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## Case Study I

### Question 1

Flow Management Holding BV experienced the following, original problems:

- A pre-tax profit of € 8 million that was calculated for the period until 09/2013 turned out to be a loss of € 5.4 million
- The result for 2012 of € 3 million had to be downgraded by € 8 million because of faults in the annual accounts
- Large management bonuses of € 3 million have been wrongfully issued to the CEO and CFO
- A contingency gain relating to three years that has been received in 2012 has been wrongfully booked as a result for 2012, because of that the result had to be negatively corrected by € 1.6 million
- A book profit for 2013 that had been anticipated in 2012 of € 2.8 million wasn't realized in neither of these two years
- The loss (downgraded from € 3 million by € 8 million) is based on the wrongful calculation of the cost-price-calculation because the real costs were not checked

Mellahi and Wilkinson (2004) differentiate in regard of the failure of an organization into two general perspectives. The deterministic view takes the stand that *'industry matters more than the firm'*, where the voluntaristic view is based on the assumption that *'who makes the decision is more important than the external context within the decision is made'*.

The financial distress of Flow Management Holding BV is not based on outside influences. Rather there is a demand for their services in the market and the forecast for these services are finding their reflection in reality. The financial problems of the company are based on wrong internal decisions. The wrongful payment should not have been signed off by management. The decision to book the contingency gain as a result should not have been taken. The book profit of € 2.8 million was based on a wrong assumption by the management. And the faulty cost-price-calculation could have been prevented by stricter oversight by the same management. Therefore there is only little room to assume that an analysis of the financial problems of Flow Management Holding BV based on a deterministic view would shed any light on the problems of the company. Rather a voluntaristic analysis seems to be more opportune.

There are several theories that try to explain why the decision makers are making the wrong decisions because of internal faults of an organization. Mellahi and Wilkinson illustrate the approaches of the Groupthink Theory, the Upper Echelon Theory, the Curse of Success and the Threat Rigidity Effect Theory. For the representatives of the Groupthink Theory the main

problem is the tendency of groups of leaders that consist only of few members to make the wrong decisions because they base their decisions on stereotypes of other groups, don't search for alternatives or ignore informations that come from outside their close-knit circle. Similar in its assessment is the Upper Echelon Theory. In its view the main problem arises from the composition of the group of decision makers. A homogeneous group is more prone to make wrong decisions than a heterogeneous group. The Curse of Success Theory locates the reason for failure in the tendency of successful leaders to base their assumptions for the future on the experiences from the past. Finally the Threat Rigidity Effect Theory points to the fact that leaders tend to stick to the status quo in a threatening situation. The two main approaches of these theories that are useful in the case of Flow Management is the tendency of leaders to hubris or incompetence. The financial problems of the company are results of lax oversight and wrong decisions by senior management. The management is on one hand (a.) not interested in the day-to-day machinations of the company and on the other hand (b.) making the wrong decisions. To determine which aspects of the aforementioned theories would fit best in the case of Flow Management Holding BV more information on the management team would be needed, e.g. tenure and composition of the management team. But the financial distress would be most likely have been prevented or at least mitigated if the oversight in regard to the management team would have been intensified.

The financial distress couldn't have been prevented if a solely deterministic would be taken, because there are no outside influences that caused them that could have been addressed. But the problems, as shown above, are based on internal faults of the company.

## Question 2

According to Adriaanse and Kuijl (2006) the advantages for an out-of-court restructuring are its flexibility, the silence it insures and the control it allows. They define out-of-court restructurings as *'a reorganization route which takes place outside the statutory framework'*. Therefore they allow for a tailor made approach to the problems of the company. They are not restricted by the constraints of formal reorganizations *'laid down by the (insolvency) law or which take place by using legal methods and possibilities'*. They are also silent because they don't have to be made public. Therefore clients and suppliers don't need to be informed on the reorganization and the difficulties of the company. Finally the management of the company stays in full control. The courts don't appoint someone to take over the administration of the company or at least to control the decisions of the management.

Adriaanse and Kuijl also show problems of out-of-court restructuring in so far as certain bottlenecks can arise. They include a passive attitude of management and shareholders to the informal reorganization, as a result of this insufficient strategic, operational and financial resources are provided. But they view these problems rather as the results of bad execution of the out-of-course restructuring. Because of this they draw the conclusion that *'insolvency legislation, in itself does not have a significant impact on the chances of success of a rescue operation.'* Their bottom-line is: that the willingness of all stake-holders to make a restructuring successful is the most important aspect regardless if it is out-of-court or based on the statutory framework.

In Germany an out-of-court restructuring is possible and would most likely be based on a settlement agreement (*Vergleich*). Besides this the German law knows the following reorganization proceedings:

- Insolvency Proceedings
- Insolvency Proceedings of a consumer
- Debtor-in-Possession
- Restructuring Process

These processes are most of the time public, e.g. the insolvency court publicizes in most cases the restraint on disposal. The restructuring process is the only restructuring stipulated by law that provides for not publicizing these orders to the general public. The biggest advantage of these court proceedings over an out-of-court solution is that the results in regard to the creditors do not run the risk to be later contested by insolvency avoidance should the company be later forced to file for bankruptcy.

### Question 3

The approaches presented by Mellahi and Wilkinson (2004) are not direct reorganization approaches. Rather, they are concerned with identifying the reasons for the failure of an organization. From this, however, the reader can derive approaches for change. If one were to focus exclusively on the deterministic view, which sees external influences as the decisive factor, there would be little possibility of counteracting failure. The two authors contrast this with the voluntaristic view. This approach sees the reasons for the failure of an organization primarily in its internal structures. Thus, the voluntaristic view in particular offers approaches for relevant changes in an organization. Since the mistakes are mainly to be found in the decision-makers of the organization, the changes must also be made there. Mellahi and Wilkinson would suggest breaking up existing structures, e.g. by enlarging the decision-making body (Groupthink Theory), diversifying this body (Upper Echelon Theory), constantly training the decision-makers to avoid overestimating themselves (Curse of Success) and achieving flexibility in the face of changing conditions (Threat Rigidity Effect Theory).

In case of Flow Management Holding BV these approaches to reorganization can be found in the announcement of the replacement of the CFO in January 2014, the replacement of the CEO mid April 2014 and the appointment of a CRO in the summer of 2014. The complete replacement of the leadership of the company seems to be the best suited tool in this case. Especially because the governing body is so small anyway. In the long-run the company should focus on a more sustainable approach to setting up and controlling its leadership (e.g. diversification, training).

The reorganization approach presented by Pajunen (2006) focuses on the influence that stake holders have on the organization from the outside. In doing so, he focuses on resource dependency on the one hand and on the stakeholder's position in the network on the other. Based on this, the stakeholders are categorized according to their influence on the survival of the organization. Minor stakeholders (M) have no influence on this. Potential stakeholders (P) have a potential influence on survival and governing stakeholders (G) have a direct influence. Furthermore, Pajunen shows that this is not a static model, as new stakeholders can be added, old ones can leave and remaining ones can be re-categorised. Since the involvement of stakeholders in the reorganization is also dependent on resources, the focus should be placed on the G stakeholders to have the most effect. In addition, Pajunen suggests six approaches to engage these stakeholders. These propositions include aiming at binding the stakeholders on a personal level to the company (*Proposition 3`In an existence-threatening crisis, personal relationships between managers and governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders`*), to achieve the position of a broker between the governing stakeholders for the management (Proposition 4) and aligning the stakeholders with the long term goals of the company (Proposition 5). All these goals can only be achieved by an active management of the stakeholder relationship.

In this case the governing stakeholders (banks A, B, C and D) have been approached by the management as well as the shareholder. As advised by Pajunen these stakeholders have been informed on the current relevant data of the company. Furthermore the management reporting system has been updated to ensure also more reliable information could be provided to the stakeholders.

Adriaanse and Kuijl (2006) shed light on reorganization in the context of an out-of-court process. They divide such a process into business and financial restructuring portions. Business restructuring is divided into four phases. The stabilization (1.), the analysis (2.), the repositioning (3.) and the reinforcement (4.). Financial restructuring includes, on the one hand, the willingness of the relevant lenders to accept changes in the existing payment obligations and, on the other hand, the provision of new capital to the extent that this is necessary, either on the capital or on the equity side.

Stabilization measures in the case of Flow Management Holding BV have been taken by spending cuts and improving the loss recovery. Furthermore the shareholder proposed to sell off 350 cars which the banks are not preferring. Rather they would like to see the shareholder to put cash into the company to ensure liquidity. This is most likely based on the view that the selling of the cars could endanger the operation of the company. In the analyzing phase a price increase has been negotiated with the major clients. The overhead cost will be cut by making 130 staff members redundant. Also the entire product range will be evaluated and reassessed. Furthermore all subsidiaries outside the core market of the company will be sold off. The last two phases (3. and 4. are not developed at this point in the case study).

Concerning the financial restructuring the following measures are agreed upon or at least discussed:

- The shareholder of Flow Management Holding BV is asked to pay off the equity capital
- The Shareholder deposits € 10 million of unsecured loan, proposes to lend another € 27.5 million under same conditions
- A new repayment scheme for € 35 million in working capital is being agreed on with the creditors
- Refinancing the remaining working capital of € 360 million is postponed from 2016 to 2019
- Default interest is no longer charged
- Shareholder will contribute at least additional € 27.5 million
- A and B banks are open to a further injection of at least € 35 million
- Shareholder willing to deposit € 10 million in the short term and to contribute the rest of € 25 million in 09-10/2014
- Furthermore the selling of the company to competitor has been as well discussed as a debt-to-equity swap (which is later implemented)

This illustrates that all tools of financial restructuring (equity- or debt-side) are taken into account.

Similar to Adriaanse and Kuijl Schmitt and Raisch (2013) differentiate the reorganization into two parts, into retrenchment and recovery. Retrenchment measures aim at efficiency gains by reducing costs and assets. Recovery, on the other hand, aims at improving the company's market position, which is to be achieved through changes in the strategic orientation. The tools Schmitt and Raisch cite for these goals include learning strategies, exploiting organizational and performance complementarities, and managing these relationships. Learning strategies are divided into focus and experimentation strategies. The focus strategy refers to the minimization of variance in order to optimize the use of resources and also free them up for alternative uses. An experimentation strategy, on the other hand, aims to increase variance in order to learn to do the same work with fewer resources. Complementarities of organization are based on formalization and participation strategies. Complementarities of performance, on the other hand, include profit and breakthrough strategies. Finally, Schmitt and Raisch point out that the management of these complementarities is of crucial importance in the context of a reorganization, as the resolution of the contradictions that exist here can be very beneficial to this process.

The measures taken in the case of Flow Management Holding BV don't include any experimentation strategies when viewed through the system provided by Schmitt and Raisch.

On the other hand a focus strategy can be found in the sale of the subsidiaries outside its core market. The reason for not testing experimentation strategies is most likely the fact that this would require a management which is committed to such an endeavor. The old leadership didn't seem to be right for this approach and the new one has most likely other priorities because of the current problems. There are also no organizing complementarities made use of. This would also take additional momentum on the leadership side which apparently isn't there. When looking at the performing complementarities only financial measures are taken to ensure stakeholder support (e.g. further equity provided by the shareholder). The fact that the interests of the employees are not taken into account is most likely based on the fact that they have no real leverage.

The turnaround strategies presented by Sudarsanam and Lai (2001) include restructuring of management, operations, assets and finances. The restructuring of management aims at replacing the current management to assure the creditors that the management that has caused the problems will not stand in the way of the turnaround. The operational restructuring is divided in the (a.) efficiency/operating stage and the following (b.) entrepreneurial/strategic stage. The first stage (a.) has the goal to *'stabilize operations and restore profitability by pursuing strict cost and operating-asset reductions'*. The second stage (b.) *'aims to achieve profitable long-term growth through restructuring the firm's asset portfolio or product/market refocusing'*. Asset restructuring can be separated into (a.) asset divestment and (b.) asset investment. The divestment (a.) can include the sale of subsidiaries and of non-profit generating assets. An examples for (b.) investment is capital expenditure to achieve improvements in the operation of the company. Finally financial restructuring *'is the reworking of a firm's capital structure to relieve the strain of interest and debt repayments'*. This can be either focused (a.) on the equity or on the (b.) debt side. (a.) Equity-based strategies focus on the rights of the owners the company, whereas (b.) debt-based strategies focus on the rights of the creditors.

With regard to the categorization of Sudarsanam and Lai (2001) measures in regard to management organization include the replacement of CEO, CFO and the appointment of a CRO. Concerning the operations of Flow Management Holding BV on the operating stage measures taken include the layoff of employees and cost cutting. On the strategic stage the entire business mix will be evaluated and reassessed. Concerning the assets of the company the selling of all non-core-market-subsidiaries has been at least discussed. But no investments into new assets have been proposed. This is most likely based on the fact that there is no capital to do so. As shown above the financial restructuring has taken place on the equity as well as on the debt side.

#### **Question 4**

Two reasons for this kind of behavior spring to mind: either (a.) it aims at increase the leverage of all banks in the workout process or (b.) it only increases the leverage of these two banks. In case of a. the goal of the banks C and D could have been to pressure the management of Flow Management Holding BV to speed up their reorganization efforts. In case of b. their reason could have been to reach a position that would have made the success of the turnaround more dependent on them than on the banks A and B so that they could have negotiated for better conditions then them or to persuade them to buy them out.

As the lawyer of the banks A and B I would have advised to make it clear to the company and especially to the representatives of C and D that they will not be pressured into making any concessions to other banks and the the filing for formal insolvency proceedings is still on the table if C and D frustrate the workout efforts. If this wouldn't have worked to bring C and D back to the table I would have advised to make them an offer to buy them out at a discount if this is still in the interest of my client.

## Question 5

The first principle can be found in agreeing on a standstill period or moratorium.

In January 2014 the banks agree that a standstill agreement must soon be signed not later than March, 31<sup>st</sup> 2014. But at the end of March 2014 such an agreement has still not been signed because of the friction between the two groups of banks. It takes to early August 2014 to mend the relationships between all banks so that they conclude that they will pursue a standstill agreement in the near future. This standstill agreement for 120 days is signed in the middle of August 2014. In October 2014 the company proposes as one of the potential scenarios for its restructuring an additional 180-day standstill. An other scenario proposes a moratorium on the payments.

The second principle stipulates that all relevant creditors refrain from enforcing their claims or to reduce their claim to get an advantage compared to the other creditors.

In the case of Flow Management Holding BV in December 2013 all relevant creditors, the Banks A, B, C and D, agree not to take action against the company. After December, 20<sup>th</sup> 2013 these banks agree not to terminate the credit agreements with the company because they assess that the liquidation of the company would negatively effect the proceeds of the assets. But at the end of June 2014 the banks C and D threaten to cancel the credit.

According to the third principle the debtor shall not take any action that endangers the prospective returns of the creditors compared to their position at the beginning of the standstill period.

The Banks A, B, C and D agree after December, 20<sup>th</sup> 2013 that a scheduled repayment of € 25 million on December, 31<sup>st</sup> 2014 will not go ahead as planned, which would potentially grant one of the banks an advantage over the others depending on the structure of the loan.

The fourth principle views it as the best option that the creditors co-ordinate their interests towards the debtor. Therefore they should select one or more representatives to a co-ordination committee.

In December 2013 the Banks A, B, C and D agree in principle that action in regard to Flow Management Holding BV must be taken jointly and in a controlled manner. But in mid February 2014 the banks C and D decide not to cooperate anymore. Only later they get back at the table. But a formal co-ordination is not introduced.

During the standstill period the debtor shall allow the creditors and their representatives access to all necessary data in a reasonable and timely fashion relating to its assets, business and prospects, to be able to evaluate its financial position and any proposals to be made to relevant creditors – fifth principle.

In this case this measure is agreed on even before the standstill period has been commenced. Flow Management Holding BV agrees with the banks A, B, C and D that an accountancy firm that is not the company's auditor will get access to the relevant data and information to investigate the relevant processes within the company before December, 1<sup>st</sup> 2013. Furthermore the company commits itself to report on the basis of actual costs and turnover each month to these banks. Furthermore in December 2013 additional information is provided to an independent turnaround consultancy agency to assess the viability of the company's business model. After December, 20<sup>th</sup> 2013 it is expected that the management information system has so far improved that the figures provided to the banks will be more reliable.

According to the sixth principle all proposals to tackle the financial difficulties of the debtor and -as far as practicable- arrangements between the relevant creditors relating to any standstill should reflect applicable law and the relative positions of the relevant creditors at the Standstill Commencement Date.

The final Restructuring agreement finalized on July, 4<sup>th</sup> 2015 reflects the relative positions of the involved financiers. This is especially reflected in the fact that the uncertain security rights of the banks are not taken into account.

All information obtained in regard to the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should be treated as confidential so far as they are not already publicly available – seventh principle.

It can be assumed that this principle in regard to the confidential handling of the information is reflected in the workout process. At least the commission of an external accountancy company indicates that all data will be professionally handled by the participants. Otherwise the creditors are informed on a monthly basis on the important data by the company.

Finally the eighth and last principle stipulates that all funding that is provided during the standstill period or under any other rescue or restructuring proposals shall be handled, as far as practicable, as priority status compared to other indebtedness or claims of the relevant creditors.

In January 2015 a total of € 25 million is paid back to providers of the additional working capital. But there are no further information if this is handled as having priority status over the other debts.

#### **Question 6**

Another possibility would be to get the creditors to sign a different Statement of Principles which is (a.) tailored to their demands but also (b.) facilitates the participation of the creditors in the workout process.

The main reason that parties in Germany would refrain from such an agreement is the fear that subsequent insolvency proceedings would frustrate these efforts. The main reason for this is that all payments received by the creditors during the workout process are in danger to be contested by the insolvency administrator as an insolvency avoidance.

#### **Question 7**

In essence all subsidiaries of Flow Management Holding BV will be put into a new holding, Flow Management II BV. The shares of this new holding are transferred to the consortium of banks A, B, C and D, which provided the original working capital of Flow Management Work BV, as well as some board members. To put it simply the viable operation of the business of the company is kept alive but put into a new holding.

The legal shell of Flow Management Holding BV is going to be liquidated. If this can be achieved out-of-court or not hasn't been determined. The claims of the banks and the shareholders against this legal entity will be cancelled. Furthermore the "old" BV and its shareholder will cancel all claims against the new holding and its subsidiaries.

The banks which provided Flow Management Work BV with additional working capital (C and D) will waive additional € 32.5 million against the "old" holding which leads to the whole debt be written off. The banks A, B, C and D which provided Flow Management Work BV with working capital will waive an amount of € 97.5 million therefore claims of € 240 million in regard to the working capital will remain. Also the € 55 million loan in Flow Management Work BV is cancelled in full.

Therefore the operating subsidiary Flow Management Work BV will start "only" with a € 240 million debt. Besides this all other subsidiaries as well as the new holding will start with a clean

slate. Because the creditors of this debt are also major shareholders of the holding company of Flow Management Work BV they are incentivized to help in the reorganization of the company and its operations.

### **Question 8**

One legal cross-border problem for the restructuring of Flow Management is the fact that the subsidiaries (Flow Management Work BV, SL, SPRL, etc.) are dispersed all over the EU, Australia, South Africa and the USA. Because of that it would be challenging to determine how insolvency proceedings of the holding would affect the subsidiaries. For example in the event that the holding company (Flow Management Holding BV) would have to file for insolvency in the Netherlands it would have to determine if these proceedings would also include the shares of the subsidiaries outside of the Netherlands. Even if that would be legally possible it could be a non-legal challenge to liquidate these shares as part of these insolvency proceedings.

Another legal challenge stemming from this situation would be the insolvency of one of the subsidiaries and how this would affect the holding.

### **Question 9**

A moratorium would most likely have the following main consequences (in regular insolvency proceedings):

- a. It could have made the financial difficulties of the company public.
- b. It may have set in motion compelling legal processes.

A moratorium, a formal suspension of payment procedures, has to be issued by a court because it affects the rights of the creditors. If this court order should be publicized or not depends on the legal requirements. The German Insolvency Code (InsO) requires only the publications of restraints on disposal (§ 21 II Nr. 2 InsO) against the debtor, § 23 InsO. An order that prohibits on measures of execution against the debtor, § 21 II Nr. 3 InsO, doesn't need to be publicized. Nevertheless, in practice, in addition to the restriction on disposal the prohibition on enforcement is also published in the case of ongoing business operations (BeckOK InsR/Kopp InsO § 23 Rn. 3-8) on the internet

**<https://neu.insolvenzbekanntmachungen.de/ap>**

Therefore there would be a real risk that the order issuing the moratorium, as well as the financial problems of the company, would become known to the general public. This could have had an adverse reaction of the market. The customers would be hesitant to lease more cars because of the uncertainty of future of the holding.

In practice the issuing of the ordering of a moratorium by an insolvency court in Germany will go hand-in-hand with the order on restriction of disposal (as mentioned above) as well as the appointment of a provisional insolvency administrator, § 21 I Nr. 1 InsO. This would entail for the debtor to give up the reins in regard to the future of the company. Because all assets would suddenly be valued with their liquidation value it is more likely that the company is suddenly over-indebted which is one of the legal reasons to open the insolvency proceedings for a legal person.

Other outcomes would be possible if specific criteria are met so that a deviation from the path determined by a regular insolvency proceedings would be possible.

First of all the the InsO allows for debtor-in-possession management in § 270 - 285 InsO. In such an insolvency proceedings a provisional insolvency administrator would not be appointed. Rather a provisional insolvency monitor shall be appointed, § 270a I 2 InsO. It can be argued that debtor-in-possession management should not be publicized because an order of restriction of disposal is not issued in such a case, § 270a I 1 InsO (BeckOK InsR/Kopp InsO § 23 Rn. 3-8). Therefore the danger of informing the general public about the difficulties of the company could be minimized. An other, comparable option would be restructuring proceedings according to the German Act on the Stabilization and Restructuring Framework for Businesses (StaRUG) which is based on the EU Directive 2019/1023 and came into effect on January, 1<sup>st</sup> 2021. In § 49 I Nr. 1 StaRUG it is stated that a stabilization order can be issued by the Restructuring court that is an restriction on disposal. But § 51 IV StaRUG specifies that this order is only issued to the creditors directly affected by the order.

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