**GIPC – CASE STUDY I - FLOW MANAGEMENT – Jelenko Lehki 202021IFU-362**

**ASNWERS:**

**Question 1.**

**1. What were in your opinion the causes of financial distress at Flow Management (see e.g. Mellahi & Wilkinson, 2004)? Could the financial distress have been prevented? If yes, explain how. If no, why not?**

Causes of financial distress at Flow Management were in my opinion mostly internal and in part shareholder related.

In regards to internal causes, management was mostly responsible for it in numerous matters. First is the matter of control of accounting for which CFO was responsible that wasn’t done properly which resulted in “sudden” realization of financial distress. That obviously came as a surprise for CEO, which didn’t prevent him from retaining payment of bonuses paid previous year. This goes along with contingent gains were also not so well calculated and turned out ot be non existent. Following up, subsidiary’s financial result were also “corrected” which further added to the overall (di)stress and need for additional working capital. These matters for which management/CEO is responsible, in my opinion, indicate the main causes of financial distress, and need for change in management. Additional confirmation of bad management came was obvious when it came to negotiations with key customers. From facts of the case we see that minimal negative feedback was received which clearly points that pricing policy was wrong. That along with operational costs calculated on basis of flawed “excel” function was main factor that contributed to negative overall financial result. In situation when market demand and choice of business were obviously positive for company/industry, all of this could be avoided if proper care was paid to the business by management. Shareholders on the other hand failed to institute proper controlling functions which were obviously lacking in procedure and execution wise which. That in my opinion didn’t bother much the shareholder (or they were aware of it) since we can notice it’s reluctance to pay additional capital to help with restructuring.

As per Mellahi ˛Wilikinson, 2004 these three factors which led to company being distressed could be categorized as organizational factors and psychological factors, not so much as environmental and ecological factors. Thy all came from “inside” of company and it’s management. Outside factors as current market state and it’s maturity phase, presence of demand were on positive side obviously, but actions of management or the lack of to be more precise led to the unfortunate state of affairs.

In my opinion (obviously hindsight), reasons for distress could have been avoided with higher degree of due care from the management or even further from shareholders. That issue isn’t much addressed in the case facts, but it can be in general said that shared responsibility (3 shareholders, one “family” and two institutional investors) tends to lead to even less than shared actions and incentive to react/additionally control the joint matters. When it later came to the time for shareholders to put up with additional working capital we see their reluctance to act immediately, but rather contemplate selling of assets of company in order to increase solvency. This led to their influence (Pajunen, 2006) being marginalized even further and led to final agreement which they were left out of.

**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?**

Advantages of an out-of-court restructuring are mostly found in fact that process can be done in relative discretion while maintaining outside appearance of distressed company not affected during the process. This in theory (and practice) should prevent rush of creditors, creditors fighting one over another for collecting which can have adverse effects on the business, gaining better value of sale of business as going concern is the plan and overall better chances of success if there is general consensus of creditors. Further more, once the agreement is reached, in some jurisdictions agreed upon restructuring plan can be confirmed by court decision to gain effect over other creditors. Out-of-court procedures have more flexibility in creating what could be called “tailor made” solutions and provide for more control as opposed to court procedures where inputs from judges, administrators/trustees (Adrianese and Kuijl) and of course provisions of insolvency code have to be recognized and taken into account procedure and possible outcome wise which inevitably has it’s influence on the outcome.

Disadvantages can certainly be found in the fact that no beneficial effects of court procedure (if needed) cannot be counted on e.g. general moratorium, provisions on voting if necessary and applicable. After creditors reach an agreement, if it is needed it cannot be forced upon other creditors, and there is a matter of subsidiaries/connected companies in other jurisdictions.

In Croatia there is no framework for out-of-court restructuring besides general provisions of Civil Obligations Act. As a rule, debtor either files for pre-insolvency procedure gaining the advantage of moratorium, or “waits” for insolvency reasons to be present which is 60 days of non payment (which confirmed that reason for insolvency present) of 120 days if FINA, short for Financial agency, government agency that provides (mandatory) assistance in collection of monetary claims and forced sale of real estate due to accounts being “blocked”) starts the procedure (in most cases), at which time there is a court hearing for opening of bankruptcy procedure. Shortly before that time is the moment in which in some cases out-of-court agreement is reached on standstill (recalling petitions for collection on bank accounts) to postpone the opening of bankruptcy procedure and negotiations begin. Usually (due to non existent out-of court framework) it leads to bankruptcy procedure being dismissed (for a period of time) in which either debtor files for pre-insolvency based on agreement reached on restructuring plan, or the bankruptcy procedure is opened after additional 60/120 days when mandatory petition is filed by FINA (again). In respect to above mentioned situation, out-of-court restructuring agreements in Croatia is very rare because, besides no possibility for court confirmation of the agreement and it’s provisions being “forced” upon all creditors, it is mostly based on general provisions of Civil Obligations Act which in case of other party (debtor) being in distressed situation leaves all involved in high risk of any agreement/arrangements being suspectable for avoidance in case bankruptcy procedure is later opened.

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

Reorganization approaches as presented in reading material that were applied in this case were retrenchments and recovery as described in Schmitt, A., Raisch, S., 2013. They were applied simultaneously as the study indicates that it should be done. The retrenchment part consisted of lay off-s, recalculating the financial aspects and finding savings in better management of assets and work process optimizations/reorganizations, while recovery part put emphasis on renegotiating terms with mayor clients (in increasing of prices) and addressing all other clients on price increase which contributed to improvement of financial result (reduction of loss in current state of business), and projected future profit which was important to keep most of stakeholders interested in saving a company as a going concern.

Shareholders contribution in restructuring was also present in part, and as study indicated (Pajunen, 2006), as it demised in terms of providing source of financials, their influence diminished, which led to new CRO (which is later compensated/awarded bonus? in shares of new company) being appointed by creditors request, which indicates shift in influence position towards creditors.

As in Adriasnse and Kujil 2006, we see phases of business restructuring applied, in short term with emphasis on stabilization, cutbacks in expenditure, optimizing stock situation, then analyzing (projections of scenarios being made and analyzed to make a decision on course of actions. Following on that measures, actions for restoring long term profitability and financial restructuring were introduced (rescheduling/postponing of payments and better control of calculation of prices) along with reinforcing measures (appointment of new CFO), all that followed in the end by agreement which changes shareholders structure and future plan to sell the company (screening the industry market for potential buyers).

**4. Banks C and D seem to frustrate the process at a certain point. What could have been the (rational and/or opportunistic) reason(s) for them to behave like that? What would you have done in that situation in your role as advisor of the other two banks?**

Actions of Banks C and D could be interpreted in several ways. Their disagreement with “plans” of banks A and B could indicate difference in their involvement in the matter at hand in relation to their relative position in overall debt (which fact is undisclosed), so they could be minor creditors in which case they could just want ot finish the case quickly and take chance on opening of formal procedure. Other perspective could come from info on their subjective exposure in this case which could be less than banks A and B and they could prolong the decision on case. Contemplated but not executed (could be presumed not accepted by banks C and D) payoff by banks A and B (with significant discount) is also indicative that their disagreement with banks A and B could just be “a play” in order to (a) put pressure on debtor (since the decision was obviously to hold position and not sell before final agreement is reached) and also (b) to establish better position among creditors).

Lacking important data on banks position in overall debt and it’s exposure to the current client, as their advisor, if the situation with restructuring was not gong according to plan maybe an advice to temporarily stop “unconditional” cooperation would be considered. This also done with a lot of “tact” in order to keep communication and continue to receive info on development of things. That also was the case since final agreement was reached.

On the other hand, if the perception that internal reorganization/restructuring of debtor was falling behind planned time frame and that it had small chances of being conducted in time to provide necessary positive changes, a suggestion of considering selling of claim could be considered (with obvious aim of smallest possible/achievable discount).

**5. Which of the eight principles of the ‘Statement of Principles for a Global Approach to**

**Multi-Creditor Workouts II’ can be found in the workout process of Flow Management**

**(explicit or implicit)?**

There were several principles found in Statement of Principles for a Global Approach to

Multi-Creditor Workouts II applied in this case.

First, there was a standstill agreed upon on, which the first states as beneficial to whole process. Also, creditors refrained from separate enforcement/collection procedures during the process.

Secondly, from facts of the case, it is obvious that at least in part (or until the press releases in late 2014), all concerned parties exercised discretion about negotiations and the whole process since it wasn’t explicitly communicated to the customers. That is what seventh principle calls for.

Additional information on state of affairs in company was regularly communicated to the creditors as stated in principle five.

Relations between creditors participating in providing work capital were conserved and put in final agreement terms as stated in principle six.

Although not clear when it was given and not named per se as “new money/financing” additional working capital provided by Banks C and D has had sort of preferential treatment through payment of EURO 25 million in January 2015 which could be reference to the eight principle.

**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?**

There are no specific “soft law” provisions in Croatia on how creditors should jointly approach workout/restructuring. Decisions are made on case to case basis, and there is no out-of-court restructuring framework.

In situation similar to Case study, where all important creditors are known (by name), and are institutions, I believe it could be beneficial that at the beginning that a short memo of understanding is signed which could serve the process in more than one way. For one, to record a “joint intention” on which they agreed at certain time which could be useful if disagreements later occur/arise (not uncommon). It could also serve as a enhancement in position of creditor(s) with their joint approach giving them more leverage to creditor(s) over debtor’s actions and more control over the whole process.

Alternative approach which is occasionally used is buying of claims with discount during the restructuring process giving one or more creditors more leverage and “voting rights” in possible future insolvency proceedings. Unfortunately, that is often the beginning of future avoidance actions because creditors after acquiring claims tend to settle them before insolvency directly taking the risk of possible law suit in future (if it comes to that).

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

The restuucturing agreement is in essence a debt to equity swap with organizational changes aimed for sale of company (now Flow Management II BV) to the prospective buyer in future, expecting it to be coming from the same industry. Previous owner is divested from it’s position. According to the facts of the case, did not oppose to the solution.

Banks C and D will waiver and amount of EUR 32.5 million, and the whole consortium will waiver EUR 97.5 million. Shareholder will waiver undisclosed amount of claims against Flow Management Holding BV.

Banks “converted” their claims after partly unknown percentage of “haircut”.

Ratio of distribution of shares of a SPV which they intend to continue to reorganize in order to sell it as a going concern is to follow initial credit figures.

Final financial results for creditors (and percentage of haircut) will be calculated after the future sale of Flow Managemnent II BV.

Considering it was an out-of-court agreement it could be concluded that it was the best possible solution for all parties.

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

Considering there were six companies in Flow Management Holding BV registered in Europe (3), Australia, South Africa and USA a lot of possible legal issues could arise, but non were mentioned in the facts of the case besides initial legal problems with securities which have presumably been settled during the negotiations. That being so, it could be presumed that total debt was structured in a way that only four previously mentioned banks and shareholder held all of the group’s debt which made possible to go through the Restructuring agreement without interference from other creditors who could have objected to the final agreement. What remains unclear (at least to me) is why they choose to go through founding a new shell subsidiary, transferring of shares and liquidation of Flow Management Holding BV afterwards, canceling part of claims, while leaving EURO 240 million claim to be settled in liquidation process of Flow Management Holding BV (already knowing shareholder, and both (C and D?) banks will get nothing in the process due to subordinated claims. Accounting/financial repercussions tax-wise of the whole arrangement are not disclosed so probably do not pose mayor factor in whole agreement, but it can lead to creating additional obligations that can in some jurisdictions have priority which can have impact on expected percentage of claims satisfaction (in the liquidation process planned ahead).

The whole process could have developed differently with many possible legal cross-border issues if they choose the formal proceedings. Having many jurisdictions which each of could have opened its own proceedings on subsidiaries (unknown (besides additional credits to Dutch company) is the whole debt structure of holding and possibly there were securities over assets of subsidiaries given as a guarantee for holdings obligations. That process without communication and cooperation between courts and administrators would have led to a long and expensive piecemeal sale process which was avoided by this out of court solution.

**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]**

Form the facts of the case, only four banks (A, B, C and D), besides shareholder were involved in financing of working capital of the company/debtor which made possible to opt for/choose an out-of-court solution which has it’s benefits over formal insolvency procedure as stated in answers above. Although there was some “friction” among these creditors, this solution in my opinion provided for a more “peace” on side of debtor’s business and subsequent start of internal reorganization enabling it to go as smoothly as possible without negative interference from market conditions (decreased reputation, problems with suppliers, loss of customers) which could adversely change in relation to debtor in case formal proceedings were announced.

Another reason to choose this route could be found in need for bridging loan which banks obviously were trying to avoid (proposing shareholder to contribute in additional money).

In case of moratorium/start of formal proceedings on company doing business in six different jurisdictions over four continents besides loss of control over it, numerous cross border legal issues with recognition and driving the whole process in “one direction”, there is a certainty that expenses of each of the procedures would reduce the final result of restructuring process.

Coming from Croatian perspective, insolvency case on such scale would fall far out of usual size of “big” insolvency proceedings for which legal framework was designed (although theoretically all provisions are there for even bigger cases). When this became reality in 2017 with Agrokor case, Government opted for passing a law on Extraordinary administration of such big cases (case…) which introduced elements from UK and USA insolvency systems to Croatian insolvency practice and went for substantive consolidation option in that case. Result in essence was pretty much similar to this one, former shareholders divested and creditors were given ownership over new partly integrated company with plan to sell all non core assets and liquidate former legal entities.