**GLOBAL INSOLVENCY PRACTICE COURSE 2022 / 2023**

 **Case Study I**

**Queries and Response:**

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?***
	1. The organizational failure and financial distress of Flow Management Holding BV (**FMHB**) can be viewed more from a *voluntaristic perspective*[[1]](#footnote-1) that caused gradual deterioration in the financial health of FMHB, as detailed below:
2. One of the primary causes of the financial distress was oversight and inaction by the management of FMHB. For instance: (a) it was only in November 2013, that the errors in the Annual Accounts of 2012 were unearthed (which amongst others included huge management bonuses). It appears that there was inadequate management information system in the organization, owing to which early warning signals of imminent decline were not detected or missed; (b) although repeated assurances were provided by FMHB and Lease Group Holding United Kingdom Ltd. (**Shareholder Company**) to banks A, B, C and D (**Specified Banks**), additional irregularities were unearthed from time to time. Further, there was significant variance in the estimates and the actual performance indicators, which raises serious concerns in respect of the decision-making and potential concealment of true and correct facts;
3. The Specified Banks had repeatedly requested the Shareholder Company to infuse the equity capital so that the solvency rate is improved, however the necessary steps were delayed by or were undertaken on a piecemeal basis, which ultimately resulted in loss of trust by the Bank C and D and caused consequential delays in relation to the reorganisation plan. Prompt corrective action at an early stage could have avoided any deterioration and consequential organisational failure. The approach of the Shareholder Company was callous and was not coordinated with the overall interest of the organisation, i.e., to ensure expeditious resolution;
4. While in most of the cases, it is arguable that the organizational failure is a combination of internal and external factors, in the present instance, the external market factors have been mostly favorable. For instance, most of the clients agreed to co-operate to price increase, market demand for the services was present, Specified Banks co-operated for the longest time and attempted to not initiate legal proceedings. However, it was conduct of the management (be it their lack of decision making, lack of supervision or providing inaccurate information to the creditors) that seems to have caused the decline. It was only after the appointment of the Chief Restructuring Officer that there was some transparency in the operations, which did aid to the growth in the long run;
5. During the entire process, the focus of key stakeholders (i.e., the Shareholder Company and the Specified Banks) was towards retrenchment measures (for instance layoffs, cost reduction, etc.) instead of recovery measures. Given that market conditions were favorable, exploring recovery measures as well (for instance, adopting new marketing strategies, tapping new markets, etc.) would have helped achieve efficiency turnaround and growth of FMHB;
6. reference may also be drawn to the *threat rigidity effect theory*[[2]](#footnote-2) in the present instance, to substantiate that the management and Shareholder Company were unwilling to acknowledge the crisis or alter the status quo for the longest time and were rather relying on false promises, which ultimately caused losses for FMHB in the long run.
	1. The financial distress could have been prevented by undertaking certain pre-emptive measure, some of which are set-out below:
7. early detection and recognition of the stress (instead of delay of more than a year) could have helped resolution of the stress in the company. At the same time, after becoming aware (in 2013), the creditors should have been more involved in the process instead of relying solely on the information provided by FMHB;
8. FMHB and the Shareholder Company should have been transparent with the Specified Banks from the inception, more so because they were willing to co-operate (such that they even avoided legal proceedings). A coordinated approach could have resolved the crisis sooner than anticipated;
9. While the professional advisors were appointed (such as the investigating agency and turnaround agency), there role in the process was very limited. The Specified Banks were relying on the information fed by the company. An enhanced role of the professional advisors with direct interactions with the Specified Banks would have helped the process;
10. infusion of growth capital by the Shareholder Company at the early stages, could have gone a long way to resolve the tussle between the Specified Banks and the Shareholder Company and FMHB, which would have in turn significantly benefitted the turnaround steps and early execution of standstill agreement;
11. At the time when the standstill agreement related discussion reached an impasse, Bank A and B had considered buy-out of exposure of Bank C and D. Subject to commercial considerations, if the proposal would have fructified, it would have expedited the process and made it more efficient;
12. During the entire process, the focus of key stakeholders (i.e., the Shareholder Company and the Specified Banks) was towards retrenchment measures (for instance layoffs, cost reduction, etc.) instead of recovery measures. Given that market conditions were favorable, exploring recovery measures as well (for instance, adopting new marketing strategies, tapping new markets, etc.) would have helped achieve efficiency turnaround and growth of FMHB.
13. ***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?***
	1. At the outset, it is relevant to note that an out-of-court restructuring / informal reorganization postulates reorganization *outside the statutory framework*[[3]](#footnote-3)*,* without intervention of courts- albeit with measures stipulated under the legal framework. In this response, I have used the terms out-of-court restructuring and informal restructuring interchangeably.
	2. Set-out below are certain advantages and disadvantages of out-of-court restructuring as compared to a formal bankruptcy:
		1. *Advantages:*
14. *Time-bound resolution*

Insofar as business and financial restructurings are concerned, time is the key to implementation to avoid deterioration in the value of the assets/organization. The legal framework governing formal bankruptcy may in certain instances delay the process whereas if the requisite stakeholders operate in coordinated manner, out-of-court restructurings can be key to resolving the stress in a time-bound manner.

In India, out-of-court restructuring by banks and non-banking finance companies is undertaken under the aegis of the Reserve Bank of India (i.e., the central bank of India) (**RBI**). The RBI has released Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 (**Stressed Asset Directions**)[[4]](#footnote-4) which primarily lays down the governing framework/principles for out-of-court restructurings in India. As per the Stressed Asset Directions, in the event of a default in an account of any lender (being the entities to whom the directions apply), all lenders are required to, within a period of 30 days of such default, undertake a *prima facie* review of the account and decide on the resolution strategy.[[5]](#footnote-5) This framework also contemplates execution of inter creditor agreements (**ICA**), setting out broad decision making contours, which will be binding on all lenders. Foreign creditors can also become a party to the ICA and participate in the resolution process.

On the other hand, the insolvency framework in India was overhauled 2016 with the introduction of the (Indian) Insolvency and Bankruptcy Code, 2016 (**Insolvency Code**) which provides for framework for resolution of a corporate entity on a going concern basis. While resolution under Insolvency Code has been a tremendous success (*such that net non-performing assets ratio for banks has dropped to a ten-year low of 1.3 per cent of total assets, paving the way for a well-capitalised banking secto*r[[6]](#footnote-6)), there is a growing inclination amongst the creditors towards informal restructuring, owing to judicial delays and backlogs.

1. *Customized resolution*

One of the key aspects of restructuring in general (be it formal or informal) is that there can be no *‘on size fits all*’ approach and the necessary steps ought to be undertaken on a case-by-case basis. An out-of-court restructuring gives adequate flexibility to the relevant stakeholders to commercially negotiate and mutually agree on a customized solution.

It may also be a plausible solution, where the legal framework provides for none or limited measures for resolution and contemplates liquidation leading to *corporate death* of the organization and piece-meal sale of the assets. For instance, in India prior to the introduction of the Insolvency Code, the legal framework only provided for winding-up and liquidation of the corporate entities under the Companies Act, 1956/2013. Liquidation in most of the cases may not be a desirable outcome when there are still chances for resolution of the underlying asset and such a scenario, informal restructuring may prove to be an important tool.

In respect of the extant case as well, the lenders in the Netherlands attempted to avoid liquidation owing to, amongst others, the fact that liquidation will yield low proceeds (a maximum of 55% of the total in outstanding debts). It was therefore a preferred route to engage in discussions for out of court restructuring instead of opting for liquidation.

1. *Debtor-in-control*

The Indian Insolvency Code is a creditor-in-control regime. Upon admission by the adjudicating authority, the powers of the board of directors are suspended and are exercised by a court-appointed insolvency professional, until the conclusion of the corporate insolvency resolution process or liquidation (as the case may be). Amongst other, the insolvency professional constitutes a committee of creditors comprising of the (unrelated) financial creditors, which is the key-decision making body. The Insolvency Code also lays down eligibility criteria for the applicants who can submit their bid for participation in resolution process to buy the corporate entity on a going concern basis. Amongst others, certain recalcitrant promoters are prohibited from submitting the bid.

In most of the cases, where the insolvency is on account on external factors (such as impact of Covid-19 pandemic), the creditors may not necessarily want to oust the management of the debtor who had taken reasonable measures and the insolvency was on account of reasons beyond control of the organization. In such a scenario, it would be more rational to let the (co-operating) management continue while various measures for resolution are implemented. Recently, in 2022, Hindustan Construction Company Limited (aggregate debt of INR 10,000 crore approximately) successfully completed restructuring under Stressed Asset Directions without any critical change in management or control.[[7]](#footnote-7)

Accordingly, in situations wherein the change in control or management is not a preferred option, restructuring would be advantageous.

1. *Limited public disclosure*

Unlike in case of formal restructuring, out-of-court restructuring is primarily between the critical stakeholders (such as the bank and financial institution) and the debtor. The same may not entail public announcements and public disclosure in relation to the process, which is not the case with the insolvency proceedings. The organization may also miss out on the opportunity cost[[8]](#footnote-8), including in relation to the market tapping, that would otherwise be beneficial for the long-term growth and prospects of the organization. Limited public knowledge in case of out of court restructuring is beneficial to that extent.

* + 1. *Disadvantages:*
1. *Lack of statutory binding effect on all stakeholders*

Under the Insolvency Code, once a resolution plan is approved by the committee of creditors (with the requisite majority of 66% of the voting share) and the adjudicating authority, it has a statutory binding effect on all stakeholders. In other words, even though the process does not contemplate participation or approval from stakeholders like operational creditors, Government and statutory authorities (unless they exceed a certain threshold), the plan will be binding on all them and all other stakeholders. However, the same is not the case in relation to the out-of-court restructuring and without taking strategic and financial measures to onboard the other key stakeholders, the likelihood of expecting cooperation from the other stakeholders, other than the lenders who execute the ICA is reduced to a large extent.

1. *Looming risk of initiation of formal bankruptcy by the relevant stakeholders*

In India under the Insolvency Code, the insolvency proceedings can be initiated by a financial creditor (such a bank or financial institution), an operational creditor (for instance, vendors) or the corporate entity itself, if the amount in default exceeds INR 1,00,00,000 (approx. € 98000). Given that the Stressed Asset Directions are only applicable to the identified set of lenders, it is likely that other creditor (such as operational creditor) may initiate insolvency proceedings against the corporate entity. If so, upon the date of admission a moratorium will be in force which will inter alia restrict enforcement of security interest, transfer of assets by the corporate debtor, etc. This will effectively stall the attempts of out-of-court restructuring. Absent co-operation from the relevant stakeholders, the risk of initiation of the corporate insolvency resolution process remains, to the disadvantage of successful out-of-court restructuring.

1. *fresh slate start*

Under the Insolvency Code, once a resolution plan is implemented, the resolution applicant (i.e., the investor) will take over the corporate debtor on *clean slate* basis.[[9]](#footnote-9) Effectively, after making the payments in accordance with the terms of the approved resolution plan, the past liabilities of the organization are whitewashed and it is given a fresh slate start. However, in the absence of the statutory intervention or binding effect of the restructuring plan, similar effect cannot be given. This can be a cause of concern for the organization dealing with huge tax liability or other statutory liability, wherein the relevant authority may not have powers to or otherwise (absent any statutory provision) be willing to waive any past liability.

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.***

While not completely, some of the turnaround/reorganization approaches presented in the reading material was applied in the extant case, as set out below:

* 1. One of crucial aspect of rescue that has been identified for rescue/reorganization is involvement of *directly affected parties* in the reorganization (Adriaanse & Kuijl (2006)).[[10]](#footnote-10) In the present instance, the Banks A, B, C and D (**Specified Banks**) were involved in the whole process. Apart from brief period of *inter se* disputes, they were patient and showed confidence in the viability of the business. The lenders also restrained themselves from initiating legal proceedings and even rescheduled (implicitly) the amounts due in December 2013.

Having said that, other important aspect in relation to *prompt action by the management* of Flow Management Holding BV (**FMHB**) and Lease Group Holding United Kingdom Ltd. (**Shareholder Company**) was lacking during the whole tenure of turnaround process. It was only after a lot of nudges by the creditors, that the management and the Shareholder Company agreed to undertake the necessary corrective actions and hold their end of the bargain (by providing much needed risk capital), which in turn did help in improving the solvency of the company. In my humble opinion, more proactive and willing role by the management in the very beginning could have helped in early revival of the company. Further, disclosure/transmission of complete and accurate information in a transparent manner by the management would have also helped in avoiding unnecessary delays caused on that account and at the same time loss of confidence by the lenders could have been minimized. In this regard, the fifth principle of Statement of Principles of INSOL International (i.e., *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*) should have been adhered to by FMHB and the Shareholder Company.

* 1. For the purpose of assessing the effectiveness of turnaround strategies, some of the scholars have placed emphasis on the *impact of timing, intensity and implementation of strategies on corporate recovery­*, while evaluating the strategies adopted by the recovery and non-recovery firms (Sudarsanam, S, Lai, J. (2001)).[[11]](#footnote-11)

In the present case, the first response of the management was to opt for operational restructuring, i.e., by way of price increase and layoffs in order to stabilize the performance and to restore the profitability. However, they did not focus on revenue generating strategies, which would have helped in the longer run in increasing the profitability. FMHB also opted for asset restructuring, i.e., divestment of subsidiaries-albeit towards the end and managerial restructuring by way of removal of CFO. In addition, financial restructuring was used as a tool for debt restructuring qua the Specified Banks which entailed issuance of equity to the said Specified Banks and waiver of the financial debt. Overall, there was a gradual departure from a non-recovery to recovery firm as in the beginning the actions were not prompt, not forward looking but more of a fire-fighting approach, less engaging and more delayed. However, after appointment of the CRO, the performance indicators changed and the emphasis shifted to prompt response and necessary actions were undertaken (including by way of execution of the restructuring agreement).

* 1. The primary turnaround methodology was inclined towards retrenchment measures (for instance layoffs, cost reduction, etc.) instead of recovery measures. Given that market conditions were favorable, adopting a *duality perspective[[12]](#footnote-12)* through recovery measures as well (for instance, adopting new marketing strategies, tapping new markets, etc.) would have helped achieve efficiency turnaround and growth of FMHB.
	2. Set out below is the assessment of the certain propositions put forward by Pajunen, K. (2006)[[13]](#footnote-13) in the facts of the case which effectively did help in the survival of the organisation in the longer run:
1. During the process the governing stakeholders (i.e., the Specified Banks) continued to provide their support (except for a brief period) in an existence-threatening crisis, which ultimately helped in the organizational survival. Having said that, I have taken into account the assumption that since the company was a going concern, the other key stakeholders (such as government and statutory authorities, vendors, etc.) were duly paid and the expenses were duly met;
2. While there was frequent communication between management and the governing stakeholders (i.e., the Specified Banks), there was lack of transparency to some extent, which to some extent prejudiced their support during the process. Similarly, the facts to some extent indicate that there was growing distrust and impact on personal relationships between the management and the Specified Banks, which to some extent was an impediment for organizational survival;
3. The case proposition shows that there was a consensus on long-term goals among Specified Banks (other than a brief period when Bank C and D were disgruntled on account of various factors), which did enhance (rather than undermine) the continuing support of those stakeholders and increased the probability of organizational survival.
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?***
	1. Basis the fact available, Bank C and D’s concerns were on account of lack of confidence in Flow Management Holding BV (**FMHB**) and Lease Group Holding United Kingdom Ltd. (**Shareholder Company**), which to my understanding was a rational decision in view of their conduct in the preceding 6 (six) months.
	2. To elaborate:
5. while Bank C and D were onboard with the proposals put forward in the beginning (i.e., until December 2013), they came across various factual inconsistencies as regards the performance of FMHB, including the accounting losses at subsidiary level and reduced solvency of 0.1% which was practically zero- even without taking into account the payments due to the financial creditors.
6. Further, while the creditors were holding on to their end of the bargain (by not initiating legal proceedings or terminating the credit arrangement), the Shareholder Company was unwilling to co-operate or put in requisite funds to improve the solvency of FMHB, which is a genuine cause of concern on the viability of the business as the cash available on December 20, 2013, was only adequate to meet obligations until April 2014.
7. amongst other measures, owing to the concerns around the management of FMHB, the Banks trusted the company to appoint a new CFO- which proposal to my understanding was based on fears that were not completely unfounded in view of the series of event which shows inadequate performance by the management and the financial performance of FMHB.

It is important to note that, once the aforesaid issues are appropriately tackled, including by way of equity capital infusion by the Shareholder Company, appointment of the CRO and channelization of true and correct information by the CRO, Bank C and D were again onboard with the turnaround process and executed the standstill agreement in August 2014. Accordingly, in my view, the conduct of Bank C and D was based on rational reasons, as elaborated above.

* 1. As an advisor to the Bank A and B, I would have recommended them to consider their proposal to buy-out the Bank C and D with a 15-20% or more discount, assuming that based on the advice from the turnaround agency the business is viable. In doing the same, the lenders would have saved 7 months of time- which was wasted because all the stakeholders were not onboard. Further, this transaction could have been used as a leverage/pre-condition for FMHB to infuse equity capital, replace the CFO and to enter into amendment to perfect the security documents simultaneously with the assignment- *presumably without any claw back risks*.

With the decision being entrusted with only one set of lenders who operates with coordinated approach, the likelihood of successfully running the turnaround process (in a time bound manner) would have significantly increased.

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)?***
	1. The following principles of Statement of Principles for a Global Approach to Multi-Creditor Workouts II (the **Principles**) can be found at play in the work out process of Flow Management Holding BV (**FMHB**):
2. The First Principle was applied mostly during the process (except for a brief period when the Bank C and D were unwilling) wherein the Bank A, B, C and D (**Specified Banks**) co-operated with each other and attempted to rescue FMHB. Even in the absence of a standstill agreement, the Specified Banks provided their implicit support and did not press for scheduled repayment of € 35 million on 31 December 2014, which was a significant aid in the rescue process. Further, taking into account the viability of the process, the Specified Banks were also actively involved in the process and evaluated the various proposal for resolving the financial difficulties.
3. The Second Principle was also applicable (although purely for commercial reasons), wherein the Specified Banks refrained from initiating enforcement or liquidation proceedings or terminating credit arrangements. This was also useful as the business was as such viable and with the favorable market conditions the prospects of FMHB improved.
4. The Fourth Principle can also be found as Specified Bank acted in a coordinated manner (except for a brief period of impasse between Bank A and B and C and D). As such the Specified Bank facilitated and participated in the whole process and considered the various proposals that were put forward by FMHB and the Shareholder Company. Having said that, the applicability of this principle would have been more effective if the professional advisory appointed (i.e., the turnaround agency and the investigating agency) had a more role to play in dealing with the Specified Banks instead of only in the beginning.
5. ***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?***

Form an Indian law perspective, there are no *soft law* principles that can be used for convincing the non-cooperating creditors. Having said that, following are the potential informal solutions that can be considered:

* 1. *Restructuring under the Stressed Asset Directions*

As mentioned in the response in 2 above, in India, out-of-court restructuring by banks and non-banking finance companies is undertaken under Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 (**Stressed Asset Directions**)[[14]](#footnote-14). As per the Stressed Asset Directions, in the event of a default in an account of any lender (being the entities to whom the directions apply), all lenders are required to, within a period of 30 days of such default (**Review Period**), undertake a *prima facie* review of the account and decide on the resolution strategy.[[15]](#footnote-15) During the Review Period while the deciding on the resolution strategy, the lenders can decide the nature of the resolution plan and the approach for implementation thereof. The lenders can also opt for initiation of legal proceedings for insolvency or recovery.

In case the lenders opt for resolution plan under the Stressed Asset Directions, the framework contemplates mandatory execution of inter creditor agreements (**ICA**), setting out broad decision making contours. Amongst others, the ICA is mandatorily required to provide that any decision undertaken by the lenders representing 75 % by value of total outstanding credit facilities and 60 % of lenders by number will be binding upon all the lenders.[[16]](#footnote-16)

As per the Stressed Asset Directions, in the event a resolution plan is not implemented within 180 days of the reference date, then the lenders are mandated to make an additional 20% provisioning and, in the event, the resolution plan is not implemented within 365 days of the reference date, then the lenders are required to provision for a additional 15%. The provisioning can only be reversed in certain circumstances. This looming provisioning threat will have an impact on the balance sheet of the lenders and in order to avoid the same, an expeditious decision of either to opt for resolution process under the Stressed Asset Directions or to initiate legal proceedings will have to be taken. If the legal proceedings are initiated then the provision can be reversed only after the court approved plan is implemented.[[17]](#footnote-17)

In view of the aforesaid framework, the lenders are prompted to take a co-ordinated approach to resolve the default accounts.

* 1. *Transfer of stressed assets*

In September 2021, the RBI revamped the regime for sale/ assignment of loans and loan participation by Indian lenders by issuance of the Master Directions-Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 (**RBI Transfer Directions**). The RBI Transfer Directions contain guidelines that are *inter alia* applicable to banks and non-banking finance companies, permitting them to transfer “stressed assets”, which are defined under the Master Direction as loan exposures that are classified as non-performing assets or as “special mention accounts”[[18]](#footnote-18). Transfer of stressed assets as part of a resolution plan (approved by lenders – 75% by value and 60% by number) under the Stressed Asset Directions, resulting in an exit of all lenders, has been permitted across class of entities, including asset reconstruction companies, a corporate entity, which is statutorily permitted to acquire stressed assets.

In the present case, since the Bank C and D were not inclined to continue, Bank A and B could have considered transfer of loan to itself or to a friendly asset reconstruction company or a corporate entity or any other identified class of entities. Consolidation of the loan account in a viable business would have benefitted the stakeholders and the informal reorganization as a whole. It would have also helped in avoiding any potential initiation of insolvency proceedings by an operational creditor.

* 1. *Special Situation Funds*

In January 2022, the capital markets regulator in India, the Securities and Exchange Board of India (**SEBI**) introduced a new sub-category of the Category I Alternative Investment Funds (**AIF**), referred to as the Special Situations Fund (**SSFs**), by way of amendment to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (**AIF Regulations**). The SSFs (subject to them meeting the minimum corpus and capital requirements) are permitted to (a) invest only in *special situations assets*; and (b) act as a resolution applicant under the Indian Insolvency Code.[[19]](#footnote-19)

The term *special situation assets* covers a wide gamut of stressed assets, i.e., (a) stressed loans available for acquisition in terms of the RBI Transfer Directions[[20]](#footnote-20), or as part of a resolution plan approved under the Insolvency Code or in terms of any other policy of the RBI or the Government of India issued in this regard (**Eligible Stressed Loans**); (b) security receipts; (c) securities of specified investee companies, subject to certain requirements; (d) any other asset as may be specified by SEBI from time to time.[[21]](#footnote-21) SSFs are able to invest up to 100% of their investable funds in a single special situations asset and may set up specific schemes targeting specific special situations asset, thereby providing much needed funding to corporate entities in distress and enable successful turnaround for the benefit of all stakeholders.

SSFs can also give a beneficial exit to the non-cooperating lenders and can thereafter effectively contribute to the successful turnaround of the organization.

* 1. *Pre-pack insolvency resolution process*

In the aftermath of the financial concerns posed by the Covid-19 pandemic, India introduced pre-packaged insolvency resolution process framework (**Pre-pack**) for micro, small and medium enterprises (**MSME**) under the (Indian) Insolvency and Bankruptcy Code, 2016 (**Insolvency Code**). This is also proposed to be extended to other larger organizations.

Pre-pack is a *debtor-in-possession* as opposed to the *creditor-in-control* model. Although the framework contemplates role of the adjudicating authorities, the role is very *limited* and is effectively towards approving the resolution plan, which will be binding on all stakeholders. Another distinguishing factor is that such plan will have to be approved by a majority of 66% voting share of the financial creditors. The pre-pack process is also a time bound process which can help avoid deterioration in the value of assets of the enterprise. The outer timeline for completion of the Pre-Pack is 120 days from the date of the admission order. However, the insolvency professional is required to submit the approved resolution plan within 90 days from the date of the admission order, failing which the process would be terminated.

The process contemplates filing of an application, post approval (with specified majority) from the shareholders and unrelated financial creditors (66%). While seeking approval from financial creditors, the MSME is required to provide such creditors with a declaration of the filing being bona fide and special resolution of the shareholders (as mentioned above) and a base resolution plan for the MSME, which confirms to certain regulatory requirements under the Insolvency Code (**Base Resolution Plan**). A Pre-pack also has moratorium protection similar to CIRP, rather more as it would be applicable from the date of filing till the conclusion of the process. Unlike normal CIRP, the role of insolvency professional is diluted (other than in exceptional circumstances), with directors running the process.

The Base Resolution Plan is evaluated by the committee of creditors, comprising unrelated financial creditors, and may be approved by or be further subjected to a Swiss challenge process. As stated above, resolution plan must be approved by a majority of 66% by voting share. Accordingly, if Bank A and B can jointly garner 66% voting share and the plan receives blessings of the court, it would bind Bank C and D as well.

1. ***Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015.***
	1. At the outset, set out below are the key commercials in relation to the restructuring agreement as signed on the July 4, 2015 (**Restructuring Agreement**):
2. all operating companies of Flow Management Holding BV (**FMHB**) (i.e., subsidiaries located in the Netherlands, Spain, France, Australia, South Africa and the United States of America) are to be accommodated in a shell subsidiary, called Flow Management II BV (**Shell Subsidiary**) [***Note****: From the facts it is not clear if the shares of operating subsidiaries are to be transferred or the assets. For the purpose of this analysis, I have assumed that the shares have been transferred.*];
3. the shares in the Shell Subsidiary are transferred to:
4. Bank A, B, C and D (**Specified Banks**) which has financed the original working capital of FMW; and
5. number of board members (including the CRO);
6. FMHB to be liquidated in an *undisclosed manner.* All claims against FMHB to be cancelled by the Specified Banks and the Lease Group Holding United Kingdom Ltd. (**Shareholder Company**);
7. FMHB and Shareholder Company to cancel all claims against the Shell Subsidiary and its subsidiaries;
8. out of the Specified Banks, bank C and D, which in the past provided Flow Management Work BV (i.e., subsidiary of FMHB) (**FMW**) with additional working capital will waive an amount of € 32.5 million. In fact, the entire debt is written off;
9. the consortium who in the past provided FMW with working capital will waive an amount of € 97.5 million. A € 240 million claim against FMW remains;
10. the € 55 million loan in FMW is cancelled in full;
11. Shell Subsidiary will be eventually sold on a going concern basis.
	1. From the aforesaid facts, essentially the following is the essence and effect of the Restructuring Agreement:
12. at the FMW level, an aggregate of € 240 million of debt remains. The balance debt of €185 million is waived/extinguished, resulting into a total haircut of approximately 43.5% on aggregate basis for the lenders at FMW level;
13. in consideration of waiver/extinguishment of unsustainable portion of debt, the Specified Banks will be provided with certain % of equity in the operating subsidiaries- which are effectively revenue generating companies and can yield results for the Specified Banks in long run;
14. the presence of the CRO in the management and now as a shareholder in the Shell Subsidiary will ensure continuity and (with more skin in the game) will also aid the turnaround process;
15. liquidation of FMHB in an undisclosed manner (subject to compliance with the applicable law) is likely not to cause negative publicity for the group as a whole, which could have impacted business operations and customer base at the larger level;
16. waivers and extinguishment of liability by the Specified Banks will allow FMW (a major subsidiary) to focus on revenue generation and strengthen its balance sheet, which in turn will improve the solvency ratio. The fact sheet also states that as a result of the debt reduction, the net profit is positive and the equity capital is strengthened (solvency is higher than 5%).;
17. sale of Shell Subsidiary to a qualified and strong buyer will not only improve the viability of the business of the operating companies but will also enhance the return for the Specified Banks in future. In addition, the secured Specified Banks will be able to realize certain proceeds in the liquidation of FMHB, which in the overall framework is a win-win for the Specified Banks;
18. above all, the Restructuring Agreement is able to save a viable business on a going concern basis which will be economically advantageous.
19. ***Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?***
	1. In the facts of the case, we have approached with certain variable factors, i.e., the management of Flow Management Holding BV (**FMHB**) and Lease Group Holding United Kingdom Ltd. (**Shareholder Company**) and the Banks A, B, C and D (**Specified Banks**). The remaining stakeholders have been rather kept constant, including for example the Government and statutory authorities, the operational vendors, workmen and employees and cross-border stakeholders. In a real life scenario, all these factors will be significantly important in implementing resolution/reorganization plan. Set out below are certain factors:
20. The restructuring agreement as signed on the July 4, 2015 (**Restructuring Agreement**) provided for transfer of subsidiaries located in the Netherlands, Spain, France, Australia, South Africa and the United States of America (**Operating Subsidiaries**) to a shell subsidiary, called Flow Management II BV. At the outset, any transfer of share or assets would have entailed requisite compliance with the governing laws of the subsidiary companies and necessary approvals, if any, would have to be obtained. Any time lapse in compliance with the applicable laws ought to have been factored in for implementation the restructuring;
21. Similarly, the eligibility of the shareholders and composition and ownership of the shareholding will be subject to the local laws of the Operating Subsidiaries;
22. Given that the entire group (which had presence in six jurisdiction) was under stress, any potential initiation of the insolvency proceedings in one jurisdiction would have raised issues in relation to cross-border insolvency. While the fact sheet is clear that the center of main interest is Netherlands, other jurisdiction, such as South Africa have not implemented the UNCITRAL Model Law on Cross-Border Insolvency.[[22]](#footnote-22) This would raise issues around the ring-fencing of assets, conduct of insolvency proceedings, etc.
23. ***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]***
	1. As mentioned in the fact sheet, in October 2014, one of the scenarios for lenders was moratorium (i.e., formal suspension of payments procedure) or restart following liquidation, with the company being sold in a ‘controlled’ manner. One of the key aspects was for the lenders to provide a bridging loan.
	2. In my opinion, from an Indian insolvency law perspective, such a scenario may have yielded the most optimal outcome as compared to other options (assuming that there were willing buyers). While there was complete loss of trust in the management, the business was still viable and the market demand was not much impacted, which in the eventuality of insolvency resolution with a strong buyer could have helped resolution on a going concern basis and at the same time could have ***avoided liquidation***.
	3. Set out in detail below are the reasons associated with the same:
24. ***Suspension of the management/board of directors and decision-making by the Creditors Committee:***

the (Indian) Insolvency and Bankruptcy Code, 2016 (**Insolvency Code**) provides a framework for corporate insolvency resolution process (**CIRP**) on a going concern basis in a time bound manner within a period of 180 days (which can be extended by 90 days, with a maximum limit of 330 days). The CIRP of a corporate debtor commences from the date an application is admitted by the adjudicating authority (such date, referred to as the **insolvency commencement date**). Along with admission of such an application, the NCLT also passes an order, inter alia, (i) declaring a moratorium (*which amongst others, prohibits institution of suits or continuation of pending suits or proceedings against the corporate debtor, transferring, encumbering, alienating or disposing off by the corporate debtor of any of its assets or any legal right or beneficial interest therein, any enforcement and recovery actions*); (ii) causing a public announcement of the commencement of CIRP of the corporate debtor and calling for submission of claims from the creditors of the corporate debtor; and (iii) appointing an insolvency professional as the ‘interim resolution professional’ (**IRP**) (who is replaced by a resolution professional (**RP**, together with IRP referred to as the **Insolvency Professional**) by the Creditors Committee (*defined below*)) in respect of the corporate debtor, who will take over the management and functions of the corporate debtor.

Accordingly, during the CIRP, the powers of the board are suspended and are exercised by the Insolvency Professional. The Insolvency Professional’s role in Indian scenario is of a facilitator or administrator who works under the overall supervision of a committee of creditors comprising of unrelated financial creditors (**Creditors Committee**)[[23]](#footnote-23). Further, the requirement for approval of shareholders (or in terms of any inter-se shareholding agreements) are dispensed with for the purposes of approval and implementation of a resolution plan.

In the present instance, key decision-making powers would have been vested with Bank A, B, C and D (**Specified Banks**). In addition, suspension of management and appointment of the Insolvency Professional (confirmed as the RP) would have given more control to the Specified Banks to run and oversee the turnaround.

1. ***No involvement of the shareholder company in the resolution process and binding effect of the requisite majority of Creditors Committee***

As stated above, the Creditors Committee plays a vital and key role in the CIRP of a corporate debtor and is required to vote on and take several decisions during the CIRP. The decision of the Creditors Committee is taken by the voting shareof the total financial debt admitted by the Insolvency Professional. The voting share of a member of the Creditors Committee is the debt represented by that financial creditor compared to the entire financial debt of the corporate debtor, as admitted by the Insolvency Professional. It is worth noting that for the purpose of participation in the Creditors Committee meetings and computing voting share, the Insolvency Code does not distinguish between secured and unsecured financial creditors.

The voting threshold: (A) for approval of the resolution plan and certain other critical specified decisions (for instance, creation of any security interest over the assets of the corporate debtor, raising of interim finance in excess of specified thresholds, effecting a change in the capital structure or ownership interest in the corporate debtor, undertaking related party transactions, amending constitutional documents of the corporate debtor, transferring rights or debts under material contracts outside of the ordinary course of business and delegation of authority etc.) is 66% of the voting share; (B) for withdrawal of a CIRP proceeding (once admitted) is 90% of the voting share; and (C) other matters requiring approval of the Creditors Committee is 51% of the voting share.

In the present instance, assuming that the Bank A and B collectively held 66% voting share, the critical decision would have been undertaken, which would have been binding on Bank C and D (if they decided to continue to not co-operate). The decision making wouldn’t have stalled the process and given that the CIRP is a time-bound resolution, quicker decision could have been undertaken with the requisite majority. Further, the involvement or approval of the shareholder company would not have been required for any of the steps.

1. ***Statutory priority to Interim Finance***

Under the Insolvency Code, interim finance provided after the insolvency commencement date is considered as insolvency resolution process cost (**CIRP Cost**). As CIRP Cost, such interim finance is given statutory primacy it will have to be paid in priority to any other payment during the CIRP or under liquidation (as the case may be). Accordingly, providing the required interim finance would have provided the much needed liquidity to the company for running the operations, which would have helped in generating the revenues. Given that moratorium would have been in place, there would have been no concern in respect of initiation of legal proceedings and the company could have entirely focused on revenue generation.

1. ***Primacy to the commercial wisdom of the Creditors Committee and binding effect of the resolution plan***

The scheme of the Insolvency Code (and related regulations) is such that, the resolution of a corporate debtor is done through bidding process, in terms of which the Insolvency Professional invites *resolution plans* from interested, eligible *resolution applicants*. A *resolution plan* is defined under the Insolvency Code as a ‘*plan submitted by a resolution applicant for resolution of the corporate debtor as a going concern in accordance with Part II*’. The statute does not limit or restrict the kind of resolution plan that may be submitted other than the fact that it must contemplate the resolution of the corporate debtor as a ‘going concern’. The intention of the statute is that for a resolution process of the corporate debtor to be approved and successfully implemented, the corporate debtor as an entity must survive post the implementation and to this effect, a resolution plan may contemplate a variety of measures[[24]](#footnote-24). Recently, the regulations have also been amended such that plans are not received for the company as a whole, the Insolvency Professional (with the approval of the Creditors Committee) can issued request for resolution plan for sale of one or more of assets of the corporate debtor.

The resolution plans are required to meet certain mandatory criteria (for instance, provide for priority payment of CIRP Cost, minimum payment to operational creditors and dissenting financial creditors, etc.). If the resolution plan meets the requirement, it is ultimately the Creditors Committee which will have to approve the plan after taking into account its feasibility and viability. Under the scheme of the Insolvency Code, as far as negotiating the terms of the resolution plan and determining the manner of distribution of the payout under the resolution plan, the collectively commercial wisdom (as evidenced by votes of the requisite voting share) has been recognized as being supreme. The Supreme Court in *Committee of Creditors of Essar Steel India Limited* v. *Satish Kumar Gupta & Ors.*[[25]](#footnote-25) upheld the primacy of the commercial decision making by the Creditors Committee and *inter alia* held as follows:

###### the financial creditors have been given complete discretion to determine the feasibility and viability of resolution plans, which includes the manner of distribution of debts that is contained in them, subject to ensuring compliance with the provisions of the Insolvency Code relating, inter alia, to dealing with the interests of all stakeholders (including operational creditors);

###### so long as the provisions of Insolvency Code and the regulations are complied with, it is the commercial wisdom of the requisite majority of the Creditors Committee (i.e., 66% by voting share) which is to negotiate and accept a resolution plan that must prevail on the facts of any given case. It may also involve differences in distribution of amounts between different classes of creditors;

###### the Creditors Committee has the discretion to so classify creditors and to pay secured creditors amounts which can be based upon the priority and value of their security[[26]](#footnote-26).

##### Accordingly, it is settled law that subject to the payment of the mandatory amounts as prescribed under the Insolvency Code (and related regulations) as described above, the manner of distribution of the remaining proceeds under the resolution plan is the sole remit of the Creditors Committee and a proposal in this regard which receives the requisite majority approval (of at least 66% of the voting share) will be binding on all stakeholders.

##### In the present Case Study as well, the Specified Banks could have taken the decision, which would have bound all the stakeholders, including the shareholder company, government and statutory authority, etc. In my experience, I have seen that generally the resolution applicants provide for extinguishment of complete liability towards shareholders (as the liquidation value in most cases to shareholders is NIL), capital reduction and simultaneous capital infusion for 100% control. Such provisions are binding on the shareholders. Given that in the present instance, the shareholder company was creating the most nuisance, getting in a new shareholder company would have benefitted all the stakeholders.

1. ***Fresh slate start***

Under the Insolvency Code, once a resolution plan is implemented, the resolution applicant (i.e., the investor) will take over the corporate debtor on *clean slate* basis.[[27]](#footnote-27) Effectively, after making the payments in accordance with the terms of the approved resolution plan, the past liabilities of the organization are whitewashed and it is given a fresh slate start.

Accordingly, in the present instance, the incoming resolution applicant, after making payment in terms of the resolution plan would have taken over the control of the company on a clean slate basis, which is a beneficial bargain for the stakeholders involved.

1. Kamel Mellahi and Adrian Wilkinson, *Organizational failure: a critique of recent research and a proposed integrative framework,* International Journal of Management Reviews, Volume 5-6 Issue 1, pages 21–41 at page 27-28. [↑](#footnote-ref-1)
2. Staw, B., Sandelands, L. and Dutton, J.E. (1981), *Threat–rigidity cycles in organizational behavior: a multi-level analysis*, Administrative Science Quarterly, 26, pages 501–524. [↑](#footnote-ref-2)
3. Ian Adriaanse and Hans Kuijl, *Resolving Financial Distress: Informal Reorganization in the Netherlands as a Beacon for Policy Makers in the CIS an CEE/SEE Regions?,* Review of Central and East European Law, 31 (2006) 135-154. [↑](#footnote-ref-3)
4. Circular dated June 7, 2019 <available at: [*https*://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0](https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0)> <last visited: April 17, 2023>. [↑](#footnote-ref-4)
5. Paragraph 9 of the Stressed Asset Directions. [↑](#footnote-ref-5)
6. The Economic Survey Report (2022-23), Government of India, Ministry of Finance, Department of Economic Affairs Economic Division. [↑](#footnote-ref-6)
7. *Hindustan Construction completes debt resolution plan,* Business Line (September 27, 2022)

<available at: <https://www.thehindubusinessline.com/companies/hindustan-construction-completes-debt-resolution-plan/article65938996.ece>> <Last visited on April 17, 2023>. [↑](#footnote-ref-7)
8. *See* Robert A. Haugen and Lemma W. Senbet, *The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure,* 33(2), The Journal of Finance (1973), 383-393. [↑](#footnote-ref-8)
9. *Committee of Creditors of Essar Steel India Limited* v. *Satish Kumar Gupta& Ors*. 2019 SCC OnLine SC 1478 [↑](#footnote-ref-9)
10. Adriaanse, J.A.A., & Kuijl, J.G. (2006). *Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?*, Review of Central and East European Law, 31(2), page 135-154. [↑](#footnote-ref-10)
11. Sudarsanam, S, Lai, J., (2001), ‘*Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis*’, British Journal of Management, Vol. 12, page 183-199 [↑](#footnote-ref-11)
12. Schmitt, A., Raisch, S. (2013), ‘*Corporate Turnarounds: The Duality of Retrenchment and Recovery’*, Journal of Management Studies, 50(7) p. p. 216-1244. [↑](#footnote-ref-12)
13. Pajunen, K. (2006), Stakeholder Influences in Organizational Survival. *Journal of Management Studies*, 43(6), 1261-1288. [↑](#footnote-ref-13)
14. Circular dated June 7, 2019, <available at: [*https*://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0](https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0)> <last visited: April 17, 2023>. [↑](#footnote-ref-14)
15. Paragraph 9 of the Stressed Asset Directions. [↑](#footnote-ref-15)
16. Paragraph 10 of the Stressed Asset Directions. [↑](#footnote-ref-16)
17. As per the recent data the whole process of resolution can take up to 687 days. [↑](#footnote-ref-17)
18. “Special Mention Accounts” are classified in three categories (i.e., SMA-0, SMA-1 and SMA-2) depending on the period for which that account has been in default, as contemplated the Stressed Asset Directions. [↑](#footnote-ref-18)
19. Regulation 19M of Chapter IIIB (*Special Situation Funds*) of the AIF Regulations. [↑](#footnote-ref-19)
20. Paragraph 58 of the RBI Transfer Directions contemplates transfer of stressed loans under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 resulting in an exit of all lenders from the stressed loan exposure to the permitted transferees specified in Annex to the RBI Transfer Directions. The Annex is yet to be updated to include SSFs. [↑](#footnote-ref-20)
21. Regulation 19I (2) of Chapter IIIB (*Special Situation Funds*) of the AIF Regulations. [↑](#footnote-ref-21)
22. The Model Law on Cross Border Insolvency was implemented in South Africa under the Cross Border Insolvency Act (42 of 2000), but its applicable only to the specific ‘designated countries’ as may be specified by the Department of Justice. Till date, no such designation has been given effect and accordingly for all practical purposes Model Law is not operational in substance in South Africa. [↑](#footnote-ref-22)
23. The Creditors Committee is formed by the Insolvency Professional basis verification of the claims submitted by the financial creditors. [↑](#footnote-ref-23)
24. Some of which are mentioned in regulations, such as: (a) sale or transfer of all or part of the assets of the corporate debtor (including the secured assets); (b) merger, amalgamation, demerger or other such corporate restructuring of the corporate debtor; (c) substantial acquisition of, or cancellation or delisting of, or issuance of new securities of the corporate debtor; or (d) restructuring the debt of the corporate debtor (along with modification of the existing security interest) etc. [↑](#footnote-ref-24)
25. 2019 SCC OnLine SC 1478 [↑](#footnote-ref-25)
26. This position has been reiterated by the Hon’ble Supreme Court in the matters of *Jaypee Kensington Boulevard Apartments Welfare Association and Ors. vs. NBCC (India) Ltd. and Ors.,* (2021) 5 SCC 624; *Ghanashyam Mishra and Sons Private Limited v. Edelweiss Asset Reconstruction Company Limited and Ors*., (2021) 9 SCC 657; *Maharashtra Seamless Limited v. Padmanabhan Venkatesh and Ors.*(2021) 11 SCC 467; *Kalpraj Dharamshi and Ors. v. Kotak Investment Advisors Ltd. and Ors*., judgment dated March 10, 2021 [↑](#footnote-ref-26)
27. *Committee of Creditors of Essar Steel India Limited* v. *Satish Kumar Gupta& Ors*. 2019 SCC OnLine SC 1478 [↑](#footnote-ref-27)