Global Insolvency Practice Course

INSOL

Case Study 1

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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?**

The analysis of business failure should take into account both internal and external factors in order to actually diagnose the causes of crisis. One approach suggests first, looking for what organizational features cause failure in the face of changing circumstances, and under what specific circumstances. Then, the next step is to understand under which environmental conditions and ecological factors, organizational aspects increase the risk of failure (Mellahi & Wilkinson, 2004). Flow Management’s distress situation was probably produced by a combination of internal and external factors that will have different levels of impact.

Concerning organizational factors, it seems that the company had, at least, the following circumstances that could have led, or at least contributed to the failure:

First, the lack of reliable information is certainly one of the most critical matters. This situation does not allow the management to take decisions that are proper to the circumstances. In fact, this failure could have been the cause of several mistakes such as granting bonuses to the directors for results that were not real.

Probably, the basis for this decision was that the management was affected by the “fantasy” of believing that the company was doing fine and was supposed to continue performing, among others, based on information that was not accurate (see Mellahi & Wilkinson, 2004).

Secondly, the management failed to make periodical benchmarks of the prices of the products and services. Certainly, had the financial information been correct, the management should have noticed that the costs where higher than the proceeds. Nonetheless, the managers failed to review the market prices of the business and the financial structure to notice that the business was not being profitable.

In the third place, it is possible that directors themselves were not aware of some of the mistakes they were making. In fact, as cited by Mellahi & Wilkinson, 2004, managers that have been for a long time in a company may be convinced on the way of doing things and may disregard environmental factors that could affect the company’s performance. In this case, the management seemed to have ignored circumstances in the market that should have been addressed timely instead waiting until the situation almost reached a breaking point.

Finally, the company could been affected by ‘cognitive inertia’ that did not allow the directors to take action timely since they did not make any adjustments to the business and they failed to notice changes in the environment so they were not able to adapt because such capacity was undermined (see Mellahi & Wilkinson, 2004).

This issue is also addressed by Kahneman as “Entrepreneurial Delusions”. As a human condition, we tend to be more optimistic and sometimes disregard information that shows the failure chances. This optimism may be dangerous when the managers become “blind” to the signs that show the business could be failing (see Kahneman, 2013).

With respect to external factors, the situation of the company does not seem to have been affected directly by market changes or unforeseeable events. Although there are some external circumstances that contributed to the crisis.

First, the financial creditors did not trust the management. This was so evident that the banks asked to appoint a CRO on the board of directors of Flow Management Holding BV and the company regained some trust from these creditors once it announced that a new CFO was going to be appointed.

Secondly, the analysis on the viability of the business was not taking into account the market circumstances. In the case, a recently hired independent turnaround consultancy concluded that the company is viable, with a view to the market share. Thus, one important conclusion is that the ecosystem is adequate for the business, and therefore, the crisis in mainly related with the administration. However, there were some changes required to make the business profitable.

Finally, the company seemed to have been charging less than market value for the services since the increase in prices was accepted by the majority of the clients. Moreover, the spending cuts could have been done years before to make the operation more efficient and, therefore, more profitable.

The crisis could have probably prevented should regular controls to the financial information were implemented. Had the management detected the flaws in the financial information, they would have probably taken timely decisions. Moreover, since the crisis became apparent, the appointment of new managers took more time than is should have. Thus, some of the losses that occurred for the delay could have been prevented and the restructuring could have been closed earlier if the trust from the banks had been recovered before.

**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?**

The legal system in Colombia allows for out-of-court restructurings and formal judicial reorganization. However, during the emergency created by the pandemic, the government created a hybrid reorganization procedure called Emergency Negotiation of a Reorganization Agreement (ENRA). Therefore, I will divide the answer considering these two alternatives.

**Out-of-court restructuring**

Out-of-court restructurings have some advantages with respect to formal reorganization proceedings. In the first place, such procedures do not involve the bankruptcy court and, therefore, are more private and allow the debtor to keep a low profile about the financial distress.

Secondly, although bankruptcy proceedings in Colombia do not involve any court fees, direct negotiation will be usually less costly because it does not involve all the creditors and allows conducting the negotiation informally rather than through formal filings and appearances in court.

In the third place, direct negotiation may also be faster and more agile than when done through a formal proceeding given that there will not be formal stages and the timeframe will be the one fixed by the parties.

Fourthly, an our-of-court agreement may be submitted to judicial validation in order to extent its effects to dissenting and absent creditors, so far as the agreement fulfills the same requirements as a reorganization plan executed through a formal reorganization.

In the fifth place, an out-of-court negotiation allows the debtor to retain control over the management since no officers from the court will be appointed. Finally, a private negotiation does not involve the liquidation risk that could commence if a formal reorganization fails.

However, an out-of-court restructuring have some disadvantages as well. In the first place, there will not be an automatic stay that protects the debtor’s assets from execution of attachment from collection proceedings, therefore, the environment for the negotiation may be affected by the enforcement of liens and attachment of assets, if the creditors are not willing to grant a standstill.

Secondly, an out-of-court negotiation will not offer enough incentives for financers to grant new loans to the debtor as they will get with a post-petition financing during a formal proceeding. In fact, in Colombia, post-petition financing will have priority over pre-petition indebtedness. Thus, in an out-of-court procedure, lenders may not be willing to loan new money because of the risk that such loan becomes pre-petition debt in a future reorganization proceeding.

Finally, with regards to executory contracts, an out-of-court restructuring will not grant the protection against termination of contracts that the law sets forth in formal reorganization proceedings. Thus, the debtor will not be protected against unilateral termination of contracts during the negotiation. Moreover, an out-of-court restructuring will not allow the debtor to reject executory contracts and that situation could limit the capacity to make substantial operational restructuring or will make it very expensive.

**ENRA**

The ENRA is an hybrid proceeding in the sense that it commences with the filing of a notice of the intention to begin negotiations before the bankruptcy court, and the court will only intervene (i) to authorize the commencement of the negotiations and (ii) to rule on the confirmation or not of the agreement. The remaining stages will be held out of the courtroom.

The ENRA grants a three-month period to the parties to reach a reorganization agreement. During this time, the parties must try to directly settle and resolve any unconformities and objections to the claims and voting rights.

The ENRA has some advantages over the out-of-court restructurings. First, the automatic stay will take place as of the admission by the court of the petition to commence negotiations.

Secondly, the debtor may postpone payment of administrative expenses until the agreement is confirmed or the negotiation fails. In either case, the debtor will have to pay the administrative expenses within the following month –unless the creditors grant more time or different conditions.

In the third place, during this type of negotiation, post-petition financing is available and therefore, the potential lenders have more incentives to provide new loans, as they will get the proper protection.

Fourth, during an ENRA, the debtor retains control over the management since no officers from the court will be appointed.

Finally, it is worth noting that the ENRA allows the debtor to choose a category or categories of creditors to engage in the reorganization. Thus, this allows the debtor to limit the extension of the effects of the bankruptcy proceeding only to those creditors where the crisis is relevant (i.e. leaving employees unaffected by the proceeding). Hence, in practice this allows the debtor to choose a category of creditors, as in an out-of-court restructuring but with the advantage of being able to extend the effects of the agreement to dissenting and absent creditors from such category.

With regards to the disadvantages in comparison with an out-of-court restructuring, these procedures are public and, therefore, the reputational risk could represent a downside for the debtors.

In short, each type of proceeding has some advantages and disadvantages and shall be chosen for the specific circumstances, considering the convenience for each case.

**3. Were the turnaround/reorganization approaches as presented in the reading material (see e.g. Adriaanse & Kuijl, 2006, Pajunen, 2006, Sudarsanam, S, Lai, J., 2001, Schmitt, A., Raisch, S., 2013) applied in this case? If yes, explain in what way. If no, detail what in your opinion should have been done differently.**

The Flow Management case is an informal reorganization which “consists primarily of *business restructuring* and *financial restructuring –* (Adriansee y Hans Kuijl). In fact, within the out-of-court negotiation, the CEO was changed and a CRO was appointed. Also, there was some capital injection and the banks ultimately granted the standstill. Moreover, the company made some spending cuts and increased the prices of its services.

The reorganization agreement mainly includes a haircut for some creditors and the creation of a new company to hold the assets, including the shares over the subsidiaries and the winding up of Flow Management Holding BV. The ultimate purpose seems to be to sell the business as a going concern.

However, this restructuring may fail if there is not a clear and structured plan that encompasses the interests of all the stakeholders. Moreover, if the information that was the basis for the negotiation is not reliable, this could contribute to the failure of the restructuring. For Adriansee y Hans Kuijl, the informal restructuring requires to go through different stages: (i) stabilization; (ii) analysis, (iii) reposition, and (iv) reinforcing.

In this case, the main issue that affected the potential success of the restructuring was the lack of clear and reliable information. Under these circumstances, the banks did not trust the company and that became a great obstacle for the decision-making. The lack of adequate information was related to the absence of proper controls by the administration and resulted in decisions that not only failed to halt the crisis but worsen it.

As part of the stabilization phase, the company implemented two effective strategies to increase the cash flow: spending cuts and increase of prices. Although this phase should focus on increasing the cash flow, in the analysis phase there was no reorganization plan based on an strategic and financial study to assess the causes of the crisis.

In the repositioning phase, the company appointed a CRO and changed the CEO in order to regain some trust from the banks. In fact, for Sudarsanam and J. Lai, one of the strategies to restructure the operation consists in the change of the top management since managers that have been for a long time are less ready to implement changes. From the perspective of the creditors, this is highly relevant since the banks will only continue lending money if they believe that the management team is strong to face the crisis. In the Flow Management case, the banks actually accepted the standstill and the agreement once the managers were changed.

In the reinforcing phase, as a final effort, the company transferred assets to a new company - Flow Management II BV- and the shares to the banks. The ultimate purpose is to sell the company as a going concern. Moreover, from the financial restructuring, the operation assumed that it was not possible to recover the solvency without the injection of new money and the haircut of some of the liabilities.

It is worth mentioning that it is very important to maintain trust on the operation in order to sell it. As Sudarsanam and J. Lai hold “Equally important in the recovery process is that the directly affected parties —particularly important suppliers and financiers— are involved in the reorganization. When they, too, have confidence in the company’s business plan, the chances of success will rise”.

The operative restructuring is also an important strategy (S. Sudarsanam and J. Lai). Thus, the restructuring agreement shall state the method and specific actions for the operative restructuring such as the spending cuts, salary cuts, and so on. However, these strategies must be carefully planned in order to maintain motivation in the stakeholders and preserve the quality of products and services (Schmitt). In the case of Flow Management, there was a reduction on 130 employees, which allowed an annual saving of € 3.3 million.

In view of the above, Flow Management restructuring applied some of the turnaround approaches set forth by Adriaanse & Kuijl, 2006, Pajunen, 2006, Sudarsanam, S, Lai, J., 2001, Schmitt, A., Raisch, S., 2013. However, the main stage that seems to be missing in the implementation of the turnaround of the Flow Management case is a deep analysis and diagnosis of the causes of the crisis, which I believe should have been the very first step.

**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?**

Banks C and D seemed to be doubtful about the situation of Flow Management given the multiple mistakes made before the crisis was revealed. The lack of precise and reliable information made the banks distrust the management. They could have been even doubtful about the perspectives showed to obtain the standstill. In that sense, I do not believe that their behavior was opportunistic.

In those circumstances, it is common that the creditors do not believe in the perspectives of the company and assume that they shall take the loss and move on, and therefore, may not be willing to cooperate and sometimes even be exposed to a greater loss.

However, it is also possible that Banks C and D were seeking to improve their position during the restructuring by pushing for securities or injection of capital. Sometimes, that kind of pressure is useful to show that the creditors want to have more control over the future of the procedure and to visualize the worst scenarios and estimate the risks of the alternatives.

It is worth mentioning that under Colombian law, banks are obliged to make reserves once a loan is subject to a formal insolvency proceeding. Thus, usually banks will prefer to reach agreements through out-of-court restructurings because that will exempt them from making the provisions.

However, there are circumstances where the banks foresee that their best chance to recover is within a formal bankruptcy proceeding, especially when the financial information is not transparent, complete or there is distrust in the management. Therefore, sometimes the banks are reluctant to negotiate outside a formal insolvency proceeding and in those cases they may deny a standstill in order to push for a formal filing.

My advice to banks A and B would have been to first understand the real financial situation and then decide whether the probabilities to recover the money are worth investing new money by acquiring banks C and D claims. The main issue will be the discount that banks A and B could obtain on the claims in order to determine whether that is proportionate to the additional risk that they are assuming.

**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)?**

Almost all the principles of the Statement of Principles for a Global Approach to a Multi-Creditor Workouts II are present in the workout process of Flow Management.

The first principle relates to the relevant creditor’s willing to co-operate and even grant a standstill period, unless such a course is inappropriate in a particular case. In the Flow Management case, the banks ultimately granted a standstill for 120 days refraining from enforcing the loans against Flow Management Holding BV. Also, during this period the main strategies where discussed: cut the costs and increase the prices.

The second principle discusses the refrain from taking steps to enforce their claims or otherwise reduce their exposure. In this case, the banks did not advance any actions in order to enforce their claims. However, banks C and D were reluctant during some time to agree upon the standstill, but they accepted it in the end.

The third principle sets forth that during the standstill period debtor should not take any action that may adversely affect the return to creditors in comparison with the commencement of the standstill date. In the Flow Management case, the debtor refrained from implementing actions to dispose its assets or otherwise reduce the recovery probabilities for the banks. In fact, the management mistakes occurred before the standstill and during that period the decisions seemed to be conservative and were even discussed with the creditors.

The fifth principle establishes that the debtor should allow the relevant creditors and their advisers to access the financial information for its evaluation. Flow Management Holding BV allowed the banks to review the information in order to assess the situation and the projections. Although in the case, the financial information was inaccurate and unreliable and this was one of the main obstacles for the negotiation.

The sext principle refers to proposals for resolving the financial difficulties with the relevant creditors relating to any standstill that should reflect the relative positions of the creditors. In the Flow Management case, the banks where the most relevant creditors and negotiation was handled directly with them, and their position was taken into account to the point that the shares were ultimately transferred to them and their petitions to change the CFO and appoint a CRO were implemented.

Hence, the out-of-court negotiation of Flow Management followed some of the principles and probably that was very helpful to make it possible to reach an agreement in adverse circumstances such as the ones described in the case, specially the lack of reliable information.

**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?**

Although there are no guidelines or “soft law” to conduct a negotiation of an out-of-court restructuring in Colombia, there are some principles in the bankruptcy law and in the commercial and civil codes that could be helpful in this type of operation.

In the first place, the Constitution and the Commercial Code (section 1603) enshrine the good faith principle. According to this principle, the parties must act in good faith during a negotiation and will be bound not only to the express obligations but also to the additional matters that arise from the nature of the agreement.

Thus, in light of this principle, during an out-of-court negotiation it is expected that, on the one hand, the creditors will not continue or begin actions to enforce the claims and, on the other hand, that the debtor will not enter into transactions that could be damaging to the interests of the creditors.

There is another principle related with the good faith, which is that the parties cannot go against their own previous acts (*venire contra factum proprium nulla conceditur*). During a negotiation of an out-of-court restructuring, the parties expect to rely on the other parties previous behavior and may not expect sudden changes.

Although in the Flow Management case Banks C and D were reluctant to enter into de standstill, this was not against their previous acts as they did not previously promise to grant such relief. However, if a creditor decides to engage in an out-of-court negotiation and suddenly files for a mandatory liquidation against the debtor, that could breach this principle.

Another principle that could guide the negotiation of an out-of-court restructuring is the prohibition of abuse of rights (usual in the Civil Law jurisdictions). This principle assumes that a party has a right but the exercise of that right exceeds the limits that the law imposes for its application.

During an out-of-court negotiation, the parties could exercise their rights (i.e. as creditors) but in the frame that the law has created for that. For instance, an out-of-court agreement shall not have the purpose or the effect to defraud or affect some creditors for the benefit of the debtor or a group of creditors. In fact, such an agreement would violate other principles such as the universality and equality that should apply in any reorganization.

In addition, the Colombian bankruptcy law also incorporates some principles that could be useful for the negotiation of an out-of-court restructuring. One of the principles states that the information must be available, transparent and complete. In the case of Flow Management this principle should have been very relevant since the lack of accurate and reliable information was the origin of the mistaken decisions.

Also, in the bankruptcy law there is another principle called “negotiability”. Under this principle, the parties should prefer transactional solutions, in good faith and proactively instead of resolving issues through litigation. In the end, negotiated solutions are more efficient and convenient for the parties.

Thus, although there is not something such as “soft law” in Colombia, the principles from the different regulations are helpful concerning the negotiation of out-of-court restructuring agreements.

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

The restructuring plan comprised a corporate reorganization and a financial rearrangement. Regarding the corporate group restructuring, the operating companies (Flow Management Work BV, FMW Spain, FMW France, FMW Australia, FMW South Africa and FMW USA) were concentrated in a subsidiary Flow Management II BV, controlled by the banks and some directors including the CRO, and Flow Management Holding BV was liquidated.

From the financial perspective, some claims were cancelled and other claims were waived. This allowed the group to have a “lighter” load of indebtedness. Also, the sale of surplus assets allowed some cash flow for the operation. Moreover, the business plan was adjusted in the sense that the prices were increased and the structure was downsized.

This restructuring seems to be an alternative solution to the crisis that apparently has the purpose to make the business attractive for an investor. Sometimes, these types of transactions are not possible given some biases of the relevant parties (such as the fear to invest in a distressed business).

Moreover, the owners of a bankrupt business face a personal crisis. As Hoffer says, “Disappointment is a sort of bankruptcy - the bankruptcy of a soul that expends too much in hope and expectation”. Considering this, the efforts should point to the preservation of the value even though that supposes the change of control.[[1]](#footnote-1)

In fact, the acquisition of distress companies may represent advantages for the investors since they may pay a low price and turnaround the operation to make the business valuable. Also, this type of transaction allows the preservation of the jobs. Moreover, this rescue operation may improve the chances of the creditors to collect their claims.

This restructuring did not involve all the stakeholders but rather was handled by the most relevant creditors: the banks. It did not involve any judicial proceedings and is a contractual based reorganization.

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

Flow Management Holding BV is the parent company of subsidiaries located in different counties. However, in an out-of-court restructuring, there are not much cross-border insolvency issues in connection with conflicts of jurisdiction, center of main interests (COMI) or conflicts of laws, given that the solution is purely contractual.

However, this also represents a risk with regards to the effects that the restructuring plan could have in the relevant jurisdiction since there will be no recognition procedure available to extend the effects to such jurisdictions. In fact, the out-of-court agreement is not binding to all the creditors and, therefore, there is a risk that in some of the relevant jurisdictions, if there are additional breaches, the creditors may force the commencement of an insolvency case. In that situation, the out-of-court agreement will probably be superseded by the formal insolvency proceeding.

Another issue that could arise could be that the transfer of assets may be subject to claw back actions in potential bankruptcy proceedings of the participants of the group. In fact, since the agreement was not executed within a formal procedure, eventually could be deemed to damage dissenting or absent creditors, especially if the restructuring ultimately fails and the operation is subject to judicial liquidation.

Moreover, given the transfer of shares and the cancellation of claims, there will some tax issues that should be considered in order to make the structure efficient and not create short-term obligations to pay taxes in a way that will alter the projections on the use of cash-flow.

Finally, the banks substantially acted as controlling parties and even assumed the property of the shares. In the new structure there is a risk that in a potential cross-border insolvency situation, some issues regarding a new COMI could arise. Also, the banks may be assuming additional liability for their participation in the restructuring and the acquisition of the property of the shares. Thus, this could expose them in the case that under the local law the parent companies may end up being liable for the obligations of the subsidiaries, for instance, as a consequence of the lifting of the corporate veil.

**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]**

Colombian law does not govern the possibility to call for a moratorium. Thus, the alternative 4 would not available in this jurisdiction. The effects of suspending the enforcement of claims or execution of liens are only available through a formal reorganization proceeding or through an emergency negotiation of a reorganization agreement (ENRA).

In fact, one of the effects of the admission of a reorganization petition is that collection of debts is stayed and interests will only accrue for over-secured claims. This stay will last for the whole duration of the proceeding.

However, generally speaking, the moratorium seemed to be an appropriate alternative if granted for a short term, given that by October the standstill was still in place. The moratorium could be helpful to temporarily avoid a liquidation scenario and find a solution that preserves value.

In fact, the shareholders will not inject new capital in a liquidation scenario whereas they may be eager to invest more in order to save the company. However, if the environment does not allow the parties to think about alternative solutions, that will not lead to a restructuring but rather to a liquidation.

During a moratorium the interested parties and stakeholders may take the time to redesign the operative structure, close operations that are inviable, sell assets, merge or separate businesses, rethink the business strategies and so on. These measures do not seem easy to do when the creditors are collecting their claims and forcing payments that the business cannot handle in the ordinary course.

However, it is worth mentioning that the moratorium does not guarantee that the business will find the way to recover. If that is the case, this period would have been a waste of time and an increase in the amount of debt on the business since interest will continue to accrue and the operational costs will add up to financial distress.

1. “Disappointment is a sort of bankruptcy - the bankruptcy of a soul that expends too much in hope and expectation”, Eirc Hoffer, “*The Passionate State of Mind*”, 1996, Buccaneer Books. [↑](#footnote-ref-1)