ASSIGNMENT QUESTIONS – CASE STUDY 1

Answer the following questions in detail. Use as much reference material as possible (e.g. the reading material provided by INSOL and/or your own library) to explain and enrich your answers.

1. WHAT WERE IN YOUR OPINION THE CAUSES OF FINANCIAL DISTRESS AT FLOW MANAGEMENT (SEE E.G. MELLAHI & WILKINSON, 2004)?

In Mellani & Wilkinson, Organizational failure: a critique of recent research and a proposed integrative framework, the authors examine the causes of organizational failure previously defined by the "classic" approach as either as a result of a deterministic or a voluntaristic view. The former emphasises the role of the environment in which the business operate the latter theory promotes the primacy of internal management such that any failure is essentially self-induced. Mellani & Wilkinson argues that such a stark line of demarcation between the two theories is not reflected in practice and that often financial distress can be cause by both internal and external factors together or separately. In my view this perspective is a less intellectually lazy analysis of the causes of organizational failure, it is also more realistic. Here, there is not much data on the environment in which Flow operated save to suggest that the market was somewhat buoyant. We also do we know the age of the business or the population in which it operated. Although a number of factors appeared to have contributed to the clear financial challenges at Flow the significant ones appeared to be

(i) large management bonuses to top management (although described as "wrongfully issued" it is unclear what precisely is meant by that, but for the purpose of this exercise I have assume that this is financial imprudence as opposed to impropriety i.e., fraudulent or dishonest conduct).
(ii) bad management, demonstrated by for example management's failure to check real costs against the result of the "costs price calculation" (as defined) with the consequence that the prices were too low; and
(iii) inaccurate/faulty financial reporting (the accounts suffered from serious deficiencies) which gave rise to unreliable figures which in turn led management to make decisions on spending and revenue generation which did not reflect the genuine financial state of affairs of the company.

(a) Could the financial distress have been prevented? If yes, explain how. If no, why not?

Yes. It seems to me that until 2011 Flow was a profit generating business. There is no suggestion that the accounts for that year was unreliable. The following year saw a sharp downturn that continued to decline for subsequent years to 2015.

What is also relevant is that there is no suggestion that this dramatic deterioration was as a result of changes in the business environment which would have necessitated an innovative response from management, indeed it appears to be uncontroversial that at all relevant times there was a market demand for "hiring and leasing days". That said, it ought to be said that there is no reason why there should not have been an effort to continue to improve profits by further taking advantage of the market rather than issuing large bonuses.

But, if the external environment can therefore be disregarded as having contributed to the financial decline of Flow then it seems to me that the internal machinations of Flow and in particular its management is to blame.

Based on the company's own report it appears that the accounts were unreliable and large bonuses were paid. If the accounts were accurate then no doubt the bonuses would not have been paid and a more conservative approach to spending adopted. Management would have also priced the services offered at a realistic market rate thus generating more revenue. In remedying the cash flow problems the company was able to make significant spending cuts particularly in the area of labour costs which in my view suggests that the labour costs may have been too high to begin with. That may have partly been because of the optimism of the inaccurate accounting but perhaps also an expansion strategy that was simply too ambitious i.e. growing too fast too quickly. While inertia clearly does not encourage corporate success a balance ought to be struck. The lack of proper oversight of the inaccuracy in the accounts for years is unexplained and needs to be. There also appeared to be tremendous reliance on loan financing working capital, in circumstances where there were assets that could have been sold. That said, and without being too harsh, it would seem to me that pivotal to Flow's failure was incompetent management.

2. WHAT ARE IN GENERAL ADVANTAGES AND DISADVANTAGES OF AN OUT-OF-COURT RESTRUCTURING (WORKOUT) AS COMPARED TO A FORMAL BANKRUPTCY PROCEDURE?

Adriaanse & Kuijl in their article, Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions, demonstrates a clear bias in favour of informal restructuring as against the more rigid and draconian consequences of a court led insolvency process. This appears to be in large part as a result of the unstated public policy that business that fail are to be rescued and/or given time to recover because of the real economic impact (e.g. loss of jobs) of corporate failure. In my view this may be a somewhat myopic view of corporate failure. It may be said that an evolutionary perspective is equally arguable. Badly managed business ought to fail to make room for more innovative and evolved management strategies and to encourage competition and recovery and rescues of companies operating sub-optimally only ought to be deployed and encouraged in the most desperate of social circumstances. It is my view that there ought to be a more organic view of corporate failure and if there is to be social intervention the legislative pre-emption that ought to be contemplated are solutions that ensure that where those businesses fail there is adequate safeguards for former employees while they wait to be re-hired by better performing companies. This approach will eliminate incompetent management but more importantly encourage new ways to manage. That said, the authors do identify clear advantages which I adopt as sensible. The disadvantages stated below are my own and no doubt reflect my own bias as a litigator.

Advantages when compared to a formal bankruptcy procedure:

(i) Flexibility in both strategy and decision making but also the timing of same.

(ii) Privacy, generally secured by confidentiality agreements.

(iii) Control of the restructuring methods and persons spearheading those measures.

Disadvantages when compared to a formal bankruptcy procedure:

(i) Under a court supervised insolvency the court because it has *in personam* jurisdiction over the BVI company has certain statutory powers and coercive control vis-à-vis the company, its creditors and other interested parties. A creditor appointed administrator appointed under an out of court restructuring do not have those powers or coercive control over the company it is asked to run.

(ii) Only certain persons can be appointed as liquidators. Those persons are required to have the requisite skill and expertise but will also need to be resident in the BVI.

(iii) In some out-of-court restructuring strategies the same management who gave rise to the company's demise are being tasked with its recovery. Even where there is a third party appointed by the creditors, that third-party's fidelity will likely be with the person appointing and compensating them, this leads to the inevitable conclusion that they may not be neutral in their approach to their appointment. In the BVI a court appointed insolvency practitioner is a court officer and by virtue of their appointment is entitled to look to the assets of the company for their remuneration and can do so in priority to all others.

(iv) In an informal restructuring there is no real ability to act secretly if the need to restructure the business was caused by bad actors or rogue directors.

(v) There are clear rules for *pari passu* distribution which is in my view is inherently fair.

(vi) There is a mandatory moratorium on legal action not requiring the agreement of a creditor or other third party.

(vii) Although the pace of a liquidation is determined by the liquidator, the Court may require that certain next steps be done within a defined timeframe. Moreover, under the rules in the BVI a petition to appoint liquidators over a BVI company must be determined within 6 months. The mischief of this rule is not only expedition but more importantly to prevent the protracted threat of liquidation of a BVI company which can have serious reputational consequences for the company in question.

(a) More specific, what are the advantages versus disadvantages *in your country*?

In summary, in the BVI there are a number of advantages to a formal bankruptcy procedure they include the following

(i) The ability to appoint a provisional liquidator in secret. This power allows the court to appoint a liquidator before a petition to appoint a liquidator has been filed where there is a need to act quickly and in secret for example if there is a risk of dissipation of assets, or if the company is in a financially precarious position as a result of certain bad actors with the ability to control decisions by the company.
(ii) A statutory moratorium which prevents that bringing proceedings against the company or in relation to its assets or "to exercise or enforce or continue to exercise and enforce any right or remedy over or against assets of the company" (see section 175 (1) of the BVI Insolvency Act 2003 (the Act)).
(iii) Court supervision
(iv) A court appointed liquidator is required to have the requisite skills and expertise be resident in the BVI and is considered a court officer.
(v) There is a restriction on execution or attachment while a BVI company is in liquidation.
(vi) The Act also mandates the calling of a creditors meeting within 21 days of the liquidators appointment.
(vii) The liquidator's ability to bring claims within the Act against certain persons and to disavow certain transactions for example if they amount to an unfair preference given

to a creditor, if the transaction is at an undervalue or is an extortionate credit transaction.

(viii) The requirement for a *pari passu* distribution which in my view is inherently fair.

(ix) The ability to compel the delivery of assets, examination of directors, require the disclosure of documents.

(x) The ability to supervise the remuneration received by the liquidator.

That said, because in the BVI and many offshore countries corporate entities act as holding companies or joint venture partners in a business incorporated elsewhere there has not been much study or analysis on the utility of encouraging out-of-court restructuring that is certainly worth exploring. Moreover, major financial institutions rarely provide loan financing to BVI companies absent a guarantor located in an onshore jurisdiction or without sufficient and properly negotiated security agreements. Those financial institutions often take their chances with the guarantor who is likely to have assets against which they could more readily enforce against. What this means in practice and in this somewhat nuanced context is that strategically creditors of a BVI company may well see insolvency or the threat of insolvency as the best bargaining tool where a business involving a BVI company fails. Further, in the broader cross-border scheme of things a BVI company is also frequently the subject of a scheme of arrangement or other restructuring, which while less contentious than a full blown insolvency does require court approval.

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.

Yes and no.

There was a clear effort to avoid a formal insolvency process and adopt an informal reorganization as advocated for by the authors of Adriaanse & Kuijl. For example, there was an attempt to restructure business operations, they sought to increase cash flow (selling assets, requiring monthly reporting, deferring payments of debts) and there was a dismissal excessive personnel. This yielded a short term saving of €15 million. The company also attempted financial restructuring by deferring payment of the €35 million additional working capital, refinancing the €360 million working capital, waiving default interest and obtaining short term additional funding by the shareholder.

In the 2006 article by Pajunen, Stakeholder Influences in Organizational Survival, his overarching theory is that there is a variation of stakeholder influences which affects managerial performance and organizational survival. Here, the key stakeholders namely the banks supported an informal restructuring and wanted to avoid a court led insolvency process. The main creditor's intervention took place at the outset no doubt because the management of Flow gave an update in November 2013 regarding the precarious financial position it was in. The banks' commitment to an informal restructuring process seems to be driven by both the uncertain legal position of their security and the reassurance that there was a market for leasing and hire services. While there were varying degrees of influence by the banks they did not diverge much from their joint approach in

December 2014. The shareholder's influence remained static, there was some sense that this was a resourced based influence and not network position based influence. The CEO and CFO were changed but there is no real sense that prior to that occurring that the previous managers had a degree of power which made the change difficult.

The Schmitt, A and Raisch, S Corporate Turnarounds: The Duality of Retrenchment and Recovery retrenchment vs recovery while a remarkably intelligent examination of the interplay of both theories, did not appear to arise in any significant measure in this case study. It did not appear that Flow was in the position it was in as a result of its inability to adapt to the changing environment such that recovery was an obvious solution. Moreover, the attempt by the then management of Flow to increase cash flow, refinance existing debts, and the change of management by the shareholder is a good demonstration of retrenchment in action albeit with clear missed opportunities. The managers and creditors main strategy for corporate turn-around was to increase efficiency through costs and asset reductions as oppose to seeking to improve the company's market position though strategic change. That may well be stage 2 of the restricting process since the "recovery" remains tenuous at best and there is obviously a need to maximise revenue.

Finally, at all material times it appears that Flow did employ operational, assets, managerial and financial restructuring strategies mentioned in Sudarsanam, S, Lai, J., 2001 article Corporate Financial Distress and Turnaround Strategies: An, Empirical Analysis although it is not clear to me whether the old management was effective in the strategy implementation since the loss soared year after year or whether the strategy was simply a bad one at the outset.

With hindsight, in my view the banks ought to have employed a new CEO and specialist CFO, and acted to implement the July 2015 restructuring agreement much sooner.

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?

There was clearly a lack of meaningful progress and thus possibly why C and D reacted the way they did. In my view the reaction was both opportunistic and rational but the key point is that they "seemed" to frustrate the process but did not actually do so. C and D were either attempting to strong-arm the other banks to inspire more tangible solutions or get a better deal for themselves, which that approach appears to be inconsistent with the spirit of cooperation which INSOL International Statement of Principles advocates it certainly is not surprising.

What would you have done in that situation in your role as advisor of the other two banks?

Precisely the above, there seemed to be a lack of urgency and a somewhat misplaced conciliatory approach to the management of Flow. There was also a naïve assumption that the management and creditors would cooperate and solve the clearly dire financial circumstances which the management found themselves in notwithstanding information that matters were not improving. I would have also advised C and D to take the deal to be bought out which was offered in April 2015 and then seek to negotiated a lower discount of approximately 10-15%.

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)?

(i) First Principle – the banks agreed to discuss the company's financial state of affairs and called in an accounting firm (not being the company's auditor) to investigate the procedures within the company. Although there was no written standstill agreement at the outset (i.e. from December 2013 to August 2014), there was a standstill in practice and the "each creditor for itself" problem did not seem to arise.

(ii) Second Principle - none of the four banks sought to enforce their security or the settlement of their debt in preference to or to the detriment of the others.

(iii) Third Principle – nothing was done during the *de jure* standstill period to adversely affect the "prospective return to the relevant creditors" when compared with their position in November 2013.

(iv) Fourth Principle – does not seem to arise

(v) Fifth – unclear if this does arise

(vi) Sixth Principle – unclear if this does arise

(vii) Seventh Principle – unclear. While it was stated that the management information systems would be improved so that the figures would be more reliable, there is some suggestion that the "information" (presumably to include the accounts and any other information being provided by the company) being provided by the company was inaccurate and certainly left much to be desired but there is no express complaint about a lack of disclosure (see reference to "changing information").

    There was an attempt by banks A and B to purchase the debt of banks C and D at a 15-20% discount but this does not appear to offend the mischief of this principle.

(viii) Eight Principle –a total of €25 million was paid back to the providers of additional working capital i.e. the shareholder in priority to other the banks and other creditors.

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 "soft law" is meant to describe guidelines that do not attract the full weight of the law then I'm afraid those do not exist in the BVI. That said, there is a commercial incentive to cooperate because of the finality of the insolvency procedure and the lack of suitable compromise solutions in our existing Act.

If yes, explain in what way. If not, do you see any alternative (informal) possibilities?

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

In summary, the assets of Flow Management Holdings BV ("Old Co"), namely its 100% shareholding in each of the operating subsidiaries were transferred to a newly form company ("New Co"). The debts and obligations of Old Co vis-à-vis the banks and the shareholder were forgiven possibly to constitute proper consideration for their shares in New Co but possibly also to enable Old Co to be liquidated on a solvency basis. As a result of the restructuring the banks now became shareholders in New Co. This outcome operated like a debt for equity swap but the equity is in New Co. By doing it in this way the banks would be able to take shares in a "clean" company but more importantly are able to side step the legal issues with their security. Since there is no insolvency Flow is able to continue as a going concern albeit under a different name and there is at the very least the potential for Flow to trade out of its financial difficulties and for

the banks to recover some monies on their previous loans in the form of an equity investment which if the company is successful will cause dividend payments to be made.

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

It is not stated where Flow Management II BV is incorporated but I see the following arising cross-border issues arising.

- (i) The recognition of the transfer to the shares in Old Co to New Co
- (ii) The transfer may be seen as asset stripping in the context of a possible insolvency of Lease Group Holdings or indeed the other ubos of LGH.
- (iii) The rights of other creditors located elsewhere
- (iv) Effect of the change of ownership of the subs in their jurisdiction of incorporation.

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

In the BVI there is a statutory moratorium which is triggered once a liquidator is appointed over the affairs of a BVI company. As stated above, that moratorium prevents the bringing of proceedings against the company or in relation to its assets or "to exercise or enforce or continue to exercise and enforce any right or remedy over or against assets of the company" and that will apply wherever located. However, there is no common law moratorium which operates outside the statutory framework and while the courts do recognise an agreement not to commence legal proceedings that agreement will only bind the parties to it and not the world at large. Said differently a moratorium against the world at large is only possible if an application to appoint liquidators over a BVI company has been filed. Here, an agreed moratorium would have obviously been useful but I am not sure it would have been necessary. As at that stage, the banks had agreed a standstill agreement which expired in December 2014 and was further extended to June 2015. There appears to be no major creditor threatening to seek to recover their debt by way of an action or an application to appoint liquidators over the affairs of Flow. In any event, that moratorium proposal in October 2014 was not without its conditions. It was tied to the banks provide a further bridging loan which may not have been sensible in light of the precarious state of Flow's finances and the somewhat gloomy predictions for the future profitability of Flow.

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