Case Study 1 - "Flow Management"

Jonathon Milne (Cayman Islands)

Brief description of the Flow Management group

Flow Management Holding BV ("**FMH**") is a well-established privately held company based and incorporated in The Netherlands. Under FMH, which acts as the centre of main interest, there are operating subsidiaries incorporated in diverse locations around the world, including Spain, France, Australia, South Africa and the USA. The co-owners of the entire group of companies are: (i) the Johnson family, based in the US (30% ownership stake); and (ii) two investment companies, both domiciled in the UK (combined 70% ownership stake).

Although certain companies within the wider group have made real estate investments and started complementary business lines (e.g. truck repair), the core business of the group and its primary operating companies is leasing of trucks and private cars. As of November 2013, there were more than 3,000 employees in different parts of the world and over 200,000 cars in the group's fleet.

<u>Question One</u>: What were the causes of financial distress at Flow Management? Could the financial distress have been prevented? If yes, explain how. If no, why not?

<u>Causes of distress</u>

Discrete issues, as communicated and identified by the management team at FMH, such as large management bonuses and specific accounting errors, prompted negative corrections to the 2012 annual accounts and led to discussions with four major bank creditors in December 2013. However, it is clear that there were broader systemic and external environmental factors at play.

It appears that financial distress was caused by at least the following six factors:

1. *Modelling flaws*: there were fundamental problems with the pricing model used by FMH and its operating subsidiaries. It appears that FMH failed to track actual costs against the price charged for their goods and services, which distorted profit margins and overall financial performance.

2. *Incorrect pricing*: aligned with the flaws in the model, it appears that FMH and its subsidiaries were selling goods and services at a price-point that was too low. Thousands of clients were willing to pay more, based on a single visit, with only a "few" negative responses.

3. *Lack of confidence in long-tenured management*[1]*:* the key stakeholders (i.e. banks A – D) had apparently lost confidence in C-suite management, including the CEO and CFO. It is unclear to what extent mismanagement caused the financial difficulties at FMH, but it appears to have played a part.

4. *Crowded market*: the rental and leasing market is highly competitive and mature. Although the Flow Management group is relatively large in terms of size of fleet and geographical spread, it is nowhere near as large as some of its multi-national competitors, such as Hertz and Avis. Accordingly, it may have suffered from erosion of market share or a competitive disadvantage in terms of scale.

5. *Unrealistic projections*: it appears that FMH management had adopted the Panglossian view of its future profitability. It is unclear whether the aspirational projections were deliberately or inadvertently inflated, although it must be assumed that they were linked to other pricing and modelling issues referred to above. However, this led to unhelpful feelings of distrust amongst key stakeholders and disguised the true financial position.

6. *Geographical spread:* it may have become too difficult to manage the business from the Amsterdam hub and deal with different regulatory and legal regimes in very different jurisdictions. Based on the names of the Flow Management subsidiaries, it appears that FMH was operating in Africa, Australasia, Europe and North America. Aside from legal and regulatory differences, the range of locations creates logistical challenges due to time-zones and physical distance, which may have put additional pressure on the FMH management team.

Adriaanse and Kiujl focus on the Netherlands in particular, when analysing root causes of financial difficulties[2]. They list: (i) poor management; (ii) excessive costs structures; and (iii) inadequate information systems, as the main reasons for financial distress in companies based in the Netherlands. Each of these causes is present in the FMH case study and, accordingly, it appears that it is an archetypal business case for restructuring analysis.

Prevention

On the positive side, it appears that FMH is well-established and has had a lengthy track record of success. However, this may have bred over confidence and arrogance in the 'curse of success' sense[3].

---

[1] "*increased rigidity and commitment to standardized practices*" (see Katz on "*The effects of group longevity on project communication and performance*" in *Administrative Science Quarterly*, 27, 81-104).

[2] See "Resolving Financial Distress" by Jan Adriaanse and Hans Kuijl in the Review of Central and East European Law (2006), Section 5 on pages 147 and 148.

[3] See 'Curse of Success' described by Mellahi & Wilkinson, on page 30 of "*Organizational failure: a critique of recent research and a proposed integrative framework*" in International Journal of Management Reviews, Volume 5/6, Issue 1, pp 21 – 41, March 2004.

Perhaps financial distress could have been avoided by refusing to allow traditions and habitual thinking to develop within the organisation.

On a similar note, it also appears that replacing upper-tier management, at the insistence of key stakeholders, was a positive development in the FMH story. It may be that there was an element of 'cognitive inertia' and rigid behaviour[4] amongst senior management. Fresh thinking and diversity of ideas had an immediate impact. Accordingly, FMH may have prevented financial decline by making changes to the senior management team at an earlier stage and developed new ways of tackling problems. The financial position could have been improved by FMH management leading by example, such as taking lower bonuses or a 'bonus holiday' for a prescribed length of time.

It appears that flaws in the pricing model were not identified until financial decline had taken hold. Although it is not clear who or what was responsible for the 'formula error', it seems likely that outdated technology and/or under-qualified employees were to blame. That issue, in particular, may have been prevented by more substantial investment in the latest technology, more rigorous tracking and better qualified staff. In light of the fact that understanding the actual cost of doing business is such a vital component of profit-making, the combination of skilled staff and the appropriate technology to perform the accounting function is essential.

Projections were not grounded in reality, which is a similar problem to the data-tracking issues. Senior management appear to have lost track of the actual position and the ability to prepare accurate forecasts. There may have been an element of 'fantasy' or 'denial', and a tendency to convert the "*ambiguities of history into confirmations of belief and a willingness to persist in a course of action*"[5]. This way of thinking could have been prevented by instructing an external consultancy firm at an earlier stage to provide some independent and cogent analysis of the true position.

It also appears that FMH did not have open lines of communication with key stakeholders (e.g. large customers or major lenders). As soon as price increases were discussed, almost all clients were prepared to accept revised terms, including all of FMH's main clients. Equally, once there was more regular dialogue with the banks, the position appeared to improve. Accordingly, it is likely that, if FMH had adopted a more transparent and collaborative approach, the outcome could have been different.

---

[4] See 'Threat Rigidity Effect Theory' (Mellahi & Wilkinson, March 2004 - page 30)

[5] See Brown and Starkey's five psychodynamic factors, as described by Mellahi and Wilkinson (Mellahi & Wilkinson, March 2004 - page 30 and 31)

Question Two: What are in general advantages and disadvantages of an out-of-court restructuring as compared to a formal bankruptcy procedure? More specific, what are the advantages versus disadvantages in the Cayman Islands?

General comparisons

Leading academics and eminent practitioners have helpfully summarised many of the advantages of an out-of-court "workout" as follows[6]:

> *"[the workout] avoids the formality, expense and delay of the statutory modes of arrangement, is much more flexible and generally leaves a greater degree of control with the management. In addition, it may enable the company to avoid an event of default under its loan agreements, and the fact it is being supported by its major creditors helps to reduce in some measure the effect of the damage to its reputation of becoming insolvent."*

For the above reasons and others, provided that creditors are willing to engage in a constructive negotiation, it is often preferable to remove the rigidity of the applicable statutory framework and the hurdles associated with judicial oversight. If the starting assumption in any restructuring scenario is that it is possible to continue to operate the relevant entity as a going concern and that a turnaround is feasible[7], it always makes sense to at least explore the prospect of reaching agreement with stakeholders on a less formal and more efficient basis.

The advantages of informal reorganization are summarised by Adriaanse and Kuijl in succinct fashion: flexibility, silence and control[8]. Put another way, an informal out-of-court restructuring has the following features: (i) less restrictions than a formal procedure; (ii) more privacy than public court-supervised regime; and (iii) management can continue to run the company with relative autonomy. This is a similar list to the version published by the World Bank[9] which includes the following headings: fast; flexible; informal; and confidential.

However, if creditors or other third parties are threatening to take legal action, it may be essential to shelter the company whilst deciding on the best path forward. As such, one of the main advantages of a court-supervised process is that, in most cases, it includes an automatic moratorium on claims against the company and provides important "breathing space" to facilitate informed discussion. This can eliminate the need to spend precious time and resources negotiating standstill agreements or fending off litigation.

---

[6] See Goode on "*Principles of Corporate Insolvency Law*" 1-56, citing Totty, Moss & Segal on *"Insolvency"*, Ch.H19.

[7] See Goode on "*Principles of Corporate Insolvency Law*" 12-02: *"If there is not merely financial insolvency but trading insolvency, there is little point in devising a scheme or contractual restructuring, and there will simply be a sale of the business or assets."*

[8] See "*Resolving Financial Distress*" by Jan Adriaanse and Hans Kuijl in the Review of Central and East European Law (2006), pages 145 – 147.

[9] See "*A Toolkit for Out-of-Court Workouts*" World Bank Group, 2017.

Although it may be useful to draw upon the knowledge of management and obtain access to up-to-date information, it is not always advisable to leave management in place with full powers. If the prevailing opinion of stakeholders is that existing management are to blame (either partly or fully), it may be beneficial to have an independent office-holder take control on an interim basis under the supervision of the court. The terms of appointment can specify the degree to which management retains or is absolved of decision-making power. If stakeholders appear to be entrenched in their respective positions, the presence of an experienced and independent professional can often increase stakeholder buy-in and may lead to a more sophisticated long-term solution.

Out-of-court restructuring options are flexible and diverse. However, in cases involving disparate stakeholder interests and complex structures, it may be helpful to have clear rules and procedures in place to deal with contentious issues. Although it might seem counter-intuitive, it is not always the case that an out-of-court workout is the most cost-efficient approach. With a prescribed framework to govern the process, the company and stakeholders must abide by court-imposed timelines and negotiate within set parameters.

As with many lists of pros and cons, there are items on either side of the list that can either be advantageous or detrimental depending on the circumstances. At the risk of stating the obvious, it is vital to consider the advantages and disadvantages of the various options with the specific facts in mind. When carrying out the preliminary analysis, perhaps the two most important considerations are: (i) the attitudes of management and stakeholders (i.e. is there scope for compromise and co-operation?); and (ii) the timing and prospects of the restructuring action (i.e. how dire is the financial position of the relevant company?).

The position in the Cayman Islands

The Cayman Islands is a unique, tax-neutral financial services centre[10]. Many of the thousands of companies and other corporate entities domiciled in the Cayman Islands do not trade in the Cayman Islands in the traditional "bricks and mortar" sense. Accordingly, many key stakeholders, such as lenders and shareholders, are typically based elsewhere and out-of-court restructuring efforts are more likely to take place outside of the Cayman Islands. Whilst it is relatively common to refinance or re-negotiate arrangements with a single creditor or class of stakeholders, it is relatively rare that a global restructuring of a Cayman Islands structure would occur without a formal process and a measure of judicial oversight.

Further, many of the holding companies incorporated in the Cayman Islands are listed on the Hong Stock Exchange, New York Stock Exchange, NASDAQ or other highly regulated exchanges. Listing rules and other ancillary sources of regulation require greater transparency for listed entities. Therefore, if a viable restructuring is to take place, it is often necessary to make an announcement to the market and suspend trading in the shares. This means that, in order to preserve market confidence and maintain regulatory approval, it is preferable to do so under the supervision of the Cayman court and explore parallel options in other jurisdictions (if necessary).

---

[10] See detailed information and analysis at https://caymanfinance.ky/

As presently constructed, the statutory regime in the Cayman Islands is far from ideal from a restructuring perspective. There is no dedicated, bespoke restructuring framework, akin to Chapter 11 in the United States or administration in the UK. Instead, the Cayman Islands judiciary and local practitioners have been forced to work within the parameters of an outdated provisional liquidation regime which is contained in Part V of the Companies Act of the Cayman Islands. Whilst there have been some innovative and highly successful examples of large-scale cross-border restructuring in the Cayman Islands in recent years[11], the general consensus amongst practitioners is that a modernised statutory toolkit is essential to maintain the reputation and standing of the jurisdiction.

As things stand, where a winding-up petition has been presented, provisional liquidators may be appointed under section 104(3) of the Companies Act where the company: (i) is, or is likely to become, unable to pay its debts; and (ii) intends to present a compromise or arrangement to its creditors. Pursuant to section 104(4), a provisional liquidator shall carry out only such functions as the Court may confer on that person and that person's powers may be limited by the order appointing that person.

There are at least three major criticisms of the current legislation: (i) the provisional liquidation procedure can be cumbersome and expensive; (ii) the word "liquidation" has negative connotations; and (iii) directors are unable to initiate the process to promote a restructuring, unless the company's constitutional documents expressly allow it[12]. The latter point brings about serious complications for directors in discharging their fiduciary duties when the relevant company is of doubtful solvency.

Over many years, local lawyers and accountants have lobbied for legislative change. There have been several rounds of consultation with the wider industry and different iterations of draft legislation tabled for consideration. The central tenet of recent proposals is to allow Cayman Islands companies to formally restructure their debt outside of a formal insolvency process under the supervision of a suitably qualified insolvency practitioner acting in the capacity of a "company restructuring officer" or similar (i.e. somewhat akin to the FMH scenario and the suggestion by bank A in mid-2014).

On 21 October 2021, the Cayman Islands' Government gazetted the Companies (Amendment) Bill, 2021. The Bill introduces a revised framework whereby companies would have the ability to restructure outside of a court-supervised liquidation process. Aside from providing greater flexibility and perhaps confidentiality for the benefit of the debtor and stakeholders, these proposed changes would have many other advantages over the current regime, not least in relation to avoiding: (i) the stigma of liquidation (provisional or otherwise); and (ii) potential triggers for cross-defaults under financing arrangements. It is hoped that the Cayman Islands will see a rise in out-of-court restructuring as a result of the new proposed legislation.

---

[11] See, for example, *Re CHC Group Ltd* and *Re Ocean Rig UDW Inc.*

[12] See *Banco Economico SA v Allied Leasing and Finance Corporation* [1998] CILR 102; and *Re China Shanshui Cement Group Limited* (23 November 2015)

<u>Question Three</u>: Were the turnaround/reorganisation approaches, as presented in the reading material, applied in this case? If yes, explain in what way. If no, detail what in your opinion should have been done differently.

Adriaanse and Kujil analyse success and failure factors (which are essentially the reverse of the same point in each case e.g. active management is good and passive management is bad) for Dutch companies in a turnaround or reorganisation process[13]. Accordingly, in light of the COMI position, the authors' research is particularly useful in the FMH context.

The shortlist they provide, as reflected in the *italicised* headings below, serves as a useful starting point for analysing the FMH turnaround approach:

- *Active attitude by management and shareholders with regard to informal reorganisation*: It appears that, despite taking large management bonuses, the original FMH management team were asleep at the wheel. FMH management had adopted a passive approach and had not been tracking the actual financial position. Costs and pricing were not being recorded on an accurate basis. In late 2013, once it became clear that there were issues, FMH management and the Lease Group Holding (i.e. the direct shareholder) took a more active role in response to the banks' concerns, but the historical passivity had caused problems which were difficult to overcome. They were too late to recognise red flags and shortcomings[14].

- *Involvement of important interested parties (financiers) in the process*: The banks were called to a meeting in November 2013 and, by that time, FMH management had communicated concerns and corrections had been made to the annual financial statements from the previous year. The banks agreed to discuss the position in December 2013 and maintained contact until a restructuring agreement was executed in July 2015. This crucial relationship appears to have been underappreciated by the former FMH management, which was a primary cause of the initial fallout with banks C and D. However, the level of engagement improved and suggestions, such as the appointment of a chief restructuring officer at bank A's insistence, were acted upon.

- *Level of transparency (towards financiers) with regard to the financial situation and intended reorganization*: banks C and D, in particular, were annoyed by the ever-changing financial picture and inaccurate forecasting. Once the dialogue became more consistent and the banks were given access to more information on a regular basis, the position improved. This suggests that earlier and more open communication with key stakeholders could have prevented divisiveness and acrimony.

- *Ability to find risk-bearing capital (equity)*: ultimately, the central part of the restructuring agreement is the debt for equity swap between Flow Management II BV and the banks.

[13] See "*Resolving Financial Distress*" by Jan Adriaanse and Hans Kuijl in the Review of Central and East European Law (2006), pages 147 – 150.

[14] "Many companies recognize the need to restructure too late, when fewer options remain and saving the company may be more difficult" – Gilson on "*Creating Corporate Value through Corporate Restructuring*" (John Wiley & Sons, New York, 2001), 7.

Accordingly, FMH is able to remain viable by convincing the banks to take a significant stake in return for various waivers, releases and cancellations.

In six succinct propositions[15], Kalle Pajunen summarises why effective stakeholder management is essential to organisational survival. The approaches and behaviours he describes are similar to those listed above in certain respects, with a focus on: open lines of communication, close personal relationships and consensus on long-term goals.

This is where FMH and the wider group could have approached impending distress and reorganisation differently (i.e. in line with the propositions Pajunen puts forward). They did not actively manage the stakeholders from the first signs of trouble or develop sufficiently close ties and a relationship of trust to avoid loss of confidence at a later stage. Due to limited information-sharing at the outset and unrealistic projections, the governing stakeholders were not comfortable or aligned.

As Sudarsanam and Lai emphasise, drastic changes at top management level are often required. Banks may continue support: "*only if they are confident that the management team can manage the crisis in hand. A change in top management is tangible evidence to bankers … that something positive is being done to improve the firm's performance* …"[16].

The FMH example demonstrates that this holds true. The FMH CFO was replaced in January 2014, as negative results came to light and corrections to published financial statements were necessary. Subsequently, the FMH CEO was replaced relatively quickly in April 2014, based on concerns raised by the banks and in response to signs of friction between the banks. The banks wanted new leadership in place and instigated the appointment of independent professionals to advise the FMH Board of Directors.

As part of the turnaround process, FMH adopted many measures to restore long-term profitability, some of which appear in a non-exhaustive list created by Adriaanse and Kujil[17]. For example, FMH: (i) cut overhead costs; (ii) dismissed excessive personnel; (iii) improved management information systems; and (iv) sold non-core operations.

These are examples of retrenchment, which are generally implemented prior to the recovery response, with a strong emphasis on cost and asset reductions as a means to mitigate the conditions responsible for the downturn[18]. Whilst Schmitt and Raisch suggest that retrenchment and recovery may be inter-

---

[15] See the six propositions from Pajunen on "*Stakeholder Influences in Organizational Survival*" on pages 1279 – 1283 of September 2006 edition of the Journal of Management Studies.

[16] See "*Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis*" by Sudi Sudarsanam and Jim Lai in British Journal of Management Vol. 12 183 – 199 (2001).

[17] See "*Resolving Financial Distress*" by Jan Adriaanse and Hans Kuijl in the Review of Central and East European Law (2006), Table 3 at page 142.

[18] See "*Turnaround: Retrenchment and Recovery*" by Keith Robbins and John Pearce in Strategic Management Journal, Vol. 13, 287 – 309 (1992).

related and can sometimes operate in unison[19], the more traditional school of thought is that retrenchment comes first and the recovery phase follows behind.

In the FMH example, the first substantive act by FMH management is to cut costs (with a focus on labour) and revisit pricing terms with important clients. Operational restructuring is then followed by divestment of subsidiaries in what are assumed to be declining markets. This has been described as the most common turnaround strategy[20].

Accordingly, for the most part, FMH used tried and tested approaches which are promoted by academics and practitioners. There were unhelpful delays in reaching consensus on standstill arrangements and long-term plans, which might have been avoided by more deliberate and active engagement with the banks and taking appropriate independent advice at an earlier point in time.

Question Four: 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?

Possible reasons for the behaviour of banks C and D

Banks A, B, C and D appear to be unified at the outset. They meet with FMH management together on 1 December 2013. They also agree, for example, that an actual cash injection is necessary to improve the solvency position, as opposed to an asset sale.

The banks are plainly conscious that they form a 'primary stakeholder group'[21]. They have substantial commercial leverage. Further, from a legal standpoint, they have the ability to terminate the credit agreements in early 2014 and withdraw access to essential financial support. They can turn off life support.

Each of the banks appears willing to sign a standstill agreement in early 2014. However, several months later, in mid-February 2014, banks C and D become uncooperative. When banks C and D adopt a different stance, FMH and the primary stakeholders are at a critical juncture in negotiations.

They are in the middle of discussing terms regarding a standstill agreement with FMH. This is often the first step towards a successful restructuring and involves a meeting of the minds. Approximately 4 – 6 weeks prior to the proposed date for executing a standstill agreement, banks C and D make it known that they may not be on-board.

---

[19] See "*The Duality of Retrenchment and Recovery*" by Achim Schmitt and Sebastian Raisch in the Journal of Management Studies 50: 7 November 2013.

[20] See "*Corporate Recovery: Successful Turnaround Strategies and Their Implementation*" by S. Slatter (1984)

[21] "*A primary stakeholder group is one without whose continuing participation the corporation cannot survive as a going concern*" Pajunen on "*Stakeholder Influences in Organizational Survival*" on page 1262, citing M.B.E Clarkson (1995).

In general, as part of any standstill negotiation, participating creditors are required to state the amount of their exposures and agree to co-operate with each other to work towards a satisfactory resolution. Creditors are often required to make a commitment to refrain from taking steps which may improve their position as against other creditors and, likewise, management must refrain from taking steps that might prejudice creditors. There must be a degree of trust and confidence on both sides of the equation. Once a standstill agreement is executed, there is a real possibility of being trapped in a long-term workout plan.

Acting in good faith is an important component of a successful out-of-court workout, as is the need for co-operation. As noted in World Bank guidance[22], "*there must be a real commitment to negotiate on the part of the financial creditors—either due to their desire or initiative, or simply by necessity*." Accordingly, based on the available information, it seems that there is both rational and opportunistic thinking on the part of banks C and D.

Their behaviour is rational because they have lost confidence in FMH management. At that time, if their preference is that FMH management are replaced and/or that the process is court-supervised with independent office-holders in the shoes of the directors, it is logical that they would not sign a standstill agreement and lose flexibility as a result. By the same token, they may have decided that it was not in their best interests to make a long-term commitment to FMH due to mounting uncertainty and a deteriorating financial position. Banks C and D wanted a swift resolution, as exemplified by their threat to cancel credit at the end of June 2014.

Furthermore, it appears that banks C and D have different exposures to banks A and B. There may be a different risk profile for the two dissenting banks. It is therefore rational that banks C and D might adopt a different stance in negotiations and have a more aggressive timeline in mind. For example, we can see in the restructuring plan that banks C and D provided additional working capital of approximately €32.5 million.

It is opportunistic in the sense that banks A and B, along with FMH, appear desperate to reach consensus and move forward. Banks C and D are cognisant of the fact that they have a relatively small window to exert maximum pressure to strike a deal for a buy-out by the other banks or use their leverage to improve their position in advance of the standstill agreement.

<u>Advice to banks A and B</u>

It is generally accepted that "*in an existence-threatening crisis, consensus on long-term goals among 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.*"[23] Banks A and B appear to agree with this proposition.

[22] See page 28 of "A Toolkit for Out-of-Court Workouts" World Bank Group, 2017.

[23] Ibid – see Proposition 6 on page 1262 of Pajunen (2006)

The banks are in a strong bargaining position, but they do not hold all the cards. Each of the banks appears to appreciate that management and the major shareholder will not commit to working with the banks or taking steps towards a viable restructuring plan without an informal moratorium (i.e. standstill agreement) in place. The liquidation analysis shows that drastic winding-up proceedings are likely to lead to an unattractive outcome. Additionally, it appears that certain security instruments may have been defective and the banks' legal position may not be as strong as they initially believed. In advising banks A and B in relation to any talks with banks C and D, it would be important to ensure that banks C and D are aware of the weaknesses in their individual and collective bargaining position with the debtor.

Open lines of communication are vital in this scenario. My advice to banks A and B would have been to endeavour to form a representative co-ordination committee at the outset and engage common professional advisors to encourage uniformity[24]. With "co-ordinators" appointed from (i) banks A and B and (ii) banks C and D there may have been an easier route to resolve disputes / disagreements and avoid giving the impression to FMH that there was a split between the two blocs.

Banks A and B should have been advised to try to understand, as early as possible, the main issues that banks C and D wished to address. For example, if the principal issue was the extent to which management are involved in the restructuring process or ongoing operation of the business, the engagement of an external management consultancy or leading firm of insolvency practitioners[25] might have been a condition of the standstill agreement. Aligned with that, it may have been sensible to propose management's decision-making powers in respect of some or all aspects of the business be curbed or made subject to certain consent thresholds. It appears that the banks are united again by August 2014, once new FMH management are in place.

Depending on the severity of the concerns held by banks C and D, it may have been possible to negotiate better terms for a buy-out by banks A and B in mid-February 2014 at the first sign of a difference of opinion (rather than waiting for the standstill agreement deadline at the end of March 2014).

Taking the lead, at a much earlier stage, on a heads of terms for a "lock-in" agreement may have helped start the dialogue between the banks. When there was momentum in late 2013, banks A and B would have been well-advised to put forward detailed proposed terms for consideration at that point. Leading practitioners suggest that it is often better to have creditors informally assent to a standard set of terms than to engage in protracted negotiations or "*leave everything in the air*."[26]

[24] See INSOL Statement of Principles II: Fourth Principle.

[25] Bank A proposes the appointment of a Chief Restructuring Officer in or around June 2014, which is approximately four months after there were signs of fractures in what was previously a united front.

[26] See Goode on "*Principles of Corporate Insolvency Law*" 12-02

Question Five: 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)?

In accordance with the First Principle, although it was a rather protracted and difficult process, the creditors engaged in discussions from January 2014 which led to the signing of a standstill agreement in August 2014. However, it was a short-term standstill agreement and various alternative scenarios were put forward at the time of execution. As such, it is not entirely consistent with the rationale behind the Second Principle which advocates for certainty and early identification of conflicts or differences of opinion amongst creditors.

The banks appear to follow the Third Principle in that, from the Standstill Commencement Date onwards, they act together and in 2015 / 2016 the situation appears to improve without any action taken by individual creditors. Banks C and D do not (consistently) adopt the rationale behind the Fourth Principle, which espouses a unified and co-ordinated approach together with bespoke representative creditor committees.

FMH does not help itself with inaccurate forecasts, belated corrections to financial statements and delayed disclosure of important financial information. This is not consistent with the Fifth Principle, which promotes reliability and timeliness of data, and becomes one of the catalysts for a loss of confidence in FMH management. Although there do not appear to be any suggestions of breaches of confidence, the concerns in relation to completeness and accuracy of information are also inconsistent with the objective of the Seventh Principle.

The restructuring agreement apparently reflects the relative positions of the financiers (i.e. banks and shareholder) in accordance with the Sixth Principle. Although it is not specified in the materials, it is implicit that Dutch law will govern, given that the Netherlands is the centre of main interest and all operating subsidiaries will collapse into a new shell company to be incorporated in the Netherlands.

The Eighth Principle is followed to the extent that, in return for financing working capital and writing off certain debt, the banks receive shares in a new shell company (i.e. Flow Management II BV), which is to be the entity within which all the operating subsidiaries reside going forward.

<u>Question Six</u>: Suppose it is not possible to convince other creditors to adopt the Statement of Principles in a given situation, are there any other possibilities for "soft law" to use (perhaps specifically in your country / region)? If yes, explain in what way. If not, do you see any alternative (informal) possibilities?

The "London Approach" is a useful starting point for dealing with banks in particular. The London Approach is a set of general principles developed in the 1970s by the Bank of England that govern how a company's bankers and, when appropriate, its other creditors should respond to news that the company is facing financial distress. The London Approach does not have any formal status.

The principal tenets of the London Approach are:

1. The Banks should remain supportive and not rush to appoint receivers;
2. Decisions are made based on reliable information shared amongst everyone; and
3. Banks work together to reach a collective view on whether and how a company should be given a financial lifeline.

The goal is an orderly, considered and well-founded approach[27]. In light of the longevity and success of this approach, it may have been helpful for the banks, especially banks C and D, to be aware of this blueprint in early 2014.

The European Law Institute has published[28] helpful guidance and recommendations on various aspects of the restructuring process, some of which could have been used to encourage the banks and other stakeholders to co-operate. For example, it may have been helpful to provide the materials cited and summarised in relation to the purpose of appointing a Chief Restructuring Officer at an early stage[29]. Similarly, following a joint project by the International Insolvency Institute and Asian Business Law Institute, the Asian Principles of Business Restructuring are to be formulated. These important industry guidance documents, based on the experiences of multiple jurisdictions are helpful reference documents for participants in a workout scenario.

In some cases, calling for a mediation run by an industry expert or commissioning an expert report can assist with increasing transparency and obtaining an independent view at a relatively early stage in the process. These individuals are detached from the immediate pressures of the crisis.

[27] See notes of a speech made by Pen Kent to the Chartered Institute of Bankers on 12 November 1992.

[28] *Instrument of the European Law Institute - Rescue of Business in Insolvency Law (2017)*

[29] Ibid: See page 173

<u>Question Seven</u>: Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015.

As noted by the World Bank[30], the restructuring process has to ensure a balance between protecting the debtor and the creditors. It is in the interests of all parties to maintain a balanced approach that can successfully lead to an agreement. In the FMH example, it is said that the contents of the restructuring agreement reflect the relative positions of the financiers involved.

With that objective in mind, the key terms of the executed restructuring agreement can be explained as follows:

1. <u>New shell subsidiary</u>: six operating subsidiaries are to be collapsed into a single entity to be incorporated in the Netherlands. Forming a company in one location (as opposed to six locations) has a number of advantages from each of tax, regulatory, governance and legal perspectives. It is clear that FMH wishes to focus on core operations and streamline the business, perhaps with a view to divesting underperforming parts of the business.

2. <u>Shares in new entity</u>: the banks have negotiated a debt-for-equity swap, whereby the banks forgive certain (likely crippling) debts in return for taking equity in the newly formed vehicle. The banks are essentially giving up their priority status in a liquidation scenario and will be deferred to any creditors of the new company. Although it is unclear what percentage of the total shares the banks have accepted, it must be assumed that it is a controlling stake or at least a substantial slice of the equity.

   The CRO and other Board members are also compensated in shares in the new entity. This is a typical arrangement for new management and consultants in a distressed workout scenario. The company may have no money to pay the fees of a restructuring specialist and therefore the payment is via shares (and dividends) in due course.

3. <u>FMH to be liquidated</u>: It is not clear what type of liquidation process is to be followed. However, a cost-effective voluntary liquidation might be appropriate in light of the fact that the banks and sole shareholder have agreed to cancel any and all claims against FMH. This is part of the *quid pro quo* for the debt for equity swap and the new risk-bearing capital, which is essential to the survival of the business.

4. <u>FMH and its sole shareholder to cancel claims against new entity</u>: The interests of the FMH entities are aligned in that they are all controlled by the same beneficial owners. FMH is to be liquidated and the banks would not want to take on risk through claims against the new entity they will now own.

5. <u>Banks C and D write-off €32.5 million debt</u>: although it is not entirely clear, the additional 'haircut' taken by banks C and D may be reflected in a greater share allocation in the new entity.

[30] See page 2 of "*A Toolkit for Out-of-Court Workouts*" World Bank Group, 2017.

6. Residual claim: although the banks receive shares in the new entity in return for financing original working capital at the main subsidiary level (i.e. Flow Management Work BV), they retain a claim against Flow Management Work BV (which is now part of the new entity) for €240 million. In that sense, it is not a complete debt write-off in return for equity swap. However, the banks waive a significant part of the debt owed by Flow Management Work BV (i.e. €97.5 million).

7. Loan cancellation: the loans advanced by the banks to Flow Management Work BV are cancelled in full. Based on the residual claim and the shares in the new entity, the banks are obviously comfortable that they have satisfactory protection and have received adequate consideration for the unpaid loans.

As at November 2013, there is total debt of €415 million. As of July 2015, there is an outstanding claim of €240 million. That is a very significant reduction in exposure and the FMH Group is in a far stronger equity capital position based on the position taken by the banks.

Question Eight: Which potential legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?

In terms of cross-border legal issues, a wide range of international companies are subject to the bankruptcy jurisdiction of not only their 'home Court', but also the courts of the foreign jurisdictions in which they operate, or with which they have other relevant connections. FMH has operating companies all over the world.

In light of the multi-national nature of the FMG group, there was always a risk that enforcement action against an operating subsidiary may have triggered problems in the overall FMH restructuring. FMH would have needed to consider commencing a formal process that includes a moratorium on the enforcement of security or other legal proceedings in the relevant jurisdiction.

It is foreseeable in the FMH scenario that, if an application to Court was made in, say, the Netherlands, there may have been a need for parallel schemes of arrangement. Parallel schemes can provide a strong legal foundation for a successful international restructuring (binding in all creditors and shareholders), but they do have the potential for duplicative expense. There have been a number of recent cross-border cases involving both Hong Kong and the Cayman Islands, in which the Hong Kong judiciary have required insolvent companies, whether acting by their directors or by provisional liquidators appointed for restructuring purposes, to give careful consideration to the necessity, costs, and benefits of any debt restructuring that contemplates the use of parallel schemes of arrangement in different jurisdictions, and to provide evidence justifying any parallel scheme.

There are also occasions on which a related company within a corporate group is placed into a foreign bankruptcy proceeding, and the foreign bankruptcy trustee or liquidator (or an equivalent officer) needs to secure recognition and assistance from the Courts of the various jurisdictions, often for something as routine as securing access to 'offshore' bank accounts, or production of documents and information, but sometimes for something more controversial or litigious (such as a substantial claim for damages, or

insolvency clawbacks). If there was distress across the FMH Group and action was taken in one or more different jurisdictions, there may have been potential cross-border issues in relation to comity and principles of universalism.

If the position became markedly worse and beyond repair, a cross-border compulsory liquidation scenario may have been on the cards for FMH and subsidiaries. There are many bankruptcy scenarios in which international companies (or corporate groups) have been placed into compulsory liquidation, or bankruptcy proceedings, in two jurisdictions simultaneously (or one after the other), with one of the courts being recognised as the "primary" court, and the other court being recognised as the "ancillary" court. The issue of which court should be granted "primary" status and which court should be granted "ancillary" status with respect to the liquidation of an international company, is a matter for determination by the respective courts in accordance with applicable law and protocols.

The restructuring agreement provides that all operating companies of FMH, which are domiciled in different jurisdictions around the world, are to be accommodated in a "shell subsidiary" based in the Netherlands. This is a common approach utilised for tax purposes. These are often referred to as Dutch special purpose entities and there are new requirements in relation to ensuring that companies in the jurisdiction have substantial economic activities. Depending on the attitudes of the jurisdictions where the business is being carried out, there may be cross-border tax and regulatory issues to deal with as a result of the collapsing of the FMH subsidiaries.

Other hostile action may have been taken by a creditor or other type of stakeholder in any of the various jurisdictions with the aim or effect of frustrating the implementation of the FMH restructuring. In light of the nature of the FMH core business, important clients could have withheld critical services or supplies; terminated contracts governed by multiple legal regimes; or sought to amend terms. These are often termed "self-help" remedies because they are exercised outside of a formal court process.

The FMH intra-group debt position is unclear. However, steps taken against FMH or other subsidiaries may have had wider implications for other members of the group. For example, as the FMH group has external funding, cross-guarantees may have been given to the external lenders.

The materials refer to potential issues with the banks' security. It is not clear whether the pledges where over assets in the Netherlands or elsewhere. However, a creditor who has security over assets in a particular jurisdiction and which is governed by the laws of that jurisdiction, should obtain a local legal opinion at the time the security is granted.

<u>Question Nine</u>: In October 2014, four scenarios have been drawn up. Why was or wasn't calling for a moratorium a good option given the situation at that time? Make reference to the Cayman Islands' position.

By October 2014, a formal moratorium had become less important than it might have been earlier in 2014. At that point in time, the banks were content with the new FMH management and there had been a "slight improvement" in financial performance. Having reached consensus on standstill terms and a

reprieve in August 2014, calling for a formal moratorium two months later in October 2014 may have been perceived by the banks as an inflammatory and destructive step.

Once a formal court process is instigated, there are generally time limits imposed by the local regime governing the restructuring. The timetable can be both unrealistic and inflexible. There were a number of changes in the attitudes and approaches of the protagonists from early 2014 to the end of that year. This typical cycle of compromise and negotiation may have been more difficult to achieve in a formal suspension environment.

FMH appears to have benefited from the confidentiality and flexibility of the informal out-of-court process. It appears that FMH was able to retain the majority of its major client relationships with limited disruption and on better pricing terms.

In most jurisdictions, any formal court-imposed stay and associated applications would become public knowledge. FMH and the banks would have reason to be concerned about how other stakeholders and competitors might use information for collateral purposes. The information to be produced in support of any formal restructuring application is often commercially sensitive, and the evidence must explain that the company is insolvent or negotiating with its creditors to avoid insolvency. The moratorium and associated court filings could also trigger termination clauses in key contracts.

The directors of FMH owed duties to the banks and other creditors. The company entered the zone of insolvency. As such, director's duties shift from shareholders to creditors in that scenario[31]. The removal and replacement of senior management added a further layer of complication and the incoming directors needed to exercise business judgment to act in the best interests of the banks in particular. By October 2014, based on progress that had been made and trust that had been restored, initiating proceedings and seeking a formal moratorium was not in anyone's best interests.

As referred to in response to question (2) above, the Cayman Islands provisional liquidation regime includes a statutory moratorium. The Cayman Islands-specific regime would have been unhelpful in the FMH scenario. The public nature of the process and the 'liquidation' tag would have been dangerous in relation to key clients and in respect of cross-defaults under financing agreements.

[31] There are exceptions. For example, in Canada the duty of loyalty does not shift (see *People's Department Stores Ltd. (1992) Inc.,* Re, 2004 SCC 68; [2004] 3 SCR 461 at para 43.