presented in the reading material (see e.g. Adriaanse & Kuikl, 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.

**ANSWER**

**Company’s Approach to the Insolvency**

**Initial strategic response**

On learning of the trading losses as of November 2013, the company submitted to the banks that it’s approach to turning the business around was to engage with its major clients for the purpose of increasing prices. The expectation would be an increase in gross profit. The stated intent was to negotiate with its major clients, exhibiting sensitivity, to ensure that dictating new prices did not result in a severance of the relationship and a move toward competitors.

The company also intended to notify other clients of price increases and absorb, ostensibly with some indifference, client losses if they were not accepting of the increased prices. The underlying thinking being that more gross profit will be earned, than lost, when comparing increased margins over lost clients because of the price increases.

The second limb of the strategy was that the company would assertively cut costs and in particular, labour costs. It is anticipated that labour costs represent a significant portion of all operating expenditure.

The initial strategy therefore was to extract from the market, the highest gross profit that customers would tolerate while at the same time strive to reduce expenses from within the labour pool expense category.

The facts show that implementation of the pricing strategy did leverage the brand to achieve better prices. In addition, redundancies were made that will have resulted in an immediate benefit of improved cash flow and profit gains. The company also reduced its cost of sales by transferring a portion of the insurance cost to the consumer.

**Intermediate strategic responses**

Given knowledge that the predicted losses were greater than earlier expected, management took further strategic measures. It improved its information systems, restructured its foreign subsidiaries, engaged further management skills by employing a new CFO and considered the introduction of new shareholder capital.

**Final strategy to be adopted**

As matters become clearer and pressure became present from the banks, management submitted the following action steps.

1. Focus on increasing turnover
2. Effect large cutbacks
3. Evaluate and assess the potential to change the product mix
4. Sell the shares of subsidiary companies that are foreign to the home country.

The final strategy can be defined as retrenchment of activity, consolidation of offerings and divestment of assets to liberate capital.

**Reference to Reading Material**

**Stakeholder influences in Organisational Survival**

The creation and continued existence of any business activity is conducted through its human actors. The achievements and outcomes of that business are a reflection of the people that manage its affairs. Their stake in the business interests is measurably effectual and carries significant importance to the welfare of the business. The different players are the stakeholders in the business.

In existence threatening circumstances, cognisance of the stakeholders, and their relative importance, is material to the recovery of the business. In a study on the topic by Pajunen[[11]](#footnote-11) (2006), he contends that stakeholders can be divided into three categories - governing, potential or minor.[[12]](#footnote-12) The degree of power a stakeholder may have, relates to the extent of dependency the focal organisation has in that stakeholder.[[13]](#footnote-13)

Pajunen (2006) concludes that stakeholder influence stems from two factors - the extent of power a stakeholder has in influencing the firms direct resource dependence that is essential to its survival - and the power a stakeholder has in influencing the firms network position that is essential to its presence.

The case suggests that the respective parties were not cognisant of stakeholder relevance until the achievements of the newly appointed CRO became evident. From the facts, it can be seen that the CRO did comprehend that a direct resource dependence existed with the banks and that meeting the banks needs was critical to the reversal of the company’s existence threatening crisis. Prior to that event, there is no evidence that the parties recognised the relevance of stakeholder influence on organisational survival.

I submit that management did not follow the Pajunen approach. If management had been conscious of stakeholder relevance, it could have gained the benefit of contributively based power that would result.

**The Duality of Retrenchment and Recovery**

Approaches to corporate turnaround activity typically sees effort start with retrenchment and then move on to activities of a recovery nature. The two activities, from a conventional wisdom perspective, are considered to be separate and distinct. On the one hand, retrenchment is a contracting activity for the purpose of increasing control and reducing expenditure. On the other, recovery operates in a mode of outward looking expansiveness. The two dynamics are intuitively inconsistent with each other.

In a study undertaken by Schmitt and Raisch[[14]](#footnote-14) (2013), it is contended that the two activities are simultaneously contradictory and mutually reinforcing[[15]](#footnote-15). They assert that turnaround success is achievable when the firm integrates contradictory, yet interrelated, retrenchment and recovery activities[[16]](#footnote-16). This suggests that, within the layers and nuances of the two blunt modes, ways exist of being expansionary while retrenching. Moreover it suggests that correcting an existence threatening situation is not achieved by following strict rules of convention but rather by understanding the needs of the firm so that its future prospects can be improved.

In the case, it is recorded that management planned a strategy with four limbs – increase turnover, cutback expenditure, change product mix and sell assets (shares in subsidiary companies). Two limbs are consistent with retrenchment and two are consistent with expansion. The important question for consideration, is whether the mix was deliberate or whether the choices were ad hoc without any rationale for their choice. Although the banks acknowledged progress through the CRO, I suggest that the mix of strategy options were more naively grasped, as valid things to do, than a consideration of any synergistic benefit between them.

Despite a strategy that expressed dual emphasis, I do not consider that management understood the potential for adopting a dual retrenchment and recovery strategy. For the strategy adopted to be successful, management would need to understand the concept of duality and harmonise the different limbs together to produce a finessed outcome.

**Effectiveness of restructuring**

Management of a firm facing an existence threatening crisis must act in a manner that strives to avoid the collapse of the firm and potential liquidation. In a study undertaken by Sudersanam and Lai[[17]](#footnote-17) the authors posited that there were five generic strategies – operational restructuring, asset restructuring, asset divestment, asset investment and financial restructuring.

As an overlay, to the implementation of the generic strategies, exists what the authors identify as control variables.[[18]](#footnote-18) They record them to be, severity of decline, internal problems, industry condition and economic condition. The deduction to be made, is that the effectiveness of any turnaround, is in large part, due to the appropriateness of the strategy chosen and the ability of management as regards the control variables. The study illustrates that success of achieving a return to the outcomes the firm enjoyed before the distress, pivots to a very large degree upon intensity of action, effectiveness of execution and the degree of expansionary vision involved.

In the case being considered, management held an expansionary vision when it proposed an asset investment strategy that included a change to the product mix and a focus on increasing turnover. In addition, it had intended to embark upon an operational restructuring that would strive to achieve large cutbacks, as well as an asset divestment strategy that involved selling its offshore subsidiaries. if the four independent strategies were a part of an intended cohesive whole, the plan would have merit. However, on reading the case, it does not seem that managements strategizing was the result of a deliberate plan to interweave different strategic activity into a reasoned whole.

In my opinion, management did not either understand or follow any conventional approach to its reorganisation. For the strategy to be successful, management would need to understand the decline it was confronting, as well as why it was not able to be informed of its economic circumstances in a timely way.

**Formal versus informal restructuring.**

Action to remedy an existence threatening circumstance can be undertaken by adopting formal insolvency processes or by addressing the issues by informal means. Analysis undertaken by Adriaanse and Kuijl[[19]](#footnote-19) (2006) suggest that correcting a firm’s reorganisation requirements, are often best undertaken by adopting informal processes.

The authors contend that successful informally undertaken reorganisations are frequently characterised by quick and adequate[[20]](#footnote-20) attention to the requirements of reorganisation. They identify that speed and adequacy will be underpinned by five factors: active attitude of management and shareholders, involvement of important interested parties, engagement with third parties for the operations reorganisation, transparency and risk bearing capital[[21]](#footnote-21).

The case suggests there to be a very strong potential to manage the difficulties it was confronting, had a sense of urgency existed. The facts show that

1. The Banks are prepared to engage in a reorganising strategy.
2. There is transparency between the company and its Bankers.
3. The shareholder is prepared to inject fresh capital.

Despite those significant elements in place, the company lacks the focus to become decisive about its affairs and constructive with any realistic plan to correct its circumstances in a timely way. On that ground, an informal process is not likely to be successful unless, and until, management exhibits that skill and urgency are required to remedy its circumstances.

It is my opinion that management did have an open mind as to whether it could resolve its issues by formal or informal means. The facts do suggest that there was scope to be decisive about its situation and remedy the difficulties by informal means. However, to do so, management would need to be purposeful and focussed on the need to harmonise all stakeholders to achieve that outcome and it clearly fell short of achieving that objective.

**QUESTION 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?

**ANSWER**

**Overview**

Risk is an integral part of commerce. An investor expects an appropriate return on time and resource employed. Typically banks that provide asset funding or working capital requirements are not risk lenders. The interest rate charged is reward for the use of the banks money.

Management has placed the banks in a position that it appears it has not bargained for. The risk it now confronts, because of the shortcomings of management, is that it may be faced with a write down of its funds invested.

The information records that there are four banks involved. There appears to be an alignment in thought between A and B, as one group, and C and D as a second group.

Discord has manifest between the two groups as well as between all the banks and management of the company. The basis for the discord, as between all the banks and management, is the banks lack of confidence in management. As between the two groups of banks, the price of failure may be paid disproportionately by banks C and D.

**Action by banks C and D**

The case records that banks C and D are no longer fully aligned to any recovery plan and that they would prefer to liquidate their position in the company. Reasons for adopting this stance will be ground in their interpretation of risk.

The risk factors able to be gleaned from the case are set out below.

1. Competency of management is questionable given the strategies posed as being able to avert a deepening existence threatening circumstance.
2. The time taken to initiate corrective measures, regardless of their validity, is too long given the severity of the situation.
3. The ability to accurately identify the full extent of the exposure is apparent.
4. The shareholder is not as forthcoming to introduce new capital as should be expected in the circumstances.
5. There is no movement by management to displace itself with persons that specialise in the tasks of business turnaround. The CRO was engaged by the banks.

Banks C and D can justify an exit strategy on the following grounds.

1. On the basis of the five points identified above, confidence in obtaining a return of the capital invested, by way of a turnaround, may be more unlikely than likely.
2. Recourse in the assets of the company may be suspect given that the security agreements may not be enforceable.
3. Exposure between the two bank groups appear to be unequally spread.
4. Although an exit may cause a right down, the loss will be certain, whereas hope associated with staying may result in a worse outcome.
5. Timing is important and leveraging C and D’s position at the right time will likely improve their realisation value.

**If I were acting for A and B**

If I were engaged by banks A and B, and in the normal circumstances of having secure pledges, I would carefully consider the risk profile of continued involvement based in hope. I would then balance that potential against the certainty of early, but definite, realisation.

There is though, the nagging uncertainty regarding the enforceability of the security pledges and the economic consequences of that risk if a recovery plan was not successful.

There is consideration that A and B may assume C and D’s position for a discounted price. Given the risk of enforceability of the bank’s security interest, it is my view that this could only improve A and B’s position if it allowed it to be more effectively decisive. In the counterfactual, A and B would significantly increase their losses if the recovery plans failed, and reliance was placed in the pledges which proved to be unenforceable. The decision to acquire C and D’s interest, must be based in achieving such a strong level of decisiveness that the recovery plan will be effective, and the need to fall back upon the security pledges is minimised.

There appears to be a waiting game as between management and the shareholding interests in one camp, and the banks in the other. This suggests that neither side has sufficient power to force the other to action. While acquiring C and D’s position could, on its face, alter the dynamics, it may work to bank’s A and D disadvantage given the human influence that the bankers of C and D will bring.

It is suggested that, rather than to take C and D out of the mix, a better approach would be to become more unified and present a more determined approach upon management to perform.

**QUESTION 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)?

**ANSWER**

A statement of eight principles have been formulated by INSOL International[[22]](#footnote-22) for the purpose of achieving a best practice approach to multi creditor workouts.[[23]](#footnote-23)

For the purposes of this discussion the relevant creditors referred to in the principles are the four banks. The relevant creditors are claimants in the debtor company.

Of the eight principles, I submit that only five have been adhered to in the case being considered. Each are addressed separately.

**Third Principle**

The Third Principle**[[24]](#footnote-24)** requires that the debtor should not take any action that will adversely affect the return to relevant creditors after the standstill commencement date.

The standstill agreement was executed during August 2014 and the debtor appears to have acted consistently with this principle by entering into a seven limbed restructuring plan and subsequently complying with its terms.

**Fourth Principle**

The Fourth Principle**[[25]](#footnote-25)** requires that the interests of relevant creditors are best served by coordinating responses through a single body and that professional advisers should be engaged to assist recovery plans.

The debtor did not appear to resist this principle but neither did it actively promote the coordination of responses through a single body or engagement of professional advisors. Despite that, there was acceptance of the bank’s engagement of a Chief Restructuring Officer and the requirement of this person to sit on the board. It is suggested that the CRO was instrumental in coordinating responses and did become an effective professional advisor.

**Fifth Principle**

The Fifth Principle**[[26]](#footnote-26)** requires that, during the standstill period, the debtor should be open and willing to provide information to relevant creditors, and their advisors, in a timely way so that proper evaluation can be undertaken, and proposals made to the relevant creditors.

Management does appear to meet the purpose and intent of this principle. Although in the lead up to the execution of the standstill agreement, the information fell short of recording accurately the full picture, there seems to be a genuine attempt to provide information in a timely way.

**Sixth Principle**

The Sixth Principle**[[27]](#footnote-27)** requires that any proposal submitted for consideration by the relevant creditors should reflect applicable law and the positions of relevant creditors as at the standstill commencement date are to be preserved throughout the standstill period.

The debtor, and the relevant creditors have complied with the essence of this principle from the execution date of the standstill agreement. The facts record that the financing restructuring agreement, as regards the financiers involved, has preserved their relevant position and the expectations of the debtor company are intended to be met.

**Eighth Principle**

The Eighth Principal**[[28]](#footnote-28)** requires that parties that provide funding during the standstill period are accorded a super priority ahead of all other pre standstill claimants.

The facts show that the shareholder has demonstrated willingness to contribute €35 million if a standstill agreement is executed. While only €25 million is repaid to the shareholders it is ahead of any distribution to the Banks which suggests conformity to such an agreement.

**Endnote**

For completeness I comment with my view as to why the first, second and seventh principle were not found in the workout process.

The first principle requires that the parties co-operate with each other for the purpose of executing a standstill agreement so that an evaluation process can be undertaken. The first notice of the financial difficulties was provided to the banks on 16 November 2013, but a standstill agreement was not executed until August 2014. During the intervening period, only a dismal attempt was made at providing worthwhile information to the banks, and valuable time was lost in commencing the investigative process so a recovery plan could be initiated.

The second principle requires that the status quo, by and between relevant creditors, will remain during the standstill period. However, in the Restructuring Agreement reached, banks C and D had their entire debt written off in one of the companies in the group, with a suggestion that their position was compromised as regards this principle.

The seventh principle requires the need for transparency of the supply of information across all relevant creditors where a proposal is being formulated, and that confidentiality should otherwise prevail. It is noted that a public statement was made in the form of a press release that reported an expected trading loss of €39 million. There is no suggestion that there was any legal obligation to do so nor that all parties agreed to the announcement.

The case material exhibits weak adherence to the principles espoused as being best practice. The explanation for this is most likely to be low awareness of how the parties should conduct themselves to achieve the best possible outcome in all the circumstances.

**QUESTION 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.

**ANSWER**

**What is soft law?**

Soft law is generally understood to be law that is not binding on the parties. The corollary being that hard law is binding on the parties that agree to be bound. While the distilled definition of non-binding law may be easily conceptualised, it is too simple when considering the context and the basis of its existence.

In an article by Wessels and Boon[[29]](#footnote-29) (2019) the authors cite Abbott and Snidal[[30]](#footnote-30) by quoting that “*hard and soft law are concepts on a continuum with hard law at one end and political arrangements at the other end”.* The authors go on to say that an instrument will be considered hard law when it refers to binding obligations, provides precise obligations and delegates authority for the interpretation of those obligations.[[31]](#footnote-31) Soft law, in contrast, will be found in an instrument that will strive to achieve a desired outcome but will not be enforceable by, and between, the parties.[[32]](#footnote-32) An example of soft law are the eight principles advocated in the Statement of Principles for a Global Approach to Multi-Creditor Workouts II referred to in question 5.

For the Statement of Principles to be adopted, with any sense of purpose and desired outcome, they would first need to be understood, and a common view held as to adherence with them. In my response to Question 5, I have observed that five of the eight principles can be identified in the activity between the parties. That is not to say though, that the parties recognised them, and adhered to them, with any sense of deliberate intention.

The issue for consideration is whether the other creditors will adopt the processes agreeable to the parties. Obligations for taxes, employee entitlements and non-party creditors, secured or unsecured, will be affected by the recovery processes being considered. The facts do not show any recognition of these claimant groups and yet their continued commitment will be essential to any plan to rehabilitate the business.

If the other creditors are not convinced that due and proper consideration has been given to their interests, then the scope of agreements will need to broaden to ensure that they do.[[33]](#footnote-33) An example of how this may be achieved is, acknowledgement of contributing creditors rights, and the establishment of a Creditor Committee. Support for this can be found in works prepared by the World Bank[[34]](#footnote-34). At paragraph C7.1 of that work it notes that best practice would ensure that *“Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors’ committee as a preferred mechanism, especially in cases involving numerous creditors.”* Paragraph C7.2 outlines the framework of a creditor committee including its rights, roles and responsibilities.

Not being able to convince other creditors to adopt the Statement of Principles may well be because they feel excluded from the process, or inappropriately subordinated. In such circumstances, the use of any power that may exist by, and between them, to appoint a creditor committee will be useful to achieve a balance of rights – especially if the creditor committee is framed in an instrument comprising Hard Law.

On 7 November 2006 the Insolvency (Cross-Border) Act 2006 was assented to and adopted into New Zealand law. That Act states its purpose[[35]](#footnote-35) to be to implement the Model Law on Cross-Border Insolvency adopted by the United Nations Commission on International Trade Law[[36]](#footnote-36).

The UNCITRAL Model Law on Cross-Border Insolvency (“Model Law”) would be applicable Soft Law if the circumstances of the Case were to include New Zealand counterparties. If New Zealand based creditors were not convinced that the Statement of Principles adhered to by the restructuring parties served their interests also, then the provisions of the Model Law could be invoked.

Paragraph 1 d of Article 1 provides that the law applies where “*Creditors or other interested persons in a foreign state have an interest in requesting the commencement of, or participating in, a proceeding [identify laws of the enacting State relating to insolvency].”* In such circumstances the other creditors could see their position strengthened by reaching agreement that was inclusive with the use of Soft Law that is authorised by enactment in New Zealand.

**QUESTION 7**

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

**ANSWER**

**Overview**

The seven-point restructuring agreement is in essence a hive down of the business interests of the six trading companies to a new entity. Ownership of the new entity will be comprised of creditors that have supplied capital, and individuals that will be influential in achieving a commercial outcome. The intention of the restructuring process is for the realisation of the business to provide an exit route and a redemption of earlier investment.

**The essence of the restructuring agreement**

The agreement provides that the first step is for a new company to be incorporated in the Netherlands under the name Flow Management II BV (“FMII”). The incorporating shareholder is Flow Management BV (“FMBV”). On incorporation, the shareholding ownership of the six trading companies are transferred from FMBV to FMII. The effect of this transfer is that the business interests of the six trading companies are now owned by FMII. The first step of the hive down is completed with all creditor’s rights, at this stage, remaining unaltered[[37]](#footnote-37).

The second step is to allocate the shareholding interest in FMII to parties that will, as consideration for the allocation, forgive debt or pledge commitment. A parcel of shares of FMII are to be allocated to the consortium of banks (A, B, C and D) (“Consortium of Banks”) in consideration of the Banks forgiving, or writing off, their claim in FMBV.

A second parcel of shares are allocated to selected board members. It is presumed that the board members are investors in FMBV. Consideration for this parcel of shares is that claims, able to be made by Lease Group Holding BV The Netherlands (“LGH”), are forgiven or written off. The third parcel of shares have been allocated to the CRO with consideration most likely being a pledge involving a contract of employment containing performance expectations.

The effect of this second step is a debt for equity swap for the Consortium of Banks, the provision of shares to the investors in FMBV (assuming them to be the board members referred to), and an allocation to the CRO that will engineer, and execute upon, the plan for commercial recovery.

In addition, write-off will occur for any claims that LGH may have against FMBV and the subsidiaries that have been transferred to FMII. The agreements reached in this second step will preserve, in balance sheet terms, the relative interests of the parties in the operating activity and its future potential. It will not provide any interest to non-party or non-shareholding interests in FMBV. It is anticipated that FMBV will be liquidated at some time and the creditors not accounted for will make a claim for their rights to the liquidator.

The third step taken reflects a need for refinement of debt advances made to Flow Management Work BV (“FMW”). As at 16 November 2013, debt advances made to FMW were working capital of €360 million and other loans of €55 million, a total of €415 million. The agreement provides that Banks C and D will write off €32.5 million and the Consortium of Banks will write off €97.5 million and will cancel the €55 million loan. The total write-off against FMW is €185 million. The agreement provides that a €240 million claim against FMW will remain. The difference of €10 million is assumed to be capitalised interest.

**The result of the restructuring**

The result of the restructuring agreement has many factors for consideration. Some are identified below as discrete topics with a comment of their value where appropriate.

1. It is expected that in consideration of the write-offs in FMW, the Consortium of Banks established binding security agreements for its reaffirmed advance of €240 million. The market value of the business assets is likely to be greater than the reaffirmed advance and therefore altering, positively, the risk profile of that amount.
2. Although the banks have written off €185 million, they have gained an equity position in FMII. This will provide the potential for them to recover the written off amounts. The swap for debt to equity will provide a share in the net proceeds of sale that will be rateably distributed across all shareholders. Although it depends upon the realisation value of the business, there is a potential to recover some, or all, of the amounts written off.
3. The new legal entity (FMII) will be free from any issues that the business may have accumulated while in the hands of FMBV that were not realised at the date of transfer - such as government claims, claims in tort or contractual breaches. Becoming a business owner by way of acquiring the vendor’s shareholding interest, brings forward to the acquirer any undesirable historical issues that may exist.
4. The affairs of the company are now to be managed by a reconstituted board. This will cast the Banks, Board Members and the CRO into a co-operative role of governing a business for the specific purpose of readying it for sale. This may prove to be an advantage but on the other hand the Banks may realise that providing capital to a business, and running a business profitably, are two entirely different commercial ventures.
5. Creditors that have a claim in FMBV, that sit outside the restructuring agreement, will be discharged in the liquidation process. A benefit falls to the shareholders of FMII as it acquires the interests of the six trading companies net of those claims. This advantage will be conditioned by the need for the liquidator to confirm that the transfer of the interests was for adequate consideration.
6. The shareholders of LGH will share, rateably, in any benefit that will fall to the Consortium of Banks without any further investment. The agreement reconstitutes the rights of the respective parties. In normal circumstances it would be reasonable to expect something to be contributed if the reconstituted rights are likely to realise a benefit. The agreement provides that the only expectation from LGH is governance which is a very attractive arrangement for this investor.

**Conclusion**

Restructuring activity occurs when an existence threatening condition is determined for the business entity. It is an intervention to be laid over the body of the business for the purpose of preventing the inevitable circumstance of demise unless action is taken.

In this restructuring agreement, an attempt has been made to provide scope for recovery of the enterprise of the business. The purpose for doing so is that the business interests can be transferred to new owners for a value sufficient to redeem the exposure of its proponents.

Much is being asked of the governance of the restructured business to achieve that outcome. Especially since the board members will be empowered by shareholders that are more at home making banking investments than by turning a business around that operates in a mature and highly competitive industry.

The restructuring in my view will not necessarily achieve the desired objective for the want of having a highly skilled unit of people that are more focussed on the rehabilitation of the business than how to redeem creditor obligations.

**QUESTION 8**

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

**ANSWER**

The restructuring process is comprised of entities that are within many different jurisdictions. Cross-border issues will not only arise between the companies across different jurisdictions but will also surface from creditors that have a claim in a company within a particular jurisdiction. For the purposes of this discussion, I have grouped all entities into three groups.

The first group is comprised of Lease Group Holding United Kingdom Limited (“LGH”) and its investors. The country of ownership interest is expected to be the United Kingdom.

The second group is comprised of Flow Management II BV (“FMII”), the Consortium of Banks and the CRO. The country of investor and business interest is expected to be the Netherlands.

The third group is comprised of the six companies acquired by FMII. Their country of business interest is The Netherlands, Spain, France, Australia, South Africa and United States of America.

The case is suggestive that the centre of main interest for the three groups is the Netherlands.

Each group will have both common and particular interests and conflicts of law will prevail.

Examples of issues that may arise are listed below.

1. The Flow Management Holding BV (“FMBV”) ownership interest of the six operating companies has changed by way of a transfer of shareholding interest. Most contracts that bind parties will see such an alteration as material to the terms of the contract and perhaps render it impotent – leasehold interests are an example. This will include contracts instigated by the six operating companies with other parties in their jurisdiction.
2. A change in shareholding interest will be relevant to the governments and enforcement entities of the six operating companies with regard to foreign laws, compliance expectations and union membership.
3. A change of ownership may trigger a review of the respective operating company’s right to trade because it may, as a result of the change of ownership, breach competition laws.
4. The assumed reorganised security agreements in favour of the Consortium of Banks may not be enforceable in the relevant jurisdictions if the terms are inconsistent with local law or are too onerous.
5. If the initial pledges made to the Consortium of Banks were unenforceable, but now enforceable because of renewal, would they be voidable in the event of liquidation on the ground that it would be security for past advances.

Issues of the kind identified above, as well as those not identified, will inevitably involve competing interests that span different jurisdictions. In those circumstances, resolution will need to be found.

In aid of resolution, reference can be made to many instruments of Soft Law that are available internationally. A significant instrument describing means of resolution in insolvent circumstances that cross borders is the UNICTRAL Model Law on Cross-Border Insolvency. This model has been adopted by 53 different jurisdictions. The list includes Great Britain, Australia, South Africa and the United States of America – four of the eight companies involved in the restructuring agreement.

In addition to UNCITRAL Model Law there exists the EU Regulation on Insolvency Proceedings. This instrument was adopted by the EU Council on 29 May 2000 and is directly applicable to all member states of the EU and will be applicable to the jurisdictions of The Netherlands, Spain and France.

In this situation, four of the trading companies could seek to resolve cross-border issues with reference to the EU Regulation. The other four trading companies may approach cross-border issues with reference to the UNICTRAL Model law. While this suggests a potential for conflict to exist, it is evident that the different instruments have a similar purpose and that any conflict is capable of being harmonised to achieve an outcome that is consistent with the purpose of both instruments.

An alternative view is that the centre of main interest (The Netherlands) is in the EU and for that reason EU Regulation would apply to cross-border issues to be resolved.

**QUESTION 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]

**ANSWER**

**Voluntary Administration in New Zealand**

On 1 November 2007, New Zealand adopted into its Companies Act 1993, the Voluntary Administration regime[[38]](#footnote-38). Its founding purpose is to provide a formal means of implementing an effective rescue plan for a debtor company that is experiencing financial distress.

The new Part introduced into the Act records its objects to be to administer the business, property and affairs of an insolvent company in a way that maximises the chances of the company, or its business, to continue in existence[[39]](#footnote-39). In circumstances where that is not possible, to manage the affairs in a way that will result in a better return for creditors and shareholders, than immediate liquidation[[40]](#footnote-40).

The regime is a formal state of insolvency and is comprised of a template structure that is logical and which systematically frames essential limbs of a rescue model for a failing business. The important limbs are instanced below.

* The establishment of a moratorium that preserves the interests of all parties while a rescue plan is developed for submission to affected creditors.
* The turnaround activity can be conducted without Court involvement unless required. The parties that are affected elect how recovery will be implemented on the ground that it is their right to consider, and resolve upon, any proposal to correct the insolvency that will ultimately be priced to them unless corrected.
* The scheme is inclusive. The focus is on the business of the company and the ability for it to rectify its affairs for the purpose of redeeming all obligations to claimants in accordance with their rank and priority.
* The regime must be administered by an independent Registered Insolvency Practitioner. This should ensure that the necessary knowledge, experience and skills required are available to facilitate the best possible outcome. Direct recourse can be had to the Administrator where it is evident that he or she has fallen short of best practice.
* Obligations incurred in the name of the company, during an Administration, are statutorily deemed to be personal to the Administrator and cannot be contracted away.[[41]](#footnote-41) This ensures that accountability guides decisions made.
* Appropriately, the outcome of the Administration is determined by the creditors – not the shareholders or the directors of the Company. This is consistent with the notion that those that have governed the affairs of the company, while it has become insolvent, should not have a say in how the matter should be finally dealt with.
* The scheme is a debtor in possession program but only insofar as the debtor can facilitate a rescue plan that is agreed to by the general body of creditor’s and is in their best interests.

The scheme suggests that it can become a bridge away from business failure toward a return to viability. The reality though, is that it is no more, nor less, than a legal instrument comprised of tools that, in the hands of knowledge, experience and skill, can correct a declining situation, or optimise an outcome if it cannot be corrected. The requirement for the existence of human actors, that can creatively bring forward solutions, is an essential aspect of the tools and talents relationship.

**Could a Voluntary Administration model have been successful?**

The question asks for the merits of adopting a turnaround model that included a moratorium, as at the date that the four options were posited. From a rescue perspective, the date that the Banks were first informed is as relevant, if not more so, than the date that the option was posited. On that ground I have provided a point of view that emanates from the date of first knowledge (13 November 2013).

Arguably, this is the date when the parties should have considered an option to adopt a turnaround model that included a moratorium. Adoption at this time, could have produced a much better result than was achieved. That assertion rests on the viewpoint that the anatomy of a successful turnaround plan is ground in rapid response to issues, comprehension of underlying causes, sagacious attention to workout options and precision execution.

All four attributes were lacking in this insolvent circumstance as discussed below.

**Responsiveness**

Both management and the banks fell a long way short of exhibiting decisiveness in the knowledge of the announcement made 13 November 2013. Indecision continued through to 4 July 2015. In between these times, the inherent value of the business would have depreciated for the lack of any expression that acknowledged the potential for business failure. Had that occurred, the process of harnessing resources available to prevent failure, could have commenced.

**Comprehension**

Management showed a lack of knowledge of its own economic position. An economic condition is unlikely to be rectified unless it is first understood what may have caused it. This knowledge may not be immediately available, or indeed accurate, but thorough diagnosis is essential to a recovery plan. Unless corrective action is taken against the causes, then more of the same is inevitable - which is precisely what occurred.

**Sagacity**

Wisdom is a manifestation of knowledge applied and results evidenced. In the case, there seems a distinct lack of insight into how the trading losses can be corrected. Management responded to the economic condition by applying activity along simple metric lines (sales, cost of sales and expenses). The situation called for a more granular analysis and the application of creative responses. Metric lines are used to measure and record historical activity so a picture can be created of what has taken place. It is narrowminded to use those same metric lines as predictors of what may occur in the future. Business planning, from the standpoint of whatever economic position the company finds itself in, is the responsibility of thinking persons focussed on how available resources can achieve a desired outcome.

**Execution**

Business is an expression of competitive human endeavour that is both mobile and volatile. Management must engage in this melee and at the very least stay in the pack if it is to remain successful. In simple terms, management must make promises, and then deliver upon them. This requires execution comparable at least to competitors. Importantly, the less the economic resources that are available, the speedier and more precise the execution must be.

Management is known and judged by what it did – not what it intends to do. When business is successful it operates mid-stream and is judged with toleration. When resources are low, and third parties are affected, management operates in the margins where commercial eddies are the most pronounced. Moreover, execution in the margins of commerce are more levered, both positively and negatively, laying management bare for harsh criticism if things go wrong.

**Conclusion**

I am of the view that the initiation of a formal turnaround model that included a moratorium would have produced a structure where management could have been influenced by independent and competent insolvency practitioners in the process. If that model had been adopted, it most certainly would have been decisive and productive. On this ground alone, the outcome would likely be much better than the actual outcome achieved.

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32. Or third-party interests. [↑](#footnote-ref-32)
33. At least to the extent that a provider, or group of providers are essential to the recovery plan. [↑](#footnote-ref-33)
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