Global Insolvency Practice Course 2021 / 2022

Student: **Paul Birkett**

Topic: **Case Study 1 - Flow Management**

Assignment questions

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?

In my opinion the causes of financial distress at Flow Management Holding BV ("Flow Management" or the "Company") are as a result of the Company's strategy, including how and by whom it was to be executed. The basis for this view is that there is very little mentioned about external factors that have influenced the Company; rather "[t]he talks pass off with difficulty and management has the impression that the takeover candidates prefer to buy the company following liquidation", perhaps indicating that these industry participants do not see value worth paying for.

In addition, in my experience, Flow Management's business model of leasing trucks and private cars is characterised by particularly thin margins, high levels of debt and a critical need to ensure disciplines, controls and procedures that are strictly adhered to.

In the case of the Flow Management, I tend to agree with the voluntaristic perspective that assumes that managers are the principle decision makers of the firm and their perceptions of the external environment have a strong effect on how they (mis)manage the firm[1]. Evidence of such mismanagement can be found, not only at the beginning of the Case, whereby the causes of the losses are stated at the meeting on 16 November 2013 with the four banks, but as an ongoing trend throughout the Case.

Accordingly, the causes of financial distress include the following -

- ***Mismanagement*** - the fact that large management bonuses (totalling €3 million), notably to the CEO and CFO, were wrongfully issued. Interestingly, there was no mention in the subsequent events as to the recovery of these bonuses that were wrongfully paid out.

  On the contrary, measures were taken to make redundant as many as 130 staff members with a view to achieving an annual saving of €3.3 million. In my view, such actions by the executive management set the wrong "tone at the top".

  In addition to the above, there were repeated calls from the banks for the shareholder to reconsider the appointment of the executive management following a loss of confidence, and we note the announcement in January 2014, that a new CFO will be appointed, and in April 2014 the replacement of the CEO.

[1] Mellahi, K., & Wilkinson, A. (2004). "Organizational failure: a critique of recent research and a proposed integrative framework". International Journal of Management Reviews, 5(1), p 27.

Lastly, and perhaps most importantly, the challenges with respect to incorrect costing, accounting irregularities and unreliable forecasts (as mentioned below) are the ultimate responsibility of the executive management.

- ***Inaccurate management information systems*** - the initial financial distress, particularly the losses that occurred in 2013, were driven by a ‘formula error’ in a spreadsheet, which inevitably resulted in the cost price calculation being incorrect and prices being charged that were too low. In addition, there was a failure to periodically check the real costs, which would have revealed the error.

  This failure to accurately calculate the cost price, as well as the subsequent failure to periodically check same, evidences the inadequacy of the disciplines, controls and procedures that should be in place for robust management information systems. In my view, this reflects the abovementioned mismanagement and perhaps a lax culture across the Company. Such a culture would be particularly detrimental for a leasing company such as Flow Management, where the margins are typically low and failure to accurately cost can quickly result in losses across the company.

- ***Accounting irregularities*** - noting the inaccurate financial reporting at the initial meeting with the banks, particularly with respect to a contingency gain and a book profit. In my view, this evidences particularly aggressive accounting and recordkeeping by the Company. Inevitably, the underlying assumptions applied in the financial reporting are likely a consequence of mismanagement[2].

  The accounting irregularities are likely to have contributed to the unreliable forecasts, considering that the assumptions upon which the forecasts are based tend to be grounding in the historical financial reporting, and accordingly needed to be revised.

- ***Inaccurate financial planning and forecasting*** - following on from the accounting challenges and inaccurate management information systems, it was repeatedly noted that profitability forecasts were made, and then subsequently missed to the downside. In my view, this contributed to the banks’ frustrations, loss of confidence in the management and threats to cancel the credit.

  As mentioned by Adriaanse and Kuijl[3], “a good relationship between the company and its primary stakeholders appears to be vital. Informal reorganizations only have a chance of success when these interested parties can be convinced of the (future) viability of the company and the abilities of management”. In the case of Flow Management, the repeatedly unreliable forecasts are likely to have been a major contributor to the banks’ frustrations.

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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*?

As set out by Adriaanse and Kuijl[3], “[a]n informal reorganisation is understood to be a reorganisation route which takes place outside the statutory framework - therefore, in the shadow of the law - with the objective of restoring the health of a company in financial

[2] Perhaps for further review, is the question as to whether such assumptions were applied with a view to achieving the management bonuses.
[3] Adriaanse, J.A.A., & Kuijl, J.G. (2006). “Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?”, Review of Central and East European Law, 31(2), p 149.

difficulties within the framework of the existing legal entity. An informal reorganisation consists primarily of business restructuring and financial restructuring."

Out of court restructurings, according to Adriaanse and Kuijl, typically have three advantages, namely *flexibility*, *silence* and *control*[4] -

- ***Flexibility*** - the reorganization is less rigid than is the case with formal procedures. Companies can reach agreement on the actions to be taken by the company and the terms and conditions under which these take place, effectively developing "tailor-made" solutions;

- ***Silence*** - out-of-court restructurings take place in relative silence. In my experience, the reputational damage and the indirect costs (e.g. loss of future sales) that result from a public process are particularly onerous. By way of a quick example, my experience in commercial aviation restructurings suggests that passengers are unlikely to purchase tickets months in advance for fear that the airline may be unable to deliver on the service.

- ***Control*** - management continue to run the company independently. Whereas in a formal bankruptcy procedure, the process may be run by the courts or an independently appointed administrator, such is the case in South Africa whereby business rescue practitioners are appointed.

South Africa has a concentration of major corporate banks[5], and in my experience, these four banks tend to know each other well and act in a relatively collegial manner (particularly considering that they are likely to work together again in the future). Accordingly, on the basis that the major debt providers are co-operative and seek to find a common solution, the South African banks tend to prefer out-of-court restructurings, particularly for larger matters.

In addition, in South Africa, there may be several other advantages to out-of-court restructurings, including -

- ***Cost savings*** - the costs of formal bankruptcy procedures can become quite prohibitive and deplete an already strained cash position of the company;

- ***Inappropriately qualified and incentivized business rescue practitioners*** - In terms of South Africa's Business Rescue legislation[6], a business rescue practitioner ("BRP") is appointed. However, many BRPs are -
    - inappropriately qualified, having limited qualifications or experience in turnaround and restructuring matters[7]; and
    - inappropriately incentivized, whereby a statutory rate of remuneration for BRPs was introduced in 2008 and has never been revised, resulting in many BRPs (particularly Senior BRPs) failing to be remunerated at a market rate. In addition, the statutory rate is calculated on an hourly basis, which in some instances is misaligned with the objectives of the entity in business rescue.

- ***Lack of funding in business rescue*** - whilst DIP financing in the United States may be well established, with several parties seeking to provide such financing, in South Africa the industry is still in its infancy. Accordingly, it was well understood that access

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[4] Adriaanse, J.A.A., & Kuijl, J.G. (2006). "Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?", Review of Central and East European Law, 31(2), p 145.
[5] South Africa's four major banks include ABSA, FNB, Nedbank and Standard Bank
[6] Chapter 6 of the Companies Act, No. 71 of 2008
[7] Particularly evident for smaller businesses whereby Experienced or Junior Business Rescue Practitioners are appointed

to funding in business rescue is a challenge[8] and companies may seek out-of-court restructurings on the basis that creditors may be more willing to consider credit;

- ***Reputation*** - business rescue in South Africa has received an unfortunate reputation for being a place where companies are merely wound up. Whilst this reputation may not be entirely justified, it does place an unfortunate stigma on the formal process; and

- ***Trust*** - concentration of debt providers in South Africa, namely the four major banks, means that fellow creditors often know each other and have a measure of trust. This trust leads to co-operation, which suggests that out-of-court restructurings have a higher likelihood of success, relative to instances whereby the creditors may be uncooperative.

Disadvantages of out-of-court restructurings in South Africa are consistent with other jurisdictions, and may include -

- No protection or moratorium from the collection efforts of creditors;

- An out-of-court restructuring lacks the formal decisiveness of a formal bankruptcy process;

- The probability of reaching a compromise in an out-of-court restructuring decreases the more creditors there are, which favours simple capital structures. For more complex capital structures, a formal bankruptcy process may be required;

- In my experience, smaller creditors, particularly where such creditors have limited experience in business restructuring, often fail to grasp the gravity of the challenges facing a company and accordingly "play hard ball". To overcome this unwillingness to accept a compromise, a formal bankruptcy process may be necessary; and

- An out-of-court restructuring may limit the urgency that is required for a turnaround of the business. In my experience, management teams too often fail to have that burning sense of urgency that is necessary for decisive actions to take place.

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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.

Several turnaround / reorganisation approaches, as presented in the reading material, were applied in the Case. In particular the following reorganisation approaches, as set out based on the work of Sudarsanam and Lai[9], were undertaken -

- ***Operational restructuring*** -
  - Including retrenchments, price increases and improved loss recovery, higher excess premiums and savings on car repairs;

- ***Asset restructuring*** -

[8] Deloitte 2021 Restructuring Survey noted that 44% of respondents suggested that the biggest hinderance to a successful formal restructuring process was *Lack of post-commencement finance*

[9] Sudarsanam, S, Lai, J., (2001), 'Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis', British Journal of Management, Vol. 12, p 189.

  - Asset sales were considered including the "proposal to sell 350 cars in order to improve the solvency rate" and subsequently there was a sale of surplus assets, which provided sufficient incoming cash flows as announced in October 2014;
  - Consideration as to divestment of certain subsidiaries, which is the restructuring that was achieved by means of transferring the operating subsidiaries into a new shell entity in July 2015;

- ***Managerial restructuring*** -
  - The CEO was removed and an announcement was made to remove the CFO in January 2014; we assume this action was taken;

- ***Financial restructuring*** -
  - The shareholder was required to contribute €10m in June 2014, together with commitments for €25m in September / October;
  - In June 2014, proposals were submitted to the banks with a view to deferring the repayment obligations as well as reducing the interest charge (e.g. default interest was no longer to be charged); and
  - The Restructuring Agreement signed on 4 July 2015 resulted in a debt equity swap, effectively converting risk-avoiding capital into risk-bearing capital.

In my view, the following could have been done differently -

- ***Introduce CRO early*** - a Chief Restructuring Officer could have been appointed earlier in the process; this would have provided the creditors with increased visibility into the financial forecasts and perhaps directed urgent action sooner in the process;

- ***Recover bonuses*** - the initial causes of the losses, in particular the €3m paid to management could have been recovered (at least partially);

- ***Asset sales*** - whilst there was a sale of surplus assets, the Company could have sold-down its fleet earlier in the process and the proceeds of such asset sales should go towards settling the banks. In particular the nature of leasing companies is such that their assets can be scaled up and down relatively quickly, as there is a liquid market for their assets;

- ***Risk bearing capital*** - As one of the banks, I would have required the introduction of risk-bearing capital earlier in the process to correct the solvency rate. It appears that the banks were relatively lenient in this regard, and it was only upon the threats to cancel the credit from banks C and D, did the shareholder agree to provide funding. In addition, such funding should have been used to reduce the bank's exposure, as opposed to fund operating losses; and

- ***Sale process*** - it appears that the management team ran the process to introduce external capital from industry participants.

  In my view, this should be an independent process and a broader pool of investors should be approached, including financial investors. In particular, the management team will drive their own agenda through such a process, and focus typically on industry participants. Whereas an independent investment bank, would have a greater view on potential participants (e.g. financial investors such as private equity and hedge funds) and will be independent of the management team.

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 appeared to frustrate the process, which could have been for a number of reasons. In any restructuring, each bank is likely to have its own incentives and views as to what would be the optimal solution, based on the nature of their exposure and security, as well as their own internal risk appetite. With this in mind, it is noted that banks C and D did provide Flow Management with additional working capital, which was subsequently written off[10].

However, in my view, the key reference in the case was -

“At that time, banks C and D threaten to cancel the credit (it later emerges that this was somehow done to give off a signal to the company to hurry up).”

In my experience, there is a significant behavioural element when it comes to restructurings, and quite often a particular party needs to play a “role” in order to catalyse a situation. A common role is that of the “bad guy” who repeatedly threatens the company and disciplines the management team. This “bad guy” creates urgency towards finding and implementing a solution.

Immediately after the threat of banks C and D cancelling the credit, it was noted that “The shareholder is subsequently willing to deposit €10 million in the short term and to contribute the remaining €25 million in September / October 2014”.

Accordingly, in my view, the threatening approach of banks C and D appeared to have the desired outcome by jolting the shareholder to introduce new funding.

As an advisor to the other two banks, I would have -

- Analysed the exposures and security of banks C and D, to better understand possible reasons for their threatening actions; and
- Increased the levels communication with these two banks, with a view to building a trusting relationship.

Only once we understand their position, and they are willing to bring us into their confidence, can we proceed to resolve the situation together.

If however, banks C and D continued down a path whereby they were unwilling to co-operate, then such actions may have been detrimental to the process and the outcomes for banks A and B. In such a scenario, I would have advised banks A and B to consider how best to increase their security in the event of an impending liquidation, including securing additional shareholder guarantees. This would likely result in an adversarial position relative to C and D, however in my view, such actions would have been acceptable had they not been willing to co-operate.

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[10] Noted in the July 2015 Restructuring that “the banks (C and D) which in the past provided Flow Management Work BV with additional working capital will waiver an amount of € 32.5 million. In fact, the entire debt is written off (‘haircut’)”

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 of the principles, in some form or another, can be found in the workout process of Flow Management, at various points along the restructuring process, including -

- ***First Principle*** - at various times, the four banks were prepared to co-operate with each other to give sufficient time (by means of the standstill) to the Company. Whilst the level of co-operation varied at times, from not co-operating (as was the case in banks C and D in June 2014), to signing a standstill agreement and a subsequent restructuring agreement in August 2014 and July 2015 respectively;

- ***Second Principle*** - the banks refrained from taking any steps to enforce their claims or to reduce their exposure to Flow Management during the standstill period, albeit the period was limited to 120-days from August 2014;

- ***Third Principle*** - during the standstill period, the Company did not take any action which would adversely affect the prospective return to relevant creditors. On the contrary, the Company sold surplus assets and various scenarios were drawn up with a view to considering the way forward;

- ***Fourth Principle*** - co-ordination efforts were put in place, including the appointment of professional advisors and a chief restructuring officer. Such efforts increased the level of transparency as well as provided much needed capacity to the management team (critical in such moments of crisis);

- ***Fifth Principle*** - following the appointment of various advisors, including the appointment of the Chief Restructuring Officer, a turnaround consultancy and an accounting firm (not the company's auditors), we understand that all relevant information was provided such that a proper evaluation of the Company's financial position could be obtained. Whilst the forecasts appeared to have been unreliable, particularly in the initial stages, there is a sense that the reporting and forecasting improved following the change of management (notably the CEO in April 2014);

- ***Sixth Principle*** - it appears that all applicable laws were appropriately considered in the course of the restructuring process;

- ***Seventh Principle*** - we assume, by the appointment of various advisors that any proposals for resolving the company's challenges were made available to the relevant creditors, notably the banks; and

- ***Eighth Principle*** - it appears that additional working capital funding was made available to the Company and this funding was repaid in January 2015, which appears consistent with affording such funding priority status as compared to other indebtedness or claims of relevant creditors.

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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?

In my view, there are several other possibilities to encourage co-operation of creditors, depending on what is motivating their underlying approach. Once the underlying motivating drivers are understood, then their actions (particularly future actions) can be considered and aligned.

In South Africa, whereby there is a concentration of corporate banks, there is a measure of goodwill that is maintained across the banks. Failing to maintain trust and goodwill on one engagement, invariably may lead to a tit-for-tat approach, whereby such bank will try to "get back" on the next restructuring engagement. Accordingly, the banks understand this well and seek to co-operate for fear that they may suffer in the next restructuring.

In addition, creditors do not want to be seen as the un-co-operative party, for fear that it reflects poorly on their reputations. This is particularly relevant whereby such uncooperative behaviour may result in the liquidation of a business and the ensuing job losses resulting therefrom. Accordingly, creditors may cooperate with a view to protecting their reputations.

Lastly, restructuring practitioners often embark on an education process whereby creditors (particularly smaller creditors) are educated as to the benefits of a co-operative restructuring process. Whilst such communication often fails to be heard at times (particularly where emotions are involved), if accepted, can lead the parties forward in a co-operative manner.

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

The restructuring agreement appears to create a new entity (being Flow Management II BV) and for the operating companies of Flow Management Holding BV to be transferred to the new entity. In addition, the equity (i.e. shares) of this entity are transferred to the consortium of banks as well as to selected board members and the CRO.

In addition, numerous claims and debts held by the consortium of banks are compromised / written off, particularly such debts with Flow Management Holding BV and its remaining subsidiaries, notably Flow Management Work BV.

Accordingly, this appears to be a debt for equity swap, resulting in a significantly deleveraged business that can be presented for sale as a going concern. In addition, by including selected board members and the CRO, there is economic alignment between the new shareholders, the board members and the CRO.

The remaining interests of Flow Management Holding BV will be liquidated and the proceeds paid out, predominantly to the providers of the original working capital. Other financiers with no or subordinated security rights are likely to receive nothing from their claims on liquidation.

In addition, new working capital has been made available on the transfer of shares and is due to be refinanced, previously in November 2016 and then postponed to July 2017.

Interestingly, notwithstanding the restructuring agreement, it appears that -

- There is limited interest from potential takeover candidates; and
- The 'new' company incurred operational losses of nearly €9m.

With the above in mind, we assume the plan to deleverage the Company and present it for sale as a going concern may be unachievable on the proposed terms. I suspect that, going

forward, an independent investment bank should be appointed to manage a broader sale process[11], and a valuation performed with a view to revising the expected sale terms.

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

There are potentially several cross-border issues that may arise from the restructuring process, including the following -

- The financing of working capital, as well as other loans, was provided to Flow Management Work BV. This entity appears to act as the treasurer for the operating subsidiaries, whereas based on the restructuring it will be liquidated as part of the remaining interests of Flow Management Holding BV.

  It remains to be seen if the group will establish a new treasurer entity that provides funding to the operating entities and how such entity may engage cross-border (e.g. there may be a requirement for new licenses or approvals to be obtained whereby intra-group funding is provided).

  In addition, if the operating entities have intra-group loans owing to Flow Management Work BV, such debts may become due and payable in the course of the liquidation proceedings of Flow Management Holding BV and its interests.

- A restructuring at the holding company or a change of control may trigger certain obligations in the underlying operating entities that need to be addressed. In particular, the sale of such entities may need the approval of local authorities, such would be the case in South Africa whereby the Competition Authorities would need to approve the transactions[12].

  Inevitably, the restructuring process may require approval across each operating entity that is transferred; a costly and prolonged process.

- The restructuring process will result in a separation between the operating entities and Flow Management Holding BV. If there were any guarantees provided by the holding company, which are now are no longer applicable, it may result in an event of default in the underling operating entities.

  This would need to be carefully considered to ensure the financial soundness of the operating entities remains intact.

- The impact of the restructuring is likely to have tax implications, particularly in the local jurisdictions that needs to be considered; and

- Any integration across the Group. In particular, leasing companies are characterised by integrated technology systems and platforms. By decoupling the operating entities from the Holding Company, it may result in the need to negotiate new technology licenses (if provided by external suppliers) or for the technology to be transferred (if held internally).

[11] Noting that only three parties active in the same industry were approached as part of the takeover talks
[12] Competition Authorities would be required to approval the transaction should it fall within their financial mandate (e.g. size of assets and revenues)

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]

In my opinion, a restart following liquidation is consistent with a formal bankruptcy proceeding. Calling for a moratorium would have been an appropriate option in the event that creditors were seeking to enforce their claims, and thereby the business needed the protection from such creditors.

However, by staying out of court (i.e. not applying for a moratorium) the creditors and the Company were able to maintain greater flexibility as to the restructuring process and benefit from the advantages of an out-of-court restructuring as highlighted in question 2.

In addition, in my experience, banks are loath to providing additional funding to companies in distress and accordingly, they would have been reluctant to pursue this moratorium with a view to providing a bridging loan.

Lastly, the costs (both direct and indirect) of a formal bankruptcy process are significant and often results in compounding the challenges faced by the company. Accordingly, the moratorium may have resulted in the business operations of Flow Management deteriorating further, thereby destroying additional value and resulting in a scenario whereby the controlled sale yields a poor financial outcome for stakeholders.