**Question 1.**

**What, in your opinion, were the causes of financial distress at Flow Management?**

Financial distress is a condition in which a company or individual fails to generate sufficient cash flows for meeting its financial obligations.

Financial stress can occur at any stage of the life cycle of an organisation (Birth/ start-up, growth, maturity, decline, and death/revival). There may be many reasons for the condition of financial stress. These reasons can be classified into (1) Internal (Managerial) and (2) External (Environmental).

The Internal factor proponents’ state that given the external environment, what matters is how the organisation’s management adapt to it. Poor performance of an organisation is generally an indication of problems with its management and strategies. It states that in the suboptimal performance of an organisation, the role of the choices made by an organisation’s management matter more than the external environment. The expectation from management is that it must be adaptive to the environmental factor. The leadership’s failure to respond to external changes leads the organisations to face a situation of distress, including financial distress.

The external factor proponents’ attributes the organisational failures to the external factors over which the management has little or no control. They contend that jolts in the external environment generate waves of organisational failure, and management can do a little to avoid these.

The impact of internal and external factors in causing financial stress depend upon the stage of the organisation’s life cycle.

At the birth/start-up stage, external factors play an important role in causing financial stress. The newly born organisation may not fit into the highly competitive market environment.

In the growth stage, both internal and external factors can play an important role in causing financial stress to an organisation. The internal causes may be the choice of an unsuitable cost structure, excessive leverage, wrong product mix. The external factors may include increased competition, technological advances, customer product preferences changes.

In the maturity stage, financial stress may be caused more by internal factors than external factors. The organisations reaching the maturity stages are well-weathered organisations that have adapted themselves to their environmental determinants. In this stage, internal factors like management inertia, information remoteness of top management, creation of liability of newness (A mature firm venturing into uncharted product/process/market/technologies) may contribute to financial distress than the external factors.

In the decline stage, the organisations become financially distressed both for internal and external reasons. The management’s inertial in recognising the froth build-up in the growth and maturity stage coupled with external factors like technological disruptions, regulatory changes, and market preferences can cause an organisation to face financial stresses.

The organisations do not reach the last stage of the organisation’s life cycle sequentially. It may come at any stage. However, financial stress caused by all (internal & External) factors is generally present at this stage.

Before identifying and analysing the reasons for the financial distress of Flow Management, it is necessary to ascertain its life cycle stage, the characteristics of internal management and the external environment within which it is operating.

Flow management is operating in the mature stage of its life cycle. Management of the company asserts that it has a proper business structure operating properly. There is demand for the services offered by it, and management forecast of the demand is in sync with the reality, and the management is confident of making good profits in a very short period. Such assertion of the management can come only when the organisation has matured in its line of business.

The company’s external environment appears to be supportive because there is demand for the services offered, and the main customers are ready to pay more. The company could reduce the workforce without causing any labour unrest. The company is operating in a stable technological, regulatory, and economic environment. The external environment is not imposing pressures and constraints on firms’ strategies that would lead to failure. There are no turbulences in demand structure due to changes in customer preferences, demand cyclical or strategic competition. Studies concluded that the company is viable to meet the revenue targets and market share.

 Despite the supportive external environment, the company suffered financial stress. Thus, the reason for the financial stress appears to be internal factors affecting the business. K Mellahi and A Wilkinson, in their article Organisational failure, a critique of recent research and a proposed integrative framework, stated that “failures are linked to internal inadequacies in dealing with external threats.” They further stated that Causes of failure are impulsive decisions that overextended the organisation’s assets, not responding to change, an executive who is either too powerful or poorly informed, and the taking of unnecessary risks.

These causes of failure can be ascribed to the situation of financial distress of company Flow Management.

 Despite having a business structure and market demand, its management could not stop it from falling into stress. The position of stress seems a creation of management. Looking at the events that unfolded in the company since November 2013, it is clear that its management was in a state of oblivion as to the actual working.

 The management appears to be poorly informed. The company employed a non-transparent management reporting system and a flawed accounting system. The flawed accounting system helped in hiding the accurate financial picture from the management. The accounting and information system is so poorly designed that it failed to produce correct information, even once, despite efforts to get it right. E.g., company’s reported results till September 2013 were a profit of 8 million. However, in November, i.e., within a month, this profit turned out to be a loss of 5.4 million. Thus, the accounting system concealed a loss of 13.4 million. In December 2013, the final loss in actual results for the year turned out to be 36.40 million against the initially reported profit of 8 million in September. Every other forecast of the revenue made by the management missed the actual results by miles. The poor management information system and flawed accounting system cumulatively kept the management in the dark about the actual working results of the company and thus prevented any corrective action. It is one of the reasons for the financial distress of the company.

Another issue with Flow Management is that its management appears inert, and the shareholders seem to have no interest in the company; this is evident from the various interactions between the lender banks and the company’s shareholders. At first, when the lenders asked the shareholders to infuse funds, the shareholder proposed to sell the assets (Cars) instead of investing fresh funds. The company is in the car rental/leasing business, and cars are the operating assets earning revenue. Such a response (Sale of cars) in the situation of financial distress may be optimal in the event the firm is operating below its normal capacity levels, and a reduction in assets can bring efficiency. However, there is no finding to suggest that the company was operating below capacity and carrying idle operating assets. There was no attempt on the part of the management to look at the strategic factors causing financial stress; instead, it jumped to assets striping without looking at the overall consequences of such exercise. There is thus evident reluctance on the part of key shareholders to show commitment to the future working of the company. The shareholders were in no mood to get their hands dirty and infuse fresh risk-bearing capital.

One of the reasons for such apathy of the shareholders appears to be the stretched organisational structure, placing the actual shareholders’ layers away from the real action, thus limiting the flow and quality of information to them. Key shareholders’ lack of concern for the company’s work can make the management complacent, and they may only act in reaction. This state of behaviour is evidently present in Flow Management’s work culture and is a reason for the company’s financial turmoil.

Another reason for the company’s failure appears to be the incompetence of the management to identify and prevent business deterioration. It is unlikely that the financial structure and not by the business inefficiencies caused the financial distress. Usually, a downfall in business causes financial disturbances by reducing revenues. The management seems to be oblivious of the business troubles which have led to the financial troubles. The reported profits of 8 million till September 2013, turned out to be a loss of 36.40 million for the year. The initially expected profit for the year 2014 ultimately turned out to be a loss of 39.00 million. These losses cannot only be attributed to deficiencies of financial structure. These losses were business losses, and the management did not attempt to identify the reasons for these, except for attributing them to the errors in the accounting system. Instead, on the other hand, the management swings into the action, raising prices to customers (though it was justified) and cost-cutting by retrenching workers and other costs. Strangely, no one took action to recover the wrongly paid bonuses to the CEO and CFO. Admittedly the company is viable to achieve turnover and market share, and retrenchment of workers and other costs could turn out to be an “error amplifying decision traps’ where the wrong response to a problem may inadvertently amplify the problem. Such knee jerk tactical responses to strategic problems are another cause of a company’s financial stress.

The management inertia is also evident from the fact that when faced with a decline in revenues, it immediately raised the prices for customers. The management clearly misread/did not understand its strength in determining the prices to be charged. Admittedly the management never checked the actual cost against the price calculations. The management never noticed the anomalies in its price and the market price and never felt the need to align its pricing policy to market prices. The company was charging less than the market price. The management was thus in complete loss of touch with the market. The entire management setup was complacent in the sense that no one set the alarm bell ringing over undercutting in prices.

The company was undercutting prices and thus building pressures on the finances. The undercutting in price appears to have been hidden in accounting shenanigans. Later on, when exposed, it resulted in frequent downgrades / downward adjustments to reported and forecasted earnings. K Mellahi and A Wilkinson attributed such behaviour of the management to the tenor of the top management. They state, “longer-tenured top management are likely to be associated with increased rigidity and commitment to standardised practices, a reduction in information processing over time reliance on increasingly narrow and restricted sources of information management cohesion and entrenchment. As a result, long-tenured managers tend to spend less time analysing the threats and opportunities facing them and become more convinced of the wisdom of the organisation’s ways of doing things. Consequently, a long-tenured top-management team may cause organisational failure under conditions of fundamental environmental transformation by becoming entrenched and unreceptive to change.” The responses of the shareholder/management of Flow Management are a replica of the situation described above and thus a cause for financial troubles.

The financial distress of Flow Management can also be explained by the “Curse of Success” phenomenon. Flow management was a successful company with operations spanned over seven countries, employing over 3000 people and owing a fleet of over 2,00,000 cars. This success appears to have made the management overconfident about the virtue of their methods of doing business. D Miller, in his article “*The Icarus Paradox: How exceptional Companies Bring About Their Own Downfall” notes* that “success can breed overconfidence and arrogance”, and it squarely applies to the management of Flow Management. It is this overconfidence that led to overlooking the actual working of the company. Management of the company was not even aware of the market prices being charged by competitors. They were confident of their ways of doing things and never bothered to verify the facts independently.

Though a flawed accounting system was one factor in cultivating this overconfidence, the accounting system itself was the creation of the management. The company was charging too low a price from customers, which was calculated based on a wrong spreadsheet formula. The company with 200000 cars in its fleet was charging too low prices in the market, and anyone sounded no alarm bells! This speaks volume of the systems of working, internal controls, and audit processes of the company. Accounting juggleries hid the losses from the operations on papers but were these invisible in actual working? Perhaps no, but the management chose to turn a blind eye to it. In addition to the losses caused by charging too low prices, there must have been other tangible and visible deterioration in the company’s performance on the ground. The low prices explained only a portion of the actual losses for 2013, i.e. 7.8 million out of a total of 36.4 million. Where did the other losses emerge from? The management appears to have turned a blind eye to the burgeoning crises. Lack of sound management information system and accounting system also helped build overconfidence of the management. Management was not all eyes and ears to the ground realities of the company’s working. It is the responsibility of the management to install an appropriate information system and reliable accounting system to get timely and accurate information. The management’s overconfidence and urge to maintain the status quo overlooked the need for such a system. It kept relying on the decayed and inaccurate information being fed to it and thus leading to state of financial distress.

**Could the financial distress have been prevented? If yes, explain how? If no, why not?**

Looking at the situation in which Flow Management find itself, it appears that it was avoidable. The company was operating in a favourable, stable, and supportive external environment. It helped prevent the negative impact of any bad management decision from amplifying. Favourable external environmental factors often offset the destructive effects of internal factors. Going into the reasons that led to this situation and steps taken by the management can answer the “how”?

The situation of financial distress of Flow Management is attributable to management inertia, overconfidence caused by poor management information systems and flawed accounting systems. The management, when it became aware of the impending problem, immediately negotiated price increase with customers. It also retrenched 130 contract workers and initiated cost-saving measures. The combined effect of this exercise is a saving of 15 million for the company. However, by the time the company undertook this exercise, it had already started spinning in the spiral. To arrest it, the shareholders must have taken steps and replaced the inert management immediately and brought fresh blood who could have the courage to re-evaluate the entire business strategy without any cognitive inertia. Given the size of the company and its stage of operations, such change would have brought efficiencies in the strategy and operations of the company.

The company as top priority must have established an efficient management information system, plugged loopholes in the accounting system and established strong internal control systems. In the absence of this priority, all other steps to arrest the downward slide would prove ineffective.

 The sequence of events indicates that the management was in the complete dark about the company’s actual financial position. The company did a forecast of a profit for the year 2013; however, it turned out to be a loss of 36.40 million. Similarly, the company made a profit forecast for the year 2014, but it turned out to be a loss of 39.00 million; all these instances point towards management’s lack of understanding of the business. Studies by constancy firms affirmed the viability of the firm in the initial days of crises. However, despite the attractive prospectus of revival, the management took incremental tactical steps that, too in a lethargic manner, spread over 18 months. The management must have thoroughly evaluated assets and immediately hived off the excess assets and non-strategic investments and subsidiaries to avoid the financial stress spiralling any further.

Further, the actual profit of 3 million in 2012 ultimately turned out to be a loss of 6.1 million. Similarly, the profit till September 2013 of 8 million ultimately turned out to be a loss of 36.4 million. By the time the management undertook the steps for the corrective course, it already had over 40 million in losses in books. It initiated restructuring talks with lenders from a weak position. The position further weakened as the information provided by it to the lenders always proved to be incorrect. A thorough analysis of the business and finances and a clear picture of the issues of stress could have given the company an upper hand in negotiating with financial creditors and saved the company & its shareholders from further losses right at the beginning of the crises.

**Question 2**

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

Out of court workouts (Informal Restructuring) are agreements between a debtor and its creditors voluntarily without the courts’ involvement. These workouts are also referred to as private arrangements or private reorganisations. These types of workouts can be used to restructure the business, management, or finances of a debtor. The process of out of court workouts is not subjected to formal rules of timeliness, participation, or priorities of creditors. These workouts work purely on commercial considerations of the parties involved, without any legal compulsions.

Formal bankruptcy procedures are legal, often court driven & supervised processes where the timelines, participation rights and priority rights of various participating creditors are determined according to legal rules.

**The advantages and disadvantages of the out of court workouts over the formal bankruptcy procedures can be summarised as below;**

* **Speed of execution**

Informal workouts do not involve procedures with defined timelines. The participating stakeholders/parties determine the speed of the and time of actions to be taken. In a restructuring, the timing of the process and speed of implementation can have a serious impact on the outcome of the process. Hence, the informal workouts offer incentives for quick decisions and faster implementation.

On the other hand, formal bankruptcy procedures are executed with predefined timelines, which takes away the participants’ discretion to manoeuvre the process’s speed.

Speed of execution of the informal workouts is, therefore, an advantage over the formal bankruptcy procedures.

* **The flexibility of choosing objectives and means to be deployed for achieving those.**

The informal processes are unrestricted by their nature. These processes are tailor-made suiting to the needs of the participating parties. The parties can agree not only to financial restructuring but also to the business or management restructuring. The parties can choose the objective of the informal process and ways and means to achieve these. The participants can deviate from their formal rights & entitlements and agree to unequal treatment.

The flexibility of choosing the outcome is generally not available to the parties in the formal bankruptcy procedures. The formal procedures are rigid, predefined processes with sequential implementation schedules under the supervision of the court or court-appointed Liquidator/ Trustee.

The flexibility of choosing the objectives and ways and means to achieve them is an advantage of informal workouts over formal bankruptcy procedures.

* **Silence/confidentiality**

Informal workouts take place in the confidentiality of the parties. These are private agreements and are known only to the parties privy to them. The confidentiality of the informal workout process offers a great advantage in reducing adverse publicity associated with any restructuring exercise. Restructuring is an admission of failure and failures have negative consequences even though the ultimate outcome of failure may be positive. If known to stakeholders in general, it may lead to a panic reaction among them and lead to the race to collect first and become a self-fulfilling prophecy. Informal workouts are carried in silence and confidentiality, thus avoiding the negative impacts of public knowledge of failures.

On the other hand, formal bankruptcy procedures are public procedures where all the stakeholders must be informed about the process. The formal processes come with a negative impact on the creditors, employees, and management. The creditors may not be willing to supply goods services without payment to a debtor undergoing bankruptcy. Workers, management may feel demoralised. The control of the organisation often shifts to Court or Court-appointed Liquidator/Trustee.

Silence and confidentiality with which the informal workouts are carried is an advantage over the public procedure of formal bankruptcy.

**Cost**

The informal workouts are usually carried out between the debtor and the creditors. These processes are speedy and thus cost-effective in terms of the actual cost of the process and the cost of business disruption caused by the formal bankruptcy procedure. In informal workouts, the debtor and the participating creditors have an incentive to keep the cost of the process low, as its creditors ultimately bear the cost in the case of a failed reorganisation. The informal workouts also save social costs as the courts and their formal system is spared from indulging in the process, thus freeing it for other issues.

The formal bankruptcy procedures are relatively costly, and the stakeholders do not have any control of the costs of the process. To creditors of an already financially distressed organisation, such costs can be prohibitionary and in the event of liquidation of the organisation, these are ultimately born by the creditors.

Cost-effectiveness is an advantage of the informal process over the form bankruptcy procedure.

**Control over entity.**

In an informal workout process, the existing management continues to be in charge of the firm’s operations. No liquidator of trustee is appointed. In addition to being cost-effective, It helps determine the process’s speed as the affected stakeholders remain in charge of the process.

Formal bankruptcy processes are court driven and supervised processes. The management is (usually) suspended, and the administrator/ trustee is appointed to manage the company as going concern. The stakeholders lose control over the company and are not in a position to influence the speed, directions and associated costs of the process.

Having control over the company’s operations during informal workouts is an advantage over the ceding control to administrator/trustee during the formal bankruptcy procedure.

**Control over the process.**

The informal workouts are private processes commenced and concluded by the private parties. The process participants decide what to negotiate and whatnot? Whether to continue the process or terminate it? Which parties to include and which not? The participants may even change the objectives of the process in the mid of the process. The process may itself be suspended or terminated at any time. Different timelines may be set for the implementation of the agreed steps. This control helps achieve speed (Unwilling parties may be left out), cost savings, and tailor-made results that may differ for different participants.

In form bankruptcy procedure, the stakeholders do not have any power to allow or prevent the participation of any specific stakeholder, determine the timelines of the process or alter the contractual status of various stakeholders. The stakeholders cannot decide to suspend or terminate the process.

Control of participating stakeholders over the process in the informal workouts is an advantage over the mechanical, legally defined formal bankruptcy procedure.

**Creditor’s bargain**

In the informal workout, the creditors have bargaining power as their participation is necessary to start such a process. A creditor has no compulsion to participate in a process or agree to the debtor’s proposals. This is a risk in the informal process as creditors can refuse to participate in the process or change their stance to non-cooperation. They can bring their agenda and strategy with the selfish objective of securing their position and influence of positions of control to gain a bargaining position at the cost of common ground and consensus. It is also called a creditor’s holdout and can jeopardise the entire process. Such behaviour of one creditor can motivate other creditors to follow suit, thus negating the very purpose of the informal process, especially if such creditors are major creditors.

In the formal bankruptcy procedure, no creditor has any scope to cause a holdout. Under such a procedure, various stakeholders have defined roles limited by the statute, and no one creditor can benefit at the cost of another by a bargain.

Creditor’s bargain is a challenge in the informal bankruptcy procedure, which is not possible in the formal bankruptcy procedure, thus a disadvantage of the informal process.

**Requirement of stakeholder’s commitment**

To initiate and finalise an informal workout, a huge commitment requirement to negotiate on common grounds by the participating stakeholders is necessary. Although the formal bankruptcy process outcomes can act as motivation to commit and cooperate, such compelled commitment will always fall short of achieving an optimal outcome. Without the desire and initiative of the major creditors, the informal workouts cannot be worked out. Such commitment is far more critical in informal workouts where debtors have complex capital structures and business operations spread over many legal jurisdictions.

On the other hand, there is a statutory stay on actions against the debtor in the court-supervised procedures of formal bankruptcy. Therefore the status quo cannot be altered at any time by any dissenting creditor. Commitment or lack of it, of stakeholders, is not an issue in such procedures.

Getting the required commitment from the significant creditors is a challenge in the informal workouts; it is not present in formal bankruptcy procedures.

**The scenario in India**.

In India (My Country), out of court restructuring (workouts) were the only option till 2017. However, as the majority of business loans are provided by the commercial banks that are strictly regulated by the central bank, the restructuring is carried out as per the guidelines of the central bank only. With the introduction Insolvency and Bankruptcy Code 2016, court-supervised restructuring has also become possible.

The informal workouts in India enjoy all the advantages as mentioned above, except that if the creditor is a bank, it cannot go beyond the restructuring guidelines issued by the central bank. Another peculiar feature of these workouts is that it applies to all the debtors who fulfil the conditions of the guidelines.

In India, the banks also frequently come out with one-time settlement schemes (OTS) where a non-discriminatory scheme of settlement is offered to a borrower in financial stress. All those who meet the eligibility of the OTS can participate in it; however, neither the bank nor the borrower has any discretion to alter the scheme in any respect, including the tenure, quantum of waivers and eligibility.

Recognising the limitation of the commercial banks in working with informal workouts, the regulator has permitted the sale of all types of loans by banks to other entities that, due to their regulatory structure, have more flexibility in carrying out of court restructuring.

**Question 3**

**Were the turnaround/reorganisation approaches as presented in the reading material applied in this case? If yes, explain in what way. If no details, what in your opinion should have been done differently.**

The Reading Material contains scholarly articles on turnaround/reorganisation approaches by Jan Adriaanse & Hans Kuijl Resolving financial distress: Informal Reorganisation in The Netherlands as a beacon for policymakers; Kalle Pajumen Stakeholder Influence in organisational survival; Sudi Sundarasanam & Jim Lai Corporate Turnaround Distress and Turnaround Strategies: An empirical analysis.

These articles present many approaches to achieve the turnaround/reorganisation of financially distressed organisations. In the given case study of Flow Management Holdings BV, the creditors and the debtor company employed many of the approaches presented in these articles.

On analysing the approaches adopted by the company, a connection can be established with the approaches presented in these articles.

**Jan Adriaanse & Hans Kuijl Resolving financial distress: Informal Reorganisation in The Netherlands as a beacon for policymakers;**

The article presents the informal reorganisation approach to turnaround/reorganisation of financial distress of companies. The author presents the idea of informal reorganisation over formal legal routes and analyses the strategies to implement successful informal reorganisation.

 The author defines informal reorganisation as a “reorganisation route which takes place outside statutory framework with the objective to restore a company’s health in financial difficulties within same legal entity”. The article’s central theme is that the informal reorganisations are flexible in nature as the terms of the reorganisation are agreed between participating parties out of commercial consideration without any legal compulsion. Further, this approach offers the flexibility of choosing the parties to participate, setting timelines, altering the priority or otherwise status of the participating creditors. The process is usually carried out in silence outside the public glare, limiting the impact of negative publicity associated with any restructuring process.

The article states that in the beginning, a business plan is drawn to achieve a turnaround. Such a plan mostly consists of two processes:

* + business restructuring;
	+ financial restructuring

The entire restructuring process is carried in two phases.

First, business is restructured on the premise that it is impossible and undesirable to carry through financial restructuring without restructuring the business operations. It is based on the understanding that it is business deterioration that has led to the deteriorated financial situation within the company. Deterioration of business is treated as the core cause of financial distress, and the first attempt is made to remove the cause of distress. The business restructuring process usually goes through the stages of

1. Stabilising, wherein the company act quickly to minimise the outflows and increase inflows to sustain it in the near future.
2. Analysing, wherein the company’s long-term business strategies are analysed in light of present market conditions to decide expansion or retrenchment of the business lines, products, territories, or technologies, etc. This process aims to establish the long term profitability of the company.
3. Repositioning, wherein the company draw and implement plans for ensuring its long-term profitability and reverse the value drain process. The stakeholders get comfort from the beginning of the reversal.

After business restructuring or simultaneously with it, the organisation engages in restructuring its financial structure. The need to restructure the financial structure is felt as prolonged business losses usually upset the assets and liabilities mix of the company. Further, the reorganised business may not be able to set off the past losses or meet the past debt obligations. In the financial restructuring, the debt covenants are renegotiated to reduce debts service obligations. The creditor may agree to forgo some of their debt and also agree to continue or extend further credit facilities.

In the case study of Flow Management, the entire reorganisations exercise has been conducted informally outside the statutory framework of the law. The Debtor company initiated the talks of restructuring with its lenders. The lenders also did not choose the legal route to take action against the company, though they had all the right to do so. The debtor company and lenders engaged in extensive negotiations.

In sync with the recommendation of the article, the debtor company, at first stage “Stabilising”, presented the plan to restructure its business (to stop bleeding) by increasing the prices to be charged to the customer and implementing the cost reduction measures, including a reduction in the number of employees.

It thereafter acted on phase II of the recommendations in the article “Analysing” by considering the possibilities of restructuring the foreign subsidiaries, appointing a new CEO, re-evaluating, and reassessing the entire product mix.

In addition to the business restructuring, it also carried out financial restructuring to strengthen the Balance sheet by injecting fresh capital, raising internal accruals by selling shares of companies outside Benelux countries and foreign branches. The waiver of the default interest, deferring refinancing and repayments, and waiver of all non-fulfilled contractual obligations were other steps that the company took in the financial restructuring Phase.

The company has, in fact, acted exactly as per the prescription in the article by Jan Adriaanse & Hans Kuijl. Management and shareholders had an active attitude towards the reorganisation of the company. All-important parties were involved in the process, and there was an infusion of risk-bearing capital in the company.

 However, there were some noticeable departures from the approaches of the article. First, the entire process lacked speed which is a must to achieve effective results. The longer a disease linger more harm it causes. Secondly, the information presented to participating stakeholders was not very transparent/accurate. As a matter of fact, every result reported or forecasted ultimately turned out to be incorrect. Thirdly the company failed to replace the CFO, which the banks initially demanded, thus giving a weak signal to the creditors about the seriousness of debtor to resolve crises.

**Kalle Pajunen: Stakeholder Influence in organisational survival**

In this article, the author explained the influence of various stakeholders on the organisation and its importance in ensuring the organisation’s turnaround. The articles provide two bases based on which the stakeholders can exercise influence over an organisation. These are resource-based influence and network position-based influence. While stressing the need for management of influential stakeholders, the author proposes six propositions detailing the function of stakeholder management in organisational survival. These are

*Proposition 1: The more secure the continuing support of governing stakeholders in an existence-threatening crisis, the more probable is organisational survival.*

*Proposition 2: In an existence-threatening crisis, frequent and open communication between managers and governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organisational survival*

*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 and increase (rather than decrease) the probability of organisational survival.*

*Proposition 4: In an existence-threatening crisis, management’s unlocked brokerage position between governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organisational survival*

*Proposition 5: 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 organisational survival*

*Proposition 6: In an existence-threatening crisis, governing stakeholders’ association of management with good firm performance is positively (rather than negatively) related to the continuing support of those stakeholders and will tend to increase (rather than decrease) the probability of organisational survival*

During the reorganisation process, the company took actions that were in line with the propositions made by the author.

The company secured the support of its lenders as they were ready to discuss and find a solution to its financial crises. Similarly, the company received support from its major customers, which proved crucial in the entire process.

The company voluntarily opened communication about its burgeoning financial troubles. It won the support of the creditors as they willingly agreed to discuss and arrive at a solution.

The personal relationship between the management and governing stakeholders was, however, missing in the entire restructuring. This, however, was mitigated by the appointment of a chosen person as Chief Restructuring Officer (CRO) by the lender banks on the board of directors of Flow Management Holding BV.

The existing management did not have much brokerage position to undermine the influence of governing stakeholders. However, still, to gain the confidence of the governing stakeholders, the CEO was replaced. This further smoothened the restructuring process as the new CEO did not carry the past burden, which would have hindered open and frank communication. However, the company fell short in completely unlocking the brokerage position as it did not replace the CFO as was demanded by the lender creditors.

The management and the governing stakeholder almost agreed on every aspect of the restructuring strategy of the company. The final restructuring strategy was agreed in consensus with all the governing stakeholders, which included haircuts to the lenders and capital write off of major shareholders and liquidation of the holding company. Thus all governing stakeholders were in complete unison for the revival of the business of the company.

One thing missing in the entire restructuring process was that the governing stakeholders were not associated with any good performing firm for bringing in their success experience to the present situation. This was somewhat mitigated by appointing the Chief Restructuring Officer (CRO) on the board of the company by the lenders.

In summary, it may be stated that the restructuring process of Flow Management followed the principles which have been propagated by Kalle Pajunen in his celebrated article “Stakeholder Influence in Organisational Survival”. The company identified the influential stakeholders and engaged with them in an open, transparent manner, unlocking the communication barrier and arriving at a consensus with regards to the long term goals of the company.

**Sudi Sundarasanan and Jim Lai, in their article Corporate Financial Distress and turnaround strategies: An empirical Analysis**, prescribes many strategies to attempt corporate recovery. The article also states that the same strategies applied in different situations may have different effects due to timing and the intensity of the implementation.

The following strategies are prescribed in the article.

* Managerial restructuring
* Operational restructuring
* Assets restructuring
	+ Assets divestments
	+ Assets investments
* Financial restructuring

***Managerial restructuring requires a*** *change in top management as* a precondition for successful turnarounds. It is based on the premise that when old operating ways need to undergo a drastic change, it is difficult for top incumbent management to change their habits and institute radical reforms. Authors state that creditors perception about the capabilities of the management to handle crises at hand is an important factor for their continued support or lack of it. It states that such changes are seen as “tangible evidence” that something is being done to improve the performance.

***The article prescribes two-stage Operational Restructuring***for a successful corporate turnaround. First efficiency/ operating turnaround strategy stage, and second the entrepreneurial/strategic stage.

The **efficiency/operating turnaround stage** aims to stabilise operations and restore profitability by pursuing strict cost and operating-asset reductions. These are the turnaround strategies implemented by an organisation facing financial stress.

The **entrepreneurial/strategic stage,** on the other hand, aims to achieve profitable long-term growth through restructuring the firm’s asset portfolio or product/ market refocusing. The entrepreneurial/strategic stage is also classified as an assets restructuring strategy.

*Asset restructuring:* in this strategy, the asset portfolio of the organisation is restructured to suit the organisation’s current realities and long-term business plans. It may involve direct assets sales or purchase*,* forming strategic alliances, joint ventures and licensing agreements, merging with other firms and divesting lines of businesses not fitting the core businesses, acquiring companies that relate to and strengthen the core, discontinuing the noncore unpromising products.

Financial restructuring is strategies used to restructure the capital structure of the organisation. In the *authors’ words,* “*financial restructuring is the reworking of a firm’s capital structure to relieve the strain of interest and debt repayments”.* The authors divided these strategies into two components: Equity-based restructuring and debt-based restructuring.

Equity-based strategies may comprise of omission of dividends, public issues, institutional/ strategic placement of equity. In contrast, the debt-based restructuring strategies may include reducing interest rates or waiver of unpaid interest, deferment of repayments, or converting debt into equity.

In the case of Flow Management, the company has utilised many of these strategies in achieving the restructuring.

The company carried out managerial restructuring by replacing the CEO (but not CFO). Further appointment of Chief Restructuring Officer in the board of holding company is another instance of managerial restructuring. Visibly these acts of managerial restructuring enhanced the faith of lender creditors in the management of the company.

The company also embarked upon operational restructuring. As for efficiency/ operating turnaround strategies, it tried to stabilise the operation by reducing cash outflow and increasing inflows by increasing the price to customers and cutting costs by reducing the workforce. It also pursued entrepreneurial/strategic strategies and asset divestment by evaluating and reassessing the entire product mix and selling shares outside Benelux countries and foreign branches.

The company also undertook financial restructuring by infusing fresh funds, deferring repayments, waiving default interest, waiving unfulfilled contractual obligations, and postponing the refinancing of the credit facilities.

The company followed almost all the Sudi Sundarasanan and Jim Lai’s prescriptions as presented in their article.

However, in addition to prescribing the strategies, the authors had also emphasised that the effectiveness of these strategies depends on the timing of their implementation and intensity of implementation. On an analysis of the case of Flow Management, the stakeholders appear to have lacked in the proper timing of implementation and the intensity of implementation for ensuring effective results of these strategies. The management took action over a prolonged period of two years in a staggered manner. The incremental steps were taken as substitution after the failure of the earlier steps. Whereas to achieve effective results, different strategies should be implemented as complementary to each other, one building on another. Flow Management implemented these measures in a lackadaisical manner.

**Question 4**

**Bank C and D seem to frustrate the process at a certain point. What could have been the rational/ 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?**

In any multi creditor informal workout, continued cooperation of the participating stakeholders is a must. As an informal workout is carried out outside the preview of formal legal rules, voluntary agreement between the participants relating the acceptable level of behaviour, the goals of the process, and methods to be used for their realisation must be mutually agreed upon among the participants.

During informal workouts, many strategies are adopted to achieve the turnaround/reorganisation of the organisation. Considering the external environment within which the company operates, the life cycle stage of the company, these strategies may include managerial restructuring, Operational restructuring, and financial restructuring. Each strategy is implemented in stages with well-defined sequential or overlapping steps. The essence of any workout, irrespective of the strategies deployed, is the timeliness of the implementation of these strategies and the effectiveness with which these are deployed. Further, a perception of creditors about the seriousness and timing of the implementation plays an important role in earning all round cooperation from participating creditors. A highly effective strategy deployed at an inappropriate time in a lethargic manner may not achieve the desired results, or rather it may aggravate the problem sought to be resolved.

Every party involved in the process is expected to contribute to the time and implementation efficiency of the process. There may be instances where one or another participant for any reason may be causing the process to be slowed down or decreasing the intensity of its implementation. Every participant must be attentive to such scenario build-ups and must take appropriate action in this regard.

The behaviour of banks C & D in the given case, at first, seems to frustrate the process. However, such behaviour was not without any base. The management of the company appears not to be serious in infusing funds in the business. It also failed to improve the quality of information supplied to the creditors. The company took half-hearted steps to carry out managerial restructuring as instead of replacing the CFO as desired by banks; it replaced the CEO. The company failed to make any recoveries despite admitting errors in payment of bonuses (3 million) to the CEO and CFO. All these factors eroded the confidence of these banks in the management.

Despite creating chaos and failing to act decisively, the company started putting the term on lenders for restructuring exercise. In such a scenario, the behaviour of bank C& D does not appear to be unreasonable. It, in fact, was a strategic posture that, demonstrably, compelled the company to fall in line. The behaviour of these banks proved to be beneficial in giving speed to the process.

 In negotiations posturing, the threat of leaving is generally used to bring efficiencies to the process. Similarly, the behaviour of banks C& D appears to be signalling to other participants to buckle up.

The process of drawing a restructuring plan for Flow Management started in November 2013, inviting lenders to discuss the downgrades in the reported and forecasted results. The management shrewdly presented the fact that due to some error in the accounting system and cost calculations, downgrades in earnings have become imperative. After that, at regular intervals, the company came up with additional disclosures and further downgrades in the results and earnings. The company was drawing up intermediate plans and changing them with incremental additions.

The company’s ownership structure was layered, and at the operational level (Flow Management Works BV), the lenders were, in fact, the only party exposed to risk in the event of bankruptcy. There is clear ad hocism in the actions of the Flow Management, and this appears to be a motivation for the un co-operative behaviour of bank C & D. The real motives behind their behaviour, as it became clear later on, was to bring speed in decision making, and while negotiating such posturing is acceptable and expected behaviour.

As an advisor to other banks, the advice would have been that these banks should also signal to the company that if things do not improve, they will also follow the path of bank C&D. The company should be informed that there is no lack of coordination among the bankers, and they are working as a team and the company should immediately set on the task to carry out the operational restructuring bringing stability to the internal affairs, improve the accuracy of the management information system and to implement an effective of an accounting system for timely reporting. It would be advised to bank A & B to fire salvos of efficiency increasing steps using the shield of the annoyance of bank C & D with the overall aim to push the management of Flow Management to act quickly on infusing the fresh funds and carry out operational restricting. The posture of bank C&D can also be used to get a better deal (playing good cop, bad cop) by banks A&B regarding the haircut to their exposure.

**Question 5**

**Which of the eight principles of the statement of Principles for Global Approach to Multi Creditors Workout II can be found in the workout process of Flow Management (explicit or implicit)?**

Out of the Eight principles prescribed for the global approach to multi creditor workouts II by INSOL International, the following principles can be found to have been followed in the workout process of Flow Management. **(Complete text of Principles is at ANNEXURE I)**

***FIRST PRINCIPLE:***

This principle was followed in the workout process of Flow Management (Company). The company’s management-initiated discussions about the firm’s financial difficulties with all of its financial creditors (lenders). As the number of creditors involved in the process was small (Only four), all the creditors were involved. The banks readily agreed to discuss the company’s situation and collectively took measures like the appointment of an accountancy firm to investigate the procedures within the company. A reporting system was also established to ensure continued communication of the situation.

The lenders followed the first principle in letter and spirit. At first, they decided not to take any legal action against the company and not panic. Thus, they granted sufficient time to the company to formulate the revival plan first by voluntarily refraining from taking any legal against the company and, later on, entering into a formal standstill arrangement. The informal standstill period lasted from December 2013 to August 2014, and after that, the formal standstill agreement for 120 days came into effect.

***SECOND PRINCIPLE***

This principle was followed in letter and spirit in work out of Flow Management by all the relevant creditors (Lender banks). The case presents an interesting scenario. The principle requires that the relevant creditors should not enforce their claims against the debtor during a standstill agreement period. The principle does not forbid any creditor to enforce its claims before or after the standstill agreement period. However, the relevant creditor in this case, despite having no standstill agreement in place, informally agreed not to panic, work collectively and refrain from taking any legal action unilaterally for the recovery of their claims. Thus, they conferred the benefits of a standstill period, on the company, even before the formal agreement for it.

The relevant creditors made this choice despite having all legal rights to initiate action against the company for recovery of debt, cancellation of the existing credit facilities or even to file for its bankruptcy. None of the creditors sought any special treatment for its debt to the company. They did not change /improve their relative position in relation to security/seniority during the informal and formal standstill period.

**THIRD PRINCIPLE:**

This principle was followed by the debtor during the entire standstill period, both informal and formal standstill. During the informal standstill, the creditors, without signing any formal agreement, agreed to act in cooperation with each other; the attempted dilution of the securities by an offer to sell the cars to improve the solvency ratio was turned down by the lenders. Other than this instance, the debtor there was no attempt to dilute or adversely affect the prospective returns to the relevant creditors. Rather the company infused fresh capital, cushioning the relevant creditor’s position further.

***FOURTH PRINCIPLE:***

The relevant creditors understood the virtue of collective and coordinated response to the debtor in financial difficulties and acted in the spirit of the principle. The number of relevant creditors was small, and hence instead of a representative committee, all the creditors collectively endeavoured in the process. Though during the process at one time, creditors appeared to not be working collectively (when bank C&D suddenly stopped cooperating and when they threatened to cancel the credit facilities), it turned out to be strategic posturing to bring efficiencies in the process. There were coordinated efforts by the creditors during the entire process, and at the end (though with some delays), the collective action strategy worked well, and revival strategy was put in place in consensus with all.

***FIFTH PRINCIPLE:***

This principle of multi creditor workouts can be found in the company’s workout process used with varying degrees of effectiveness during different stages of the process. At first, the company voluntarily initiated the information divulgation process. However, later on, it appeared that the management itself was in the dark about the extent of the real financial troubles of the company. (Or although fully aware but was economical in bringing it out).

The information was made available to the relevant creditors regularly, but the quality (Accuracy) of the information always remained in doubt. For the quality of the information, there was considerable delay in the selection and implementation of a proper rehabilitation strategy. None of the forecasts of the revenue made by the company actually materialised. In fact, the forecasts itself were revised so frequently that the entire information system of the company was in question. e.g. In November 2013, the company made a forecast of profit for 2014. In mid-December 2013, the forecast for 2014 was revised to a loss of 5.7 million. In March 2014, the said forecast was again revised for a loss of 8.5 million. In June 2014, the forecast was revised for 27.5 million, and in October 2014, the company again revised this forecast to a loss of 39 million.

Thus, the company did not withhold information from the relevant creditors, but the quality of information was not as per the spirit of the principle, which could have helped in proper evaluation of financial position and preparation of revival plan.

**SIXTH PRINCIPLE:**

This principle can be found in practice, implicitly, in the case of work out of Flow Management. In relation to the standstill agreement, initially, the relevant creditors did not enter into any formal standstill agreement but agreed to refrain from taking any action against the debtor. They also agreed to act in coordination & cooperation in a controlled manner. There was no change in the relative position of the creditor per se because of this informal arrangement. Further finally, when the creditors signed the formal standstill agreement, it was unanimous, thus indicating that none of the participating creditors was adversely affected.

As regards the final restructuring agreement, it is specifically stated that it reflected the relative position of the financier involved. This appears to be so as there was no disagreement among the creditors relating to the proposal. Further, the benchmark for the restructuring entitlements was the liquidation proceeds which would have satisfied not more than 55% of their debts, or perhaps far less than that or even Zero. The long-drawn legal process and defective security titles of assets were feared to erode the value of assets substantially or completely.

***SEVENTH PRINCIPLE***

The company Flow Management followed this principle completely during the process. The company provided all the information to all the relevant creditors without any discrimination, though the quality of information, in terms of accuracy, was always in question. There were no instances of breach of confidentiality of information by the creditors during the process.

***EIGHTH PRINCIPLE:*** During the process, only the company’s shareholders infused additional funds as unsecured loans. However, in the restructuring agreement that was finally reached, no priority of payment was given for its repayment.

**Question 6**

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

Though it is always beneficial to arrive at a restructuring plan for a debtor in financial stress voluntarily outside the court, it may not always be possible with multi creditors’ involvement. Every relevant creditor may not agree to work in coordination with other creditors. It may be more probable where a class or creditor(s) have a superior security position relative to others. In such a scenario, the alternatives must be looked at to keep the restructuring process outside the formal legal process of insolvencies.

In the event of a deadlock on the adoption of the statement of principles, the soft law options as they exist in India may be used for reaching the desired restructuring objectives. The use of any soft law depends upon the type of creditors involved in the process. Private investment banks, private equity /debt investors, Assets Reconstruction Companies have more flexibility in adopting/customising the restructuring solutions. On the other hand, regulated entities like commercial banks, deposit-taking institutions, and collective investment managers (Mutual funds, Insurance companies) are constrained by their regulators’ rules and regulations. These regulated institutions work within the guidelines with no scope for customisation to suit the business situation.

The simplest route to exit from this deadlock to a creditor willing to restructure is to buy out the debt of other dissenting creditors. In most of these cases, the threat of loss in liquidation works well in arriving at a mutually beneficial sale price. However, such buyouts are more common among private debt investors than banks. Once the willing creditor has the majority of the debt, it may pursue the out of court restructuring without holdup from the other creditors.

The Indian debt market is dominated by regulated entities that have over 80% share of business debt. In the USA, these regulated entities constitute just 15% of the business loans.

In the case of banks, the Reserve Bank of India (The Central Bank) issues guidelines from time to time to facilitate the restructuring of the financially stressed companies within defined parameters of negotiating flexibility. However, it is important to note that such guidelines relate only to the company’s finances, whereas operational deficiencies that could have led to financial stress are left out. The guidelines provide for the borrowers’ eligibility for restructuring, the time frame for restructuring, and the basis for any concession or waiver. The borrowers have no obligation to use these guidelines, but they cannot seek any deviation from them if they choose to do so.

The lenders are provided with discretion to select restructuring candidates selectively. Such guidelines can be used to restructure the affairs of Flow Management. However, as more than one bank is involved, there must be an inter-creditor agreement among the lenders to restructure. The central bank (RBI) also provides the framework of the inter-creditor agreement.

Another option of using the soft law is available in the form of the sale of a loan. The regulator in India provides for the sale of loans to Asset Reconstruction Companies (ARC’s). Though they operate under Central bank supervision, the assets reconstruction companies are commercial entities and have the freedom to enter into any kindly arrangement with their clients. The banks or the company flow Management can approach an Assets Reconstruction Company (ARC) and sell or get the loan from banks sold to it. These ARC’s then can restructure the financial facilities on private terms with the company.

Another route for restructuring similar to the ARC route is to get a strategic investor (mostly a private equity player) who negotiates with the banks and buy their loan exposure. On purchase of the loan, the company can convert the same (or part of it) with or without losing controlling interest into equity. Such investors, in addition to financial powers, bring along with them the business domain expertise and can truly revive the company out of financial stress and put it back on profitability track. Of lately, such restructurings have become common in India.

**Question 7**

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

A restructuring plan provides:

1. an overview of the action to be taken;
2. guidance and ensure complete focus on the objectives of the restructuring;
3. a communication to the stakeholders about the objective of the restructuring.

A good restructuring plan should have an analysis of the external environment, analysis of the operational strengths and weaknesses, operational plan, financial restructuring proposals, financial projections post-restructuring implementation, the time for implementation, risk analysis of projected outcomes and its impact on the current stakeholders including creditors, workers, employees, Govt authorities.

The restructuring agreement signed on 4th July is a financial restructuring plan along with a complete change in the ownership structure of Flow Management BV. The objective of the restructuring plan of 4th July is to prepare the company for sale as a going concern by removing the dead weight of past accumulated losses, leveraged capital structure and layers of shareholding. The plan has been prepared on the assumption of the existence of a viable business structure capable of generating profits, though, in the actual results, it incurred operational losses.

Before restructuring, the organisational/ownership structure looked like below.

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
|   | Lease Group Holding United Kingdom Ltd. |  |  |
|  |  |  |  |  |  |   | 100% |  |  |  |  |  |
|  |  |  |  |  |  |   |  |  |  |  |  |  |
|  |  |  | Flow Management Holding BV The Netherlands |  |  |
|  |   |   |   |   |  |   | 100% |   |   |   |   |  |
|   |  |  |  |  |  |  |  |  |  |  |  |  |
| Flow Management Work BV The Netherlands | FMWSpain SL |  | FMWFrance SPRL | FMWAustralia Ltd. | FMWSouth Africa Ltd. | FMW USALtd. |

After the restructuring the organisational / ownership structured became as below;

|  |  |  |  |
| --- | --- | --- | --- |
|   | Lease Group HoldingUnited Kingdom Ltd. |  | Bank A, B, C, D, CRO  |
|  |  |  |  |  |   | 100% |  |  |   | 100% |  |
|  | Flow Management Holding BV  |  |  | Flow Management II BV |
|  |   |   |   |   |   |   |   |   |   |  100% |  |
|   |  |   |  |   |  |   |  |   |  |   |  |
| Flow Management Work BV The Netherlands | FMWSpain SL | FMWFrance SPRL | FMWAustralia Ltd. | FMWSouth Africa Ltd. | FMW USALtd. |

The essence of the restructuring is that all the subsidiary operating companies along with their assets were transferred to the new company Flow Management II BV. Flow Management Holding company retained its assets and liabilities. All revenue-generating operations were being carried out in operating companies, and after restructuring, the holding company lost these with the transfer of all operating companies to the new company.

In the newly formed company and its subsidiary company Flow Management Works BV, except for working capital liability of 240milion, all other claims of bank’s A, B, C and D are cancelled. Flow Management Holding BV’s existing shareholders and the holding company also forgo their claims against the new company.

The new company and its subsidiaries (the transferred operating companies) now have a lean capital structure with a liability of 240 million towards working capital finance. Banks and members of the erstwhile board, including CRO, are the new shareholders.

The lender banks took a haircut on their lending to the Flow Management Works (FMW) but got shares in the newly formed company, which now has all the operations of the erstwhile holding company. Shares of the new company compensate the haircut at the holding company level and FMW, and thus, for lenders, it is akin to a debt-to-equity swap. To pursue the restructuring better, the CRO has also been incentivised by making him a shareholder along with other holding company board members.

The Flow Management Holding BV is liquidated, and all claims of banks and shareholders against it are cancelled. In the end, the restructuring exercise aims to result in a company with a sustainable level of debt and a diversified group of shareholders. The new company carries no burden of past except for working capital liability of 240 million. This will facilitate the sale of the company as a going concern after restructuring.

The restructuring agreement entered into on 4th July is only financial restructuring. The developments post-restructuring indicates that the restructuring objective of preparing the company for sale as a going concern was not achieved. The interested buyers still preferred to buy the company in liquidation. From buyers’ perspective, the restructured entity still is not viable as a going concern as even the emerged lean capital structure is not supportive to the operational position. In the plan, there is no attempt of any operational/managerial restructuring. The deteriorated financial position of the company is not due to financial structure but to declining profits in the business. Even the restructured entity incurred operational losses. The restructuring agreement does not provide for any measure for carrying the business improvements. Given the bleeding business, even the restructured entity may become unviable shortly. The restructuring agreement is a symptomatic treatment to of real disease effect of which may not last long. In this scenario, the objective of the restructuring plan, i.e., to sell the new company as a going concern, seems unachievable.

**Question 8**

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

As the subsidiaries operating under local laws change in their ownership structure will have legal implications. Many countries require prior approval of any change in the ownership of the companies in their jurisdiction. Getting acknowledgement of the change in ownership of subsidiaries may pose legal issues to the subsidiaries.

Taxation issues may arise on change of ownership and waiver of loans. As the restructuring exercise is being carried out informally outside the court, all the waiver and transfer of shares transactions will be subject to local tax laws. The waiver of loans is treated as a remission of liabilities and taxable in the borrower’s hands. Similarly, the issue of shares to the consortium bank, CRO and members bord may be taxable in many jurisdictions. It may reduce the overall effectiveness of the restructuring exercise.

The Flow Management Holding BV, after the transfer of the operating companies, is rendered assets less. The unsecured creditors of the holding company who have a residual right of recovery against all company assets in the event of liquidation may bring a lawsuit challenging the proposed transfer of subsidiaries.

The restructuring agreement has overlooked the issues of wrongful payment of bonuses & incorrect reporting results. All these incidents have happened at FM holding BV. As in the restructuring agreement, the holding company will be liquidated. The liquidator/trustee looking into these transactions/events can proceed against the management to recover losses. The Liquidator (Under Indian Insolvency Law) can proceed against the creditors who were privy to this information but did not act to minimise their impact.

The restructuring of Flow Management can create issues relating to the claims of the foreign subsidiaries against the parent holding. In the event of initiation of insolvency proceedings in respect of any of the foreign subsidiaries, the restructuring can be challenged for diluting the rights of creditors of the subsidiary against the holding company.

**Question 9**

**In October 2014 four scenarios have been drawn up. Why was or wasn’t calling for a moratorium (see scenario 4) a good option given the situation at that time? [you are allowed to give your opinion based on your own countries Bankruptcy Act be as detailed as possible]**

The restructuring scenarios in October 2014 were drawn in the background of the following information.

* Banks having securities in the form of pledges realised that the contracts in respect of these securities were defective, and in the event of liquidation, the proceeds on their enforcement may be nil.
* The entire risk capital (equity) of the company had become zero. Thus, the shareholder had already suffered the maximum loss they could. Any loss during liquidation in this scenario would be of creditors only.
* The maximum expected recovery by banks in the event of the liquidation was 55% of the total outstanding debt.
* As desired by the relevant creditors, the shareholders did not replace the CFO but instead replaced the CEO of the company.
* The creditors forced the appointment of a Chief Restructuring Officer (CRO) on the board of the company as I the perception creditors, the company management lacked such expertise.
* The reorganisation implemented by the management has started showing results in the form of improvements in results and provision of information.
* Shareholders are ready to infuse 35.00 million, which is sufficient to offset the expected losses for 2014.

 **Option to go for suspension of payment as per Law in The Netherlands.**

The option is available to a (legal entity) debtor to file for suspension of payment if the debtor foresees that it will not be able to pay its debts as they fall due. If the court is satisfied the debtor will be unable to meet its liabilities, it may grant a suspension of the payment order.

If the order of suspension of payment is made by the court, all unsecured creditors will be barred from recovering their claims against the debtor’s assets, and enforcement measures already taken are suspended by the operation of law. All attachments on the assets of the company are lifted. Therefore, suspension of payment provides only a limited period of breathing space to the debtor to formulate its revival plans. However, such a time stop comes at the cost of loss of autonomy of the management to run the company on their own. The business decisions are usually taken in consonance with the administrator appointed by the court.

**Option of the restart following the liquidation.** On these petitions of either debtor or its creditors, the court may declare the debtor bankrupt The “principle of fixation” results in an automatic general stay over the assets of the company. Unsecured creditors are prohibited from enforcing their claims on the assets of the company. Even the secured creditors may be barred from enforcing their claims against the debtor for a limited period of time. The court appoints one or more bankruptcy trustees who will work under the supervision of a bankruptcy judge. The debtors and creditors do not have any choice in appointing the trustee. The directors of the company cannot act in the capacity of a director. The trustee can seek any information from management, directors, creditors concerning the company. He can terminate any agreement or contract entered into by the company. The trustee will ultimately sell the assets of the debtor’s business to an interested party. In this sale, the trustee with the objective to fetch a higher price can sell the business as a whole. Thus, the purchaser gets the company along with its business on a clean slate. Such going concern sale plan may be prepared before bankruptcy, in cooperation with secured creditors such as financiers with security, banks, and restructuring the company may be achieved after bankruptcy.

Both these scenarios were not good options for the creditors or the company Flow Management to adopt. The creditors and the company we’re working in coordination with each other to resolve the company’s financial distress. Given the complex structure of the business, cross border issues involved the formal route of suspension of payment or liquidation would have caused more harm than benefit to the creditors and debtor company. The company’s business was viable, and the proper management strategies could put the company back on the profit track. Seeking any formal routes to restructuring would have resulted in the company’s liquidation and probably nil realising the lender creditors.

**Options under Indian insolvency law.**

Under the law relating to bankruptcy, i.e., insolvency & Bankruptcy Code 2016, in my country (India), the taking of formal route of insolvency would have resulted in mixed outcomes. The formal regime is creditors friendly as during the process; they control its speed, direction, and the ultimate outcome. On the other hand, the shareholders lose control over the company and in the end, mostly the company ownership is changed without any compensation to the existing owners for any of their investments.

Under Indian law, the test of insolvency is the cash flow test, i.e., the company should have failed to pay its liabilities. It is not the inability to pay but the actual default which triggers can trigger the insolvency proceedings by the company or its creditors.

There is no concept of suspension of payment under Indian law. On admission of the application, the formal process sets in, and that is carried in two separate stages.

The first stage is to resolve the debtor’s insolvency; the process Corporate Insolvency Resolution Process (CIRP) sets in on the admission of the insolvency application. In this process, the company’s Board of Directors is suspended, and an insolvency professional appointed by the court takes over the management. The applicant who files an application to initiate the insolvency process has a right to nominate Insolvency Professional. On the order of admission, a general moratorium on proceedings relating to recovery of debt sets in and applies to all creditors secured & unsecured. The moratorium applies only from the date of order of the court to initiate the insolvency resolution process; no protection is available during the pendency of the application.

All the creditors file their claim before Insolvency Professional. The insolvency professional constitutes a committee of creditors (CoC) which consists of all financial creditors, both secured and unsecured. The committee of creditors (CoC) takes all major decisions in relation to the rehabilitation of the debtor or termination of the process of insolvency resolution.

Although he has legally defined roles, rights, and responsibilities, the insolvency professional is often guided by the CoC on critical issues, including framing the eligibility criteria for prospective applicants for the resolution of the company. The law casts a foremost duty on the insolvency professional to maintain the debtor’s status as a going concern. In the CIRP, any plan acceptable to the CoC can be worked out to revive/restructure the debtor’s business. The law has many advantages: there is a stay on all recovery proceedings against the company; it is a time-bound process, and any decision taken by the CoC with a vote of 66% or more is binding on all the creditors, including the Govt authorities.

The entire corporate insolvency resolution process is required to be completed in 180 days. A ninety-day extension can be granted in exceptional circumstances. The timelines do not leave any scope for holdups in the process by any stakeholder.

Secondly, if no resolution plan is approved in 180 or 270 days, as the case may be, in that case, the process of resolution converts into the Liquidation process, and the insolvency professional appointed in CIRP designated as Resolution Professional is appointed as liquidator. In liquidation, the company’s board of directors ceases to exist (in contrast to suspension in CIRP). The order of liquidation is treated as a notice of discharge to the workers and employees of the company. The liquidator sells the company’s assets and distributes the proceeds among the creditors as per the payment priorities provided in the law. The liquidator, however, has a mandate to first attempt to sell the debtor as a going concern, and in case he finds no buyer for the company, the business as a going concern and ultimately the assets in parcels or individually.

During the CIRP process, the financial creditors have complete control over the company, and they can make any decision with or without the cooperation of the management of the company. Moreover, creditors with the majority (not consensus) of 66% in value take all decisions. Thus, the majority can cram down the decisions on minority creditors (up to 33% of total debt). The workers and Govt authorities, including taxation authorities, have no role in the entire process. The role of the existing management is also limited to advisory, which though in complex business structure is extremely important, is not binding on the CoC or the resolution professional. Under Indian law, unless the company’s promoters are eligible, initiation of the formal process (CIRP) means the sale of the company to a new set of shareholders. The eligibility criteria for the promoters are pretty stringent, and usually, it is exceedingly difficult for them to qualify to retain control over the company. (**Eligibility criteria is at ANNEXURE II).** Because of this scenario, there is typically no interest of the existing management/ shareholders to infuse funds or cooperate during the process. They participate in the company’s running as no remuneration can be paid for their efforts during the process.

The insolvency professional under the law is duty-bound to continue the entity’s business, but in practice, the businesses, if at all, are run on a nominal scale. Customers and suppliers are hesitant in dealing with the company during the process. Employees/workers often leave the company due to uncertainties of the outcome of the process. This cause disruption to the business, which imposes a high cost on the organisation, and the creditors ultimately bear these costs.

In the given situation, from the creditor’s point of view, the company’s restructuring could have been achieved much more effectively had the company or the creditors opted for the Corporate Insolvency Resolution Process (CIRP) under Indian Law. However, in that scenario, the existing shareholders would have gone out of the company. Further such restructuring, in practice, is financial restructuring, reducing the debt burden and allowing longer tenures of repayments. The buyers may or may not continue the company’s business as their interest may only be in some of its assets.

Thus, considering the above discussions, formal liquidation under either the law of The Netherlands or India is not a good option for restructuring Flow Management in the given scenario.

**Annexure I**

**STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO**

**MULTI-CREDITOR WORKOUTS II**

**FIRST PRINCIPLE:** Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to cooperate with each other to give sufficient (though limited) time (a “Standstill Period”) to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor’s financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

**SECOND PRINCIPLE:** During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their

exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced. Conflicts of interest in the creditor group should be identified early

and dealt with appropriately.

**THIRD PRINCIPLE:** During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position

at the Standstill Commencement Date.

**FOURTH PRINCIPLE:** The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

**FIFTH PRINCIPLE:** During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

**SIXTH PRINCIPLE:** Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

**SEVENTH PRINCIPLE:** Information obtained for the purposes of the process concerning 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, unless already publicly available, be treated as confidential.

**EIGHTH PRINCIPLE:** If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

**ANNEXURE II**

**Eligibility criteria for for participating as resolution applicant in the Corporate Insolvency Resolution Process under Insolvency & Bankruptc Code 2016.**

**Section 29A. Persons not eligible to be resolution applicant. -**

A person shall not be eligible to submit a resolution plan, if such person, or any other person acting jointly or in concert with such person—

1. is an undischarged insolvent;
2. is a wilful defaulter in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949 (10 of 1949);
3. at the time of submission of the resolution plan has an account,or an account of a corporate debtor under the management or control of such person or of whom such person is a promoter, classified as non-performing asset in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949 (10 of 1949) or the guidelines of a financial sector regulator issued under any other law for the time being in force,] and at least a period of one year has lapsed from the date of such classification till the date of commencement of the corporate insolvency resolution process of the corporate debtor:

Provided that the person shall be eligible to submit a resolution plan if such person makes payment of all overdue amounts with interest thereon and charges relating to non-performing asset accounts before submission of resolution plan:

Provided further that nothing in this clause shall apply to a resolution applicant where such applicant is a financial entity and is not a related party to the corporate debtor.

***Explanation* I*.-***For the purposes of this proviso, the expression “related party” shall not include a financial entity, regulated by a financial sector regulator, if it is a financial creditor of the corporate debtor and is a related party of the corporate debtor solely on account of conversion or substitution of debt into equity shares or instruments convertible into equity shares or completion of such transactions as may be prescribed, prior to the insolvency commencement date.

***Explanation* II*.—***For the purposes of this clause, where a resolution applicant has an account, or an account of a corporate debtor under the management or control of such person or of whom such person is a promoter, classified as non-performing asset and such account was acquired pursuant to a prior resolution plan approved under this Code, then, the provisions of this clause shall not apply to such resolution applicant for a period of three years from the date of approval of such resolution plan by the Adjudicating Authority under this Code;

1. has been convicted for any offence punishable with imprisonment –
	1. for two years or more under any Act specified under the Twelfth Schedule; or
	2. for seven years or more under any law for the time being in force:

Provided that this clause shall not apply to a person after the expiry of a period of two years from the date of his release from imprisonment:

Provided further that this clause shall not apply in relation to a connected person referred to in clause(iii) of *Explanation* I

1. is disqualified to act as a director under the Companies Act, 2013 (18 of 2013):

Provided that this clause shall not apply in relation to a connected person referred to in clause *(iii)* of *Explanation I;*

1. is prohibited by the Securities and Exchange Board of India from trading in securities or accessing the securities markets;
2. has been a promoter or in the management or control of a corporate debtor in which a preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction has taken place and in respect of which an order has been made by the Adjudicating Authority under this Code:

Provided that this clause shall not apply if a preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction has taken place prior to the acquisition of the corporate debtor by the resolution applicant pursuant to a resolution plan approved under this Code or pursuant to a scheme or plan approved by a financial sector regulator or a court, and such resolution applicant has not otherwise contributed to the preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction;

1. has executed a guaranteein favour of a creditor in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under this Code and such guarantee has been invoked by the creditor and remains unpaid in full or part;
2. is subject to any disability, corresponding to clauses (a) to (h), under any law in a jurisdiction outside India; or
3. has a connected person not eligible under clauses (a) to (i).

*Explanation*I**.** — For the purposes of this clause, the expression “connected person” means—

* 1. any person who is the promoter or in the management or control of the resolution applicant; or
	2. any person who shall be the promoter or in management or control of the business of the corporate debtor during the implementation of the resolution plan; or
	3. the holding company, subsidiary company, associate company or related party of a person referred to in clauses (i) and (ii):

Provided that nothing in clause (iii) of *Explanation* I shall apply to a resolution applicant where such applicant is a financial entity and is not a related party of the corporate debtor:

Provided further that the expression “related party” shall not include a financial entity, regulated by a financial sector regulator, if it is a financial creditor of the corporate debtor and is a related party of the corporate debtor solely on account of conversion or substitution of debt into equity shares or instruments convertible into equity shares or completion of such transactions as may be prescribed], prior to the insolvency commencement date;

*Explanation* II—For the purposes of this section, “financial entity” shall mean the following entities which meet such criteria or conditions as the Central Government may, in consultation with the financial sector regulator, notify in this behalf, namely:—

1. a scheduled bank;
2. any entity regulated by a foreign central bank or a securities market regulator or other financial sector regulator of a jurisdiction outside India which jurisdiction is compliant with the Financial Action Task Force Standards and is a signatory to the International Organisation of Securities Commissions Multilateral Memorandum of Understanding;
3. any investment vehicle, registered foreign institutional investor, registered foreign portfolio investor or a foreign venture capital investor, where the terms shall have the meaning assigned to them in regulation 2 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 made under the Foreign Exchange Management Act, 1999 (42 of 1999);
4. an asset reconstruction company register with the Reserve Bank of India under section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002);
5. an Alternate Investment Fund registered with Securities and Exchange Board of India;
6. such categories of persons as may be notified by the Central Government.