**Case Study I**

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

In their paper ‘*Organizational failure: a critique of recent research and a proposed integrative framework*’[[1]](#footnote-1), Mellahi & Wilkinson discuss how current literature splits the causes of organizational failure into two broad categories:

* **External factors**: The industrial organization and the organizational ecology schools of thought believe that organizational failure results from external factors that largely cannot be controlled by the organization’s management. These factors can include changes in regulations, technological developments, change in demand cycles, competition levels in the market, age of the organisation, size of the firm, among others.
* **Internal factors**: On the other hand, the organization studies and the organizational psychology schools believe that failure results from internal failings and inadequate response to external factors at the firm. For example, poor management, excessive risk-taking, weak information systems, long-tenured executives’ rigidity to adapt to challenges.

Barring instances where either external and internal factors have a severe effect (e.g., global economic crisis or fraudulent management), generally financial distress at a firm can be expected to be a result of the combined effect of internal and external factors which may either aggravate or offset each other.[[2]](#footnote-2)

Adriaanse categorises causes of financial distress into the following[[3]](#footnote-3):

* **Marketing**: causes related to company’s strategy with respect to its market and clients;
* **Management**: causes related to the quality and workings of management;
* **Information**: causes related to weak information systems at firms;
* **Efficiency**: causes related to excessive expenditures and costs; and
* **Economy**: causes related to the macroeconomic environment and the industry in which the firm operates.

In the case of Flow Management, the cause of financial distress seems to mainly emanate from weak corporate governance and internal factors such as:

* **Gross mismanagement, errors, lack of adequate internal controls and weak management information systems**: The wrongful issuance of large management bonuses (€3 million), the gross error in the cost-price calculation formula in the spreadsheet which resulted in low prices being charged resulting in losses indicate mismanagement and absence of internal controls.
* **Weak accounting practices**: Several instances in Flow Management’s case such as: reported pre-tax profit until September 2013 of €8 million turning out to be a loss of €5.4million, discrepancies in 2012 annual accounts, wrongful booking of contingency gain relating to three years in 2012 and accounting of book profit (‘paper gain’) which was never realised, repeated wrong forecasts and projections) indicate that weak accounting practices were followed at the firm.
* **Inefficient management of working capital**: The facts indicate that Flow Management was not managing its working capital efficiently. Prior to facing financial distress, low prices were being charged, there was inefficient loss recovery and existence of surplus assets which were not being managed efficiently.

Therefore, from the information provided in the case study, Flow Management’s financial stress appears to mainly be a result of internal factors rather than any specific or obvious change in external factors such as change in market demand.

This is also evident by the fact that the independent turnaround consultancy agency that was appointed, concluded that the company is viable with a view to the market share. The given facts also note that there was market demand for their products. Therefore, the financial distress at Flow Management appears to be a result of internal adequacies and management failures.

The financial stress at Flow Management could have been prevented by taking the following steps:

* **Better management:** Instance of wrongful issuance of bonuses and gross errors in the cost-price formula sheet could have been avoided if a better, more efficient and active management was in place.
* **Better internal controls to verify accounting practices:** Examples of discrepancies in Flow Management’s accounts indicate that the internal controls for its accounting systems was weak. The company could have had stronger internal controls in place to ensure that the integrity and accuracy of their accounting data was maintained.
* **Improved management information systems**: Building strong management information systems could have assisted the managers of Flow Management in identifying problem areas (charging of low price, inefficient working capital management, weak accounting systems) and implementing efficient strategies to fix them.
* **Better working capital management by the managers**

1. **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?**

The general advantages of an out-of-court restructuring (workout) as compared to a formal bankruptcy procedure are discussed below along with a discussion of how the issue plays out in the Indian context:

* **Cost-efficient**: Out-of-court workouts are usually cheaper as compared to formal reorganisation or liquidation procedures. Costs associated with cumbersome court procedures, mandatory appointments of administrator/trustee/liquidator can be avoided.

**Indian context**: The corporate insolvency resolution process or ‘CIRP’ under India’s Insolvency and Bankruptcy Code (IBC) is India’s equivalent of a formal Chapter 11 reorganisation procedure in the US. A CIRP involves appointment of resolution professionals (‘RP’ who is akin to an administrator), appointed of financial and legal advisers for the creditors as well as the RP, appointed of forensic auditors to audit past transactions undertaken by the distressed entity, among others. Therefore, there are often large costs associated with undergoing a CIRP versus an informal out-of-court restructuring. Needless to say, several of these advisors may also need to be appointed in an informal reorganisation but the relative costs involved in the cumbersome procedure under the formal process is usually higher. Therefore, one of the key advantages of an out-of-court restructuring is that it is relatively more cost-efficient as opposed to a formal CIRP.

* **Discreet**: Unless the firm is listed, informal out-of-court procedures are usually not made public. A public procedure is likely to have a negative impact on the firm’s customer base, its suppliers and trade creditors. Adriaanse and Kuijl discuss this advantage under the head of “*silence*” [[4]](#footnote-4) in their article and highlight how a public procedure often leads to a “*race to collect*” amongst the creditors with the aim of getting paid ahead of other creditors. This has an adverse impact on the prospects of a successful restructuring. Therefore, reputational damage associated with public reorganisation procedures can often be avoided in informal workouts.

**Indian context**:The advantage of ‘discreetness’ is particularly important in the Asian context. A strong stigma is associated with insolvency and bankruptcy processes in Asia.[[5]](#footnote-5) Therefore, the benefits of a relatively private out-of-court restructuring may be significant in the Indian context where the stigma associated with a formal insolvency can discourage promoters or managers from taking timely action to address financial distress at the firm.

* **Existing management can retain control of the firm**: As highlighted by Adriaanse and Kuijl, informal restructuring procedure offer the benefit of “*control*”[[6]](#footnote-6) to the management of the distressed firm. Unlike formal reorganisation procedures where a third party such as an administrator, resolution professional or trustee is usually appointed, the management can continue to retain control of the firm in informal workouts.

**Indian context**: The advantage of ‘control’ is of particular importance to debtors in the Indian context. A CIRP under the IBC does not follow the ‘debtor-in-possession’ model. Instead, once the debtor is admitted into insolvency, the resolution professional is vested with the management and control of the debtor and the current board of directors is suspended.[[7]](#footnote-7) Key actions related to the debtor are then undertaken by the RP according to the vote of the debtor’s creditors. More importantly, section 29A of the IBC (which lays down the eligibility requirements for who can submit a bid for debtors in CIRP) bars entities holding accounts classified as non-performing assets for a period of one year, among others, from participating in the IBC process. This means that existing promoters are often barred from bidding for their company during CIRP. Therefore, a formal insolvency under the IBC presents a realistic threat to the promoter that she might lose her company. In this regard, out-of-court workouts offer an attractive avenue for promoters to restructure their company without the risk of losing its control entirely in a CIRP. In fact, this threat has had a positive impact on debtors resolving distress at its early stages to avoid formal insolvency. 24,222 applications for initiation of CIRPs with an underlying default of INR 7.6tn (USD 93.8bn) were resolved before the application was admitted, according to data available till December 2022.[[8]](#footnote-8)

* **Flexibility**: As discussed by Jan Adriaanse and Kuijl one of the key advantages of out-of-court workout over formal reorganisation or bankruptcy procedures is the “*flexibility*”[[9]](#footnote-9) it offers in the restructuring process. Creditors and the distressed firm can arrive at suitable solutions without being bound by the confines of minimum requirements and the cumbersome procedure set out under the relevant bankruptcy law.

**Indian context**: As discussed above, CIRPs under the IBC have strict eligibility requirements for bidders, involves a cumbersome procedure and court involvement (for admission into insolvency, approval of the final restructuring plan, among others). Therefore, the flexibility offered by an out-of-court restructuring is also beneficial in the Indian context.

* **Quicker**: While this may not be a significant advantage in all markets, formal reorganisation procedures in emerging markets often suffer from delays on account of cumbersome procedures and judicial delays. Informal reorganisation may offer a considerable time advantage especially in jurisdictions like India where the formal reorganisation procedures can often take years to conclude and result in value erosion at the firm.

**Indian context**: According to data published by the Insolvency and Bankruptcy Board of India[[10]](#footnote-10), as of March 2022, the average time taken for conclusion of a corporate insolvency resolution process (India’s equivalent of a Chapter 11 reorganisation procedure) is 536 days. While the prescribed timeline for completion of a CIRP is 330 days, this timeline is often not met on account of court delays, litigation by disgruntled creditors, losing bidders and promoters. Therefore, an out-of-court restructuring is likely to offer a more time-efficient solution in a restructuring.

* **Especially suited for MSMEs:** The costs involved in formal insolvency procedures often function as a deterrent for MSMEs who cannot afford it. Formal insolvency processes and the costs associated are often more suited to large debtors which has a large number of creditors and a diverse creditor composition. Therefore, out-of-court workouts may have significant advantages for restructuring of MSMEs.

**Indian context:** In India, MSMEs are estimated to contribute about 30% to the country’s gross domestic product and offers employment to 111 million people.[[11]](#footnote-11) Therefore, having an accessible and cost-efficient means of restructuring for MSMEs is critical. This is also discussed as a part of ‘Key Principle 1’ of International Insolvency Institute & the Asian Business Law Institute’ Guide on *the Treatment of Insolvent Micro and Small Enterprises in Asia* which discusses how informal workouts can offer several advantages to MSMEs – lesser costs, lesser stigma associated with the process and reduced burden on already overburdened judicial systems in several Asian emerging markets.[[12]](#footnote-12)

While out-of-court workouts offer several advantages over formal insolvency procedures, it also has some disadvantages that should be kept in mind:

* **Absence of statutory protections (e.g., a stay/moratorium) available under insolvency law**: For example, most insolvency and bankruptcy statutes offer a statutory moratorium against enforcement of claims against the debtor once it is admitted into a formal insolvency procedure (e.g., moratorium under section 14 of IBC in India). However, an informal process does not offer this protection to the debtor automatically and it would need to depend on a unanimous and contractual standstill agreed to by its creditors to achieve the same effect. It may be important to note that several jurisdictions have come up with hybrid procedures which allow a mix of out-of-court restructuring with minimal involvement of the court and such procedures can sometimes offer the statutory protection of a moratorium (e.g., prepacks in India).
* **Lack of accountability of the management for behaviour that may have resulted in financial distress and no benefit of ‘avoidance action’ provisions**: Formal insolvency law usually contain ‘avoidance actions related provisions’ which allow investigation of suspect transactions undertaken by the debtor in the period preceding its insolvency. Common avoidance transactions that are often investigated under these provisions include undervalued, preferential, fraudulent or extortionate credit transactions[[13]](#footnote-13). These provisions provide teeth to the debtor’s creditors and stakeholders to reverse suspect transactions and hold the erstwhile management liable to the extent that they were involved and facilitated such transactions.
* **Lacks the teeth and binding nature of a formal reorganisation procedure**: Usually, a restructuring plan approved by the courts under a formal insolvency process (e.g., resolution plan approved by India’s insolvency tribunal under the IBC) becomes binding on all stakeholders of the company (i.e., its employees, creditors, shareholders as well as the government)[[14]](#footnote-14). Moreover, violation of the terms of the restructuring plan is a cause for liquidation of the debtor. These benefits (i.e., the restructuring’s binding nature, statutory consequences in case of violation of restructuring plan) may not be available in an informal workout.
* **Risk of a rogue creditor filing the company into insolvency**: One of the key requirements for the success of an informal workout is that it requires all creditors to be onboard. In the absence of unanimous support, a rogue creditor may take action to admit the debtor into formal insolvency and the insolvency tribunal in India is not statutorily bound to consider out-of-court settlement efforts before admitting the debtor into insolvency. As long as the requisite payment default is shown, the debtor may be admitted into CIRP and the out-of-court workout efforts may come to naught.

1. **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.**

The following turnaround/reorganization approaches presented in the reading material were applied in this case in the following manner:

| **Turnaround approach described in reading material** | **Application in Flow Management’s case** |
| --- | --- |
| **Approach discussed by Adriaanse, J.A.A. & Kuijl, J.G.[[15]](#footnote-15):** Informal reorganization involving business and financial restructuring.  Adriaanse and Kuijl discuss the benefits of informal reorganization (i.e., a restructuring conducted outside the framework of formal reorganization procedures under the insolvency or bankruptcy law of the relevant jurisdiction) along with the following business and financial restructuring steps that are undertaken in an informal reorganization:  **Business restructuring related steps**: | The turnaround approach suggested by Adriaanse and Kuijl were largely followed in Flow Management’s case. Its creditors decided to opt for an informal reorganisation despite having an avenue to formal reorganisation as liquidation was likely to result in lower recoveries. Importantly, the strategy employed by the debtor and creditors incorporated elements of both business and financial restructuring discussed by Adriaanse and Kuijl in the following manner:    **Business restructuring related steps:** |
| * **Stabilizing phase**: steps aimed at increasing cash flows (e.g., reducing costs, quicker turnover of receivables) | * **Stabilizing phase:** Flow Management took several steps to increase cash flows. This included price increases for their products and services, cost reductions by reducing labour costs, steps towards better loss recovery, charging higher excess premiums and making savings on car repairs. |
| * **Analyzing phase**: steps aimed at evaluating the debtor’s prospects and developing a reorganisation plan, adapting marketing strategies, improving information systems, capital injection, recruit external turnaround experts, among others | * **Analyzing phase:** The debtor and the creditors took several steps towards assessing the financial position of the company. An independent accounting firm and independent turnaround consultancy agency was appointed to monitor the procedures and viability of the company. Changes were also made to the management of the debtor – the CEO was replaced. The shareholder also deposited certain amounts as an unsecured loan to the company. Moreover, a chief restructuring officer (CRO) was appointed to the board of the company. There were simultaneous discussions on direct injection of equity capital by the shareholders, possibility of restructuring foreign subsidiaries and improvement in the management information systems so that projections can be more reliable. |
| * **Repositioning phase**: steps aimed at initiating reorganisation, transparent exchange of relevant information to restore creditor confidence. | * **Repositioning phase:** The steps in this phase largely coincide and overlap with the analyzing phase. Plans were also drawn up to re-evaluate its entire product range, restructure or sell-off its non-benelux companies, among others. |
| * **Reinforcing phase**: steps aimed at reinforcing debtor’s management and balance sheet, potential transfer to a new company. | * **Reinforcing phase:** Ultimately in July 2015, a restructuring agreement is signed which involved transfer of Flow Management’s operating subsidiaries to a new shell company. Shares of this shell company were transferred to Flow Management’s creditors as well as to its board members (including the CRO). |
| * **Financial restructuring related steps:** may includereduction/waiver of interest/principal repayments, delaying repayments, debt-equity swap, capital injection by shareholders or raising new loans from creditors. | * **Financial restructuring related steps**   Several financial restructuring related steps were employed by Flow Management and its creditors. Through the discussions, the debtor made proposals towards restructuring (delay in repayment or refinancing) of its existing working capital financing and other loans. The shareholder also deposited €10 million in the company as an unsecured loan.  Before the restructuring agreement was signed, four possibilities – a going concern sale of debtor, selling the debtor in case viability is not proven, a debt-to equity conversion by the creditors, a moratorium or ‘restart’ following liquidation were also considered.  In the final restructuring agreement, a going concern option where the operating subsidiaries of Flow Management Holding BV would be transferred to another shell company was agreed to. Flow Management Holding BV was to be liquidated. Creditors which had provided working capital to the debtor waived a portion of their claim. Moreover, and other loans worth € 55 million were cancelled in full. Additionally, creditors of Flow Management, were given equity in the shell company that took over the operating subsidiaries of the group. Therefore, several elements of financial restructuring can be seen in Flow Management’s case. |
| **Approach discussed by K. Pajunen**[[16]](#footnote-16): Pajunen discusses certain key propositions for organizational survival.  He notes that continuing support of governing stakeholders increases the probability of organizational survival. He makes the proposition that the following approaches increases support and the probability of organizational survival:   * Open and active communication amongst managers and governing stakeholders * Personal relationships between managers and governing stakeholders * Management’s unlocked brokerage position between governing stakeholders * Consensus on long term goals amongst governing stakeholders * Governing stakeholders’ association of management with good firm performance | Some of Pajunen’s propositions can be seen in Flow Management’s restructuring process, for example:   * **Importance of open and active communication**: Throughout the restructuring process, the projections provided for the debtor were often inaccurate. At one stage, this triggered a lack of confidence by Banks C and D in the debtor and they stopped co-operating on the standstill agreement. Therefore, open, reliable and active communication was critical to Flow Management’s survival. * **Management’s unlocked brokerage position between governing stakeholders and governing stakeholders’ association of management with good firm performance**: Despite repeatedly inaccurate projections, the appointment of new management (i.e., resignation of the CEO and appointment of the CRO) provided creditors with enough confidence to enter into a standstill agreement and increased their support for the organization’s survival. This indicates the benefits of management’s unlocked brokerage position between governing stakeholders and the importance of the governing stakeholders’ association of management with good performance. |
| **Approach discussed by A. Schmitt and S. Raisch**[[17]](#footnote-17): They discusses how retrenchment and recovery need not necessarily be seen as contradictory and interaction between retrenchment and recovery related steps can be helpful in turnarounds.  Retrenchment activities include reduction in inventories, layoffs, reductions in marketing, maintenance costs and R&D expenditures, among others.  Recovery activities include exploring new markets, new products, new production or service process, new competitive advantages, acquisitions and new organisational structure. | Flow Management’s restructuring process seems to have mainly relied on retrenchment activities such as reduction in costs and layoffs with certain elements of recovery activities (such as change in organizational structure). |
| **Approach discussed by S. Sudarsanam and J. Lai[[18]](#footnote-18) :** They discuss the following four key restructuring strategies and analyze how they have been applied in recovery and non-recovery firms (i.e., firms which were successful or failed in recovering from financial distress):   * Operational restructuring: reduction in costs, focus on increasing revenues. * Asset restructuring: strategic restructuring, divestment of non-core businesses, forming strategic alliances and undertaking acquisitions. * Managerial restructuring: change in top management * Financial restructuring: equity issuances, dividend cuts, debt restructuring involving reduction in payments of principal or interest, debt to equity conversions.   Sundaram and Lai discuss how non-recovery firms focus more on operational and financial restructuring (debt restructuring and omission of dividends). While recovery firms adopt a more expansionary and external market focused strategies. | Flow Management’s restructuring employed each of operational restructuring (layoffs, price increases), managerial restructuring (removal of CEO and appointment of CRO) and financial restructuring (waiver of debts, issuance of equity in the newly formed shell company to the consortium of banks).  While elements of asset restructuring (such as sale of shares of its non-benelux companies, restructuring its foreign subsidiaries) were considered at certain stages, it is unclear from the given facts if this was finally done.  The final outcome of Flow Management’s restructuring is not known so Sundaram and Lai’s study on recovery and non-recovery firms and the strategy employed by them cannot be evaluated. |

**What could have been done differently in Flow Management’s case?**

* **Better information flow from the debtor**: As highlighted in several readings and discussed above, consistent flow of reliable information between the debtor and its creditors is key to building confidence and to the success of a turnaround. In Flow Management’s case, projections about future profits/losses were frequently inaccurate. This affected the creditors’ confidence (especially Banks C and D) in the process and led to delays in the restructuring.
* **Better coordination amongst creditors**: Better and timely coordination amongst Flow Management’s creditors would have definitely benefitted its workout process. While discussions between the debtor and creditor about the financial distress at the group were on since December 2013, the standstill was only signed nearly a year later in August 2014. One of the reasons for the delay in signing the standstill was non-cooperation from Banks C and D at one stage. This resulted in conflicts between not just the debtor and the creditors but also split the creditors in two groups resulting in an inefficient outcome. The shareholder’s capital injection was also conditional upon signing of the standstill agreement. Therefore, it is possible that if the creditors had acted more cooperatively, capital injection by the shareholder could have been pursued in a timely manner.
* **Increased efficiency in implementation of business restructuring related steps**: According to the facts provided in the case study, in 2014 the CRO announced that a € 27.5 million loss was expected for 2014 and a liquidity shortage was looming. The reasons given were the delay in carrying out price increases and cost reduction. Efficient implementation of business restructuring related steps aimed at improving cash flows would have been beneficial to Flow Management’s restructuring.
* **Potential exploration of recovery related or strategic restructuring steps**: Flow Management’s recovery process appeared to be focused on retrenchment related steps (such as cost reductions). It is unclear whether Flow Management actively explored recovery related steps or strategic restructuring such as exploration of new markets or products. Depending on the external environment and demand, these steps could have benefited its restructuring.

1. **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?**

The potential reasons for Banks C and D to frustrate the process at a certain stage could be:

* **Lack of confidence in the debtor**: Throughout Flow Management’s restructuring process and till the ultimate signing of the standstill agreement, it repeatedly provided projections for losses/profits which turned out to be highly inaccurate. It is likely that the constantly inaccurate and unreliable information being provided affected Bank C and D’s confidence in the debtor and led them to not cooperate at a certain stage.
* **Exerting pressure on the debtor**:Banks C and D also appear to have provided additional working capital to the debtor (in addition to the original working capital provided by the consortium of Bank A, B, C and D). Moreover, the contracts for the securities backing the debtor’s loans were not fool proof. Therefore, proceeds in liquidation would be much lower. It is possible that the goal of Banks C & D in not cooperating on a standstill agreement at a certain point was driven by the desire to threaten/exert pressure on the debtor to quickly implement steps towards restructuring its operations, especially injection of capital. While this may actually be counter-productive in certain cases (as it adds to delays), given that Banks C and D seem to have an additional exposure in the form of the additional working capital as well as the issues with the security for the original working capital may have led them to take desperate measures to exert pressure on the debtor. They could have potentially adapted a non-cooperating stance for an opportunistic reason, as a way to also put pressure on other creditors to buy them out.

As an advisor to the other two banks, the advice to them would be to take the following steps:

* Have discussions with Banks C and D on how a coordinated out-of-court workout would be preferable to a liquidation outcome in Flow Management’s case. This is especially given the fact that the contracts for their security were not fool proof and the recoveries in liquidation would be much poorer.
* Discuss the various other benefits of a coordinated approach with Bank C and D (cheaper process, quicker process, ability to pressure the shareholder into injecting risk bearing capital into the company, among others).
* Assure Banks C and D that their relative positions would be maintained under any restructuring agreement that is agreed to by the remaining creditors.
* In case discussions with Banks C and D do not lead to a favourable outcome, then consider buying their exposure at a discount to ensure that a unified and coordinated approach can be followed going forward. This was considered by Banks A and B according to the facts of the case.

1. **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)?**

The following principle of the ‘Statement of Principles for a Global Approach to Multi-Creditor Workouts II’ can be seen in the workout process of Flow Management:

* **FIRST PRINCIPLE:** *“Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate 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.*”

**Application in the Flow Management case**: Several elements of the first principle can be found in Flow Management’s case. For example, when the financial distress of the Flow Management group is revealed to its four banks – Banks A, B, C and D (the ‘relevant creditors’ for its workout) decided to act in a joint and controlled manner. They also decided to not take any legal action till the final report on the company is received from an independent turnaround consultancy agency. All relevant creditors (Banks A, B, C and D) also eventually sign a standstill agreement in August 2014, while relevant information and proposals for resolving the financial difficulties of Flow Management were being formulated and assessed (i.e., going concern sale, selling the company if it is shown to be unviable, debt-to-equity conversions, or a moratorium).

Arguably, however, while the banks were in discussions with the debtor since December 2013, and relevant information was being gathered while resolution strategies and options were being formulated (i.e., appointment of an external accounting firm, appointment of chief restructuring officer, plans of capital injection by shareholders, replacement of CEO, price increases, cutbacks), the standstill was only signed almost a year later in August 2014. One of the reasons for the delay in signing the standstill was non-cooperation from Banks C & D at one stage. Therefore, while the first principle can be seen in Flow Management’s case, the delayed timelines and lack of cooperation at one stage also show some deviation from the principle.

* **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.*

**Application in the Flow Management case**: In the Flow Management case, the principle of ensuring that relative positions of all creditors was maintained and not prejudiced was implicitly followed post signing of the standstill agreement in August 2014. Even the final restructuring agreement that was finally signed in July 2015, maintained and reflected the relative position of the creditors. For example, the consortium of banks who provided the original working capital backed by pledges on assets were to receive a part of their claim on liquidation. On the other hand, the two banks who also provided the additional working capital and the shareholders had either no or subordinated security and were to make no recovery in liquidation.

* **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.*

**Application in the Flow Management case**: This principle was implicitly followed in the Flow Management workout process. From the information available, the debtor does not seem to have undertaken any action during the four-month standstill period (between August 2014 and December 2014) which would adversely affect the returns to the relevant creditors. Notably, there was a repayment of €25 million to the providers of the additional working capital in January 2015. However, this repayment appears to have been in line with the discussion with its creditors.

* **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.*

**Application in the Flow Management case**: No co-ordination committee was formed in Flow Management’s case and given the few numbers of creditors involved, the relevant creditors ended up 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.*

**Application in the Flow Management case**: During the standstill period, and from the very beginning of discussions between Flow Management and its creditors, it provided access to information relating to its assets, liabilities, business and prospects to facilitate a proper evaluation of its financial position. It had to report actual costs and turnover each month. An independent accounting firm and an independent turnaround consultancy agency were also appointed to investigate the company affairs. However, it is also important to note that the projections of expected losses and profits during the restructuring negotiations were highly inaccurate. Therefore, while the debtor appears to have provided access to information relating to its assets etc., some of the information being provided was unreliable and inaccurate.

* **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*

**Application in the Flow Management case**: The restructuring agreement reflected the relative positions of the relevant creditors. Moreover, it is also implicit in Flow Management’s workout that the information provided, and evaluation processes conducted by creditors during the workout process enabled the creditors to assess whether they were receiving equitable treatment and also compare the outcome to recoveries that could be made in a formal insolvency or liquidation scenario.

* **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.*

**Application in the Flow Management case**: The given facts do not indicate that that any of the information provided during the workout process was not treated as confidential by the relevant creditors. Therefore, this principle appears to have been implicitly followed in Flow Management’s case.

No additional funding was provided by the creditors during the workout process. Therefore, the eight principle was not relevant or applied in Flow Management’s case.

1. **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?**

**‘Soft law’ options**

Several jurisdictions provide “soft law” options to facilitate out-of-court workouts. These are commonly in the form of guidelines or regulations issued by banking regulators or the central bank authorities which are aimed at enabling efficient out-of-court workouts.

**Example of ‘soft law’ options**

For example, Bank of Thailand, Thailand’s central bank has issued ‘*The Bank of Thailand Policy on Out-of-Court Workouts’* which contains recommendations and guidelines for out-of-court workouts by financial institutions. This policy encourages out-of-court works outs which are beneficial to both the creditors and the debtor and encourages creditors to have clear policies for workouts.

Another example of “soft law” which facilitates out-of-court workouts is the ‘Turnaround ADR’ or ‘Jigyo Saisei ADR’ regime under Japan’s Act on Strengthening Industrial Competitiveness. The Turnaround ADR regime provides an option to creditors to opt for a settlement amongst financial creditors with the debtor remaining in control of the firm during the process. A mediator is appointed to facilitate the discussions with the creditors. It is a consensual process and requires unanimous consent from all participating creditors.

**‘Soft law’ option in India – RBI’s 7 June 2019 circular**

In India too, the Reserve Bank of India (India’s central bank) issued a circular dated 7 June 2019 providing a ‘*Prudential Framework for Resolution of Stressed Assets*’. This circular lays down the process for early identification and resolution of stressed assets. It applies to entities regulated by the RBI, such as scheduled commercial banks, financial institutions, and certain non-banking finance companies and provides a framework for resolution of distressed entities outside of formal insolvency.

As per the circular, when a financially stressed borrower is identified, its creditors need to formulate a “resolution strategy” within 30 days from the date that the borrower defaults. A “resolution strategy” may include change in ownership, sale processes, formulating restructuring proposals, initiating recovery proceedings against the borrower or even taking the formal insolvency route. If the consortium of lenders chooses the out-court resolution route, then the creditors are required to enter into an inter-creditor agreement (ICA) laying down the ground rules for finalizing and implementing a resolution plan for the borrower. Decisions taken by lenders representing 75% of the total outstanding credit facility by value and 60% by number are binding on all signatories to the ICA under the circular.

**Other possibilities**: **contractual agreements between the creditor and debtor**

Another informal possibility that is always an option and is often seen in practice is creditors entering into contractual agreements with the distressed borrower to undertake out-of-court workouts. These settlement agreements often employ several strategies mentioned in the Statement of Principles, such as a standstill period, coordinated approach amongst creditors, remission or delay in repayment schedules among others.

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

The essence and result of the restructuring agreement can be described as follows:

* **Transferring the assets out of the Flow Management Holding BV into a new shell subsidiary called Flow Management II BV**: By transferring the operating subsidiaries from Flow Management Holding to a shell subsidiary, the opcos and money generating assets were transferred out of the company. This would eventually facilitate the liquidation of Flow Management Holding (along with its liabilities) and separate and transfer its assets into a different entity.
* **Liquidation of Flow Management Holding BV**: Once its key assets (i.e., the operating subsidiaries under it) have been transferred to a separate entity (i.e., Flow Management II BV), the erstwhile holding company would be liquidated. Its liabilities (i.e., claims by its creditors and shareholders) would then be cancelled.
* **Shares of the new Flow Management II BV would be issued to the groups’ creditors and board members**: The consortium of banks A, B, C and D who financed the working capital of the main operating subsidiary – Flow Management Work BV as well as board members (including the chief restructuring officer that was appointed to the board of Flow Management Holding during the workout process) were issued shares in the Flow Management II BV. This indicates that the banks were offered equity in the new shell subsidiary in exchange for waiver of certain debt under their working capital and additional working capital loans. Banks can benefit and receive value for these shares when Flow Management II BV is sold as a going concern at a later stage.
* **Flow Management Holding BV and its shareholder cancelled their claims against Flow Management II BV and its subsidiaries**: By cancellation of any remaining or prior claims from Flow Management Holding and its shareholders, the arrangement protects Flow Management II BV and its subsidiaries from any future claims from them.
* **Waiver of certain portions of debt**: Banks C and D waived an amount of €32.5 million from the additional working capital loan provided to Flow Management BV. Moreover, the consortium of banks (A, B, C and D) which provided Flow Management BV with original working capital waived an amount of €97.5 million. The waiver of debt helped in restoring the solvency ratio of the group.
* **Effectively retained the relative positions of the creditors**: The restructuring agreement retained the relative position of the creditors. For example, the consortium of banks (A.B.C and D) who provided the original working capital backed by pledges on assets were to receive a part of their claim on liquidation. On the other hand, the two banks (C and D) who also provided the additional working capital and the shareholders had either no or subordinated security and were to make no recovery in liquidation.

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

The potential cross-border issues in Flow Management’s restructuring process are:

* **Potential issues with recognition of the restructuring agreement in the jurisdictions of the other operating subsidiaries**: In addition to Flow Management Work BV, which is incorporated in the Netherlands, the five other operating subsidiaries of Flow Management are incorporated in different jurisdictions - Spain, France, Australia, South Africa, USA. In case a creditor of any of these operating subsidiaries objects to the arrangement under the restructuring agreement, then recognition of the informal workout and restructuring agreement in these jurisdictions may be a challenge. While several jurisdictions have adopted the UNCITRAL Model Law on Cross-Border Insolvency for recognition of foreign insolvency proceedings, similar provisions are not usually available for recognition of informal workouts. Therefore, in case a creditor in any of these offshore jurisdictions objects to the restructuring agreement, then seeking recognition and binding such objecting creditors may lead to challenges.

* **Potential labour law related issues**: The given facts state that 130 staff members which included employees and independent contractors were laid off in Flow Management’s restructuring. Flow Management has international operations and it is unclear which jurisdiction these staff members were employed in. Flow Management would need to comply with the necessary labour law of the relevant jurisdiction (e.g., requirements in relation to severance related payments etc.) in connection with these layoffs.

1. **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 fourth scenario of calling a moratorium under India’s Insolvency and Bankruptcy Code (IBC) may not have been a good option at that time because:

* **Public nature of formal insolvency proceedings**: In order to call a moratorium in India, the debtor would need to be admitted into formal insolvency. The moratorium provided under section 14 of the IBC comes into effect from the date on which the insolvency application against the debtor is admitted by its insolvency tribunal (the National Company Law Tribunal). Initiation of formal insolvency or corporate insolvency resolution process is a public process. Therefore, Flow Management would lose the benefits of having a private restructuring process. Moreover, the restructuring process would need to abide by the cumbersome procedure set out under the IBC and lose the flexibility offered by an informal workout.
* **Potential issues with verifying creditors’ claims and their security**: According to the given facts, the contracts for the security offered to the consortium of banks was not fool proof. In a corporate insolvency resolution process (CIRP) under the IBC, all creditors are required to submit their claims along with the relevant documentation evidencing their claims to the resolution professional (RP) who verifies these claims[[19]](#footnote-19). Given the issues with the security documents, the banks would potentially risk the RP rejecting their claim as a secured debt or undermine their security depending on the severity of the issues with the documentation. Therefore, initiating a moratorium and a formal insolvency process may not necessarily be in the creditors best interest.
* **Long process**: The average time taken for conclusion of a CIRP is 536 days (as on March 2022).[[20]](#footnote-20) Therefore, initiating a formal moratorium which would consequently initiate a CIRP is likely to be long drawn which can often result in further value erosion.
* **Existing management may lose control of the debtor**: The IBC places eligibility restrictions on bidders who can bid for the insolvent debtor. As discussed above, section 29A of the IBC (which lays down the eligibility requirements for who can submit a bid for debtors in CIRP) bars entities holding accounts classified as non-performing assets for a period of one year from participating in the IBC process. This means that that the existing promoters are often barred from bidding for their company during CIRP. Therefore, calling a moratorium and initiating a formal insolvency procedure may result in the existing management getting kicked out. This is not always a negative outcome, especially in cases where the existing management has acted in fraudulently. However, it may sometimes not be the best result especially if the existing management has started acting efficiently and has close relationships with the debtor’s suppliers and stakeholders making the operation of the company difficult in their absence.

Some of the reasons why calling a moratorium may have been a good option at that time are:

* **Benefits of provisions related to avoidance actions**: According to the given facts, some of the losses at Flow Management were a result of wrongful issuance of bonuses and gross errors in the cost-price formula. By initiating a moratorium and consequent formal insolvency proceedings, the creditors could benefit from investigating these transactions and reversing them or holding the officers-in-charge accountable under avoidance provisions under the IBC (sections 43-52 and 66 of the IBC). Reversal of these transactions would increase the value available for distribution amongst the creditors.
* **Potential risk of Banks C and D acting unilaterally at that stage (before signing the restructuring agreement)**:At one point, banks C and D had stopped cooperating with the other creditors and debtor. Therefore, there was a potential risk that they would take unilateral action (be it initiating recovery procedures or enforcement of security)against the debtor. By calling for a moratorium, this risk could have been avoided at that stage and collective and coordinated action by the creditors can be ensured.
* **Ability to cram-down claims**: As mentioned above, calling a moratorium would require the debtor to be admitted into formal insolvency or the corporate insolvency resolution process. In the formal insolvency process, there is an ability to cram-down creditors (be it trade creditors or financial creditors) and wipe-out claims (so long as liquidation value or value that would be realised by the claimant upon liquidation is paid). For example, claims resulting from damages payable (as on the insolvency commencement date) for termination of redundant supplier contracts can be crammed down under the restructuring plan under the IBC. Therefore, by initiating the formal process, Flow Management would benefit from cramming down certain creditor claims, among others.

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2. *Ibid.* [↑](#footnote-ref-2)
3. Adriaanse, J.A.A. 2005, *Restructuring in the Shadow of Law Informal Reorganisation in the Netherlands* Kluwer Law International, p 14. [↑](#footnote-ref-3)
4. Adriaanse, J.A.A. & Kuijl, J.G. 2006, ‘Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?’, *Review of Central and East European Law*, vol. 31, no.2, pp 135-154 at 146. [↑](#footnote-ref-4)
5. Tan, Meiyen, ‘*Changing the Asian cultural mindset about corporate debt restructuring and turnarounds*’, at <<<https://www.lexology.com/library/detail.aspx?g=98b8389c-7cd2-4cde-a01f-f27fe5ccc30a>>>, accessed on 10 April 2023. [↑](#footnote-ref-5)
6. *supra* note 4, pp 146-147. [↑](#footnote-ref-6)
7. s. 17, Insolvency and Bankruptcy Code 2016. [↑](#footnote-ref-7)
8. Insolvency and Bankruptcy Board of India, Quarterly Newsletter – Insolvency and Bankruptcy News, October – December 2022, vol. 25 at p 20. [↑](#footnote-ref-8)
9. *supra* note 4, p 145. [↑](#footnote-ref-9)
10. *supra* note 8, p 19. [↑](#footnote-ref-10)
11. International Insolvency Institute & the Asian Business Law Institute, ‘*Asian Principles of Business Restructuring - Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia’*, p11. [↑](#footnote-ref-11)
12. *supra* note 11, p 21. [↑](#footnote-ref-12)
13. s. 43-52,66, Insolvency and Bankruptcy Code 2016. [↑](#footnote-ref-13)
14. s. 31, Insolvency and Bankruptcy Code 2016. [↑](#footnote-ref-14)
15. *supra* note 4. [↑](#footnote-ref-15)
16. Pajunen, K. 2006, ‘Stakeholder Influences in Organizational Survival’, *Journal of Management Studies*, vol. 43, no. 6, pp 1261-1288. [↑](#footnote-ref-16)
17. Schmitt, A. & Raisch, S. 2013, ‘Corporate Turnarounds: The Duality of Retrenchment and Recovery’, *Journal of Management Studies*, vol. 50, no. 7, pp 216-1244. [↑](#footnote-ref-17)
18. Sudarsanam, S & Lai, J. 2001, ‘Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis’, *British Journal of Management*, vol. 12, pp 183-199. [↑](#footnote-ref-18)
19. Regulation 13, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016. [↑](#footnote-ref-19)
20. *supra* note 8, p 19. [↑](#footnote-ref-20)