Global Insolvency Practice Course 2023
Case Study I

Submitted by John T. Young, Jr. on 5 April, 2023

Question 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?

Response:

The Mellahi & Wilkinson paper draws upon works in the study of organizational failure to assess the driving causes of business demise. The article generally bifurcates cause of failure between 'environmental' factors and 'managerial' factors. It struck me as similar to studies of the success of people and how it can be attributed to combinations of nurturing home environment or simple genetics. Just as many successful people come from bad homes, many successful companies survive unfavorable environments when equipped with the right managerial DNA.

The Flow Management case in my opinion supports the *voluntaristic* view described by Mellahi and Wilkinson that *the actions and perceptions of management are the fundamental cause of organizational failure*. The financial distress at Flow Management is not caused by macro or micro-economic factors or any discernable environmental factor. To the contrary, the financial distress at Flow Management is ultimately caused by lax accounting and financial controls that allowed the company to operate for almost two years without warning of operational issues. Without the feedback loop of reliable accounting information to those managing operations, problems could not be identified and corrected in time to avoid failure. It is my view, for the aforementioned reasons, the financial distress could have been prevented.

It is likely a management team *with the right managerial DNA* may have never had an issue. With proper procedures, controls and pricing systems in place, management could have responded much sooner. Liquidity measures could have been implemented. Bonuses (to insiders) would not have been overpaid. A number of alternatives would have been available under proper leadership. In the Flow Management case, it was too late *for this management team* to navigate the resulting situation once the reporting issues were identified and communicated to the lenders.

Question 2

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

Response:

In general, out-of-court restructurings are best suited for companies with more simple capital structures and fewer legal complexities. They are less expensive but they don't solve many of the problems that may exist with more complex companies or those with significant litigation exposure. In-court processes are more costly and more public, but provide protections against creditors and a structured forum to resolve more complex issues.

The alternatives available to debtors in the U.S. vary much more broadly than out-of-court restructuring versus formal bankruptcy. While the two mentioned alternatives are the most common, US restructuring can be accomplished through many types of processes including the following:

1) Out-of-Court Restructuring
2) U.S. Chapter 11 Bankruptcy Alternatives
    a. Chapter 11
    b. Pre-packaged Chapter 11
    c. Pre-arranged Chapter 11
    d. Sub-chapter V Chapter 11
3) State Law Alternatives
    a. Uniform Commercial Code (UCC) Article 9 Transactions
    b. Assignment for the Benefit of Creditors

Out-of-court restructuring has many obvious benefits including 1) lower cost, 2) avoidance of a public process that could impact revenues and result in unwanted disclosure of financial information, 3) ability to maintain more control of the company without seeking court approval for actions such as entering into contracts or implementing incentive / retention programs, 4) avoiding potential litigation with vendors in connection with preference payment avoidance, 5) avoiding the significant burden placed on accounting and finance departments resulting from the need for incremental non-standard bankruptcy financial reporting and most importantly, 6) it's much faster. Unfortunately, out-of-court restructurings aren't practical for companies with complex capital structures or which require the protections and benefits of the bankruptcy code to successfully reorganize.

Question 2 (*cont'd*)

Larger debtors with more complex issues often require the benefits of the automatic stay, the ability to reject executory contracts (e.g. real property leases) and the ability to sell assets free and clear of liens. Also, in the U.S., a Chapter 11 debtor can move pending litigation from non-bankruptcy courts into the bankruptcy court. The ability to remove pending litigation to the bankruptcy court may also be advantageous to a debtor. While these processes can be far more expensive than an out of court restructuring, the benefits received often far outweigh the costs.

Often overlooked, the use of state law (versus federal) for restructuring in the U.S. is sometimes a very effective tool for completing a restructuring transaction. This often involves a sale of debt, at a discount, from the lender to the desired owner of the borrower. The purchaser of the debt then forecloses on the equity (or assets) of borrower. When performed correctly, the unwanted liabilities do not travel with the desired assets.

Question 3

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

Response:

In summary the referenced articles generally address the following approaches:

- Adriaanse & Kuijl, 2006 – successful out-of-court, or 'Informal Reorganizations', are characterized as having two primary approaches including the operational restructuring and the financial restructuring. The operation restructuring is a four-phase process of 1) stabilization, 2) plan development, 3) initial implementation of the plan and 4) taking steps to ensure long term viability such as upgrading management and/or potentially a strategic transaction. The financial restructuring could involve renegotiating financial covenants or potential equitization of debt.
- Pajunen, 2006 – organizational survival is highly dependent on identifying the most critical stakeholders and influencing their support through communication and involvement. Stakeholders should be considered for the impact each has on the distressed company's resource procurement as well as its networking benefit.
- Sudarsanam, S, Lai, J., 2001 – successful restructuring strategies can include a combination of approaches including 1) operational restructuring, 2) asset restructuring, 3) managerial restructuring and 4) financial restructuring.
- Schmitt, A., Raisch, S. 2013 – while tension is perceived between retrenchment and recovery, the best outcome for a troubled company most often stems from shedding non-core and unprofitable operations and recovering as a stronger, more streamlined business that's better positioned to grow.

While difficult to respond 'yes' or 'no' to the question, I believe its more appropriate to suggest that some elements discussed in the materials were attempted, though the application of those methods may not have been well executed.

A meaningful aspect of the process occurred from the very beginning. Poor oversight of accounting and financial processes created a severe creditability issue made worse, implicitly, by the detail that the CEO and CFO benefited from overpayment of bonuses. The need for restatement along with executive self-gain and ongoing errors would hamstring a restructuring from the beginning. The decision to restructure management was correct and addressed throughout the materials. While not directly addressed by Pajunen, without management credibility a distressed business will have great difficulty influencing the support of its critical stakeholders.

Question 3 (*cont'd*)

Based on my experience and views of triage which are shared by Pajunen, as well as stabilization mentioned in the Adriaanse & Kuijl article, earlier consideration should have been given to 'stop the bleeding' at subsidiaries by discontinuing operations at negative EBITDA foreign subsidiaries or even Flow Management Work BV. For instance, sale of the non-Benelux business units was discussed, it is unclear from the materials that it ultimately occurred. While communication with customers and price increases are meaningful, the response time and actions taken to address losses were insufficient.

Much of the case study was focused on lender discussions and potential financial restructuring alternatives. Ultimately the case involved an equitization of the loans and a planned going concern sale. This approach was a reasonable outcome given the proven inability of the shareholders and management to return the business to profitability.

Question 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?

Response:

Banks C and D did precisely what I would have advised a lender in an out-of-court restructuring similar to this (in defiance of the Principles.). It is a zero-cost option to increase leverage against the cooperating banks, potentially resulting in a buyout of the position at a greater recovery than what would naturally occur through the process. Secondly, it creates fear and urgency with the borrower which seemed lacking. The lack of reliable reporting and projections, along with executive overpayment, collectively influence my opinion.

As the advisor to banks A and B, I would have recommended a communication to banks C and D that the recoveries to all banks would likely be in a range of low and if cooperation is lacking downside risk is higher. I would also advise banks A and B that the lack of cooperation is likely nothing more than posturing and the likelihood of C and D cancelling the credit is unlikely. In support of this view, I would point out that banks C and D, which appear to be the two participants in the €55 million additional working capital loan, have a greater portion of their overall loans subject to characterization as unsecured loans due to the defective security. Put more clearly, the projected recovery to banks A & B is greater than the projected recovery to banks C and D. They have greater risk of loss as seen in the below recovery scenarios.

Scenario I - Banks C & D DO receive January 2015 €25 million paydown

Lender	Borrower	Purpose	Original Balance	Post Reorganization Going Concern Sale Recovery Sensitivity: €200 MM	€250 MM	€300 MM	€350 MM
Banks A, B, C, D	FM Work BV	Working Capital	€ 360.0	56%	68%	77%	86%
Banks C, D	FM Work BV	Working Capital *(Additional)*	55.0 *	45%	49%	68%	87%
Shareholder Loan		Bridge (*Unsecured*)	10.0	0%	6%	36%	66%
Total			€ 425.0	53%	65%	76%	88%

** Recovery %s consider €25 million pre-transaction paydown of Additional Working Capital facility*

Scenario II - Banks C & D DO NOT receive January 2015 €25 million paydown

Lender	Borrower	Purpose	Original Balance	Post Reorganization Going Concern Sale Recovery Sensitivity: €200 MM	€250 MM	€300 MM	€350 MM
Banks A, B, C, D	FM Work BV	Working Capital	€ 360.0	56%	68%	77%	86%
Banks C, D	FM Work BV	Working Capital *(Additional)*	55.0	0%	4%	23%	42%
Shareholder Loan		Bridge (*Unsecured*)	10.0	0%	6%	36%	66%
Total			€ 425.0	53%	65%	76%	88%

Question 5

Which of the eight principals 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)?

Response:

First Principal – Yes – The four creditors agreed to engage with the borrower and generally cooperate. Proposals were discussed throughout the process. While there was initially no formal standstill period, there was also no exercise of remedies or formal notice of default during that time. Once the standstill agreement was in place, all creditors continued to observe the First Principle.

Second Principal – Yes – Ten months into the process a standstill agreement was executed and from that point forward the creditors refrained from enforcing claims.

Third Principle – Yes – There was no standstill agreement in place for most of the process, yet during the entire process the debtor took no unilateral action affecting the priority or collateral position of any lender.

Fourth Principle – No – It is not apparent that the banks were coordinated over the first ten months of the process and it also is not clear the professionals were retained directly by the banks to assist in facilitating communications with Flow Managment.

Of additional note, while the lenders did in fact have a CRO placed into the company, it would have been constructive for the banks to hire advisors to coordinate directly with the CRO. In the U.S., for instance, fiduciary obligations of a CRO often make it difficult to properly counsel lenders.

Fifth Principal – Yes – Throughout the standstill period it appears the banks had access to the debtor's relevant information. However, had the lenders relied upon advisors who had full access to Flow Management's financial information, diligence would have likely surfaced issues highlighting concerns that the financial projections were unreliable.

Sixth Principal – Not addressed.

Seventh Principal – Yes – It appeared from the case study that lenders were afforded common access to management, the shareholders and financial information.

Eighth Principal – Yes 'ish' – The Additional Working Capital (€55 million) lenders agreed to a deferral of a €35 million scheduled repayment. €25 million was repaid in January 2015 prior to the restructuring transaction.

Question 6

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

Response:

I am not aware of any soft law remedies that may exist in the U.S. beyond the enforcement of intercreditor agreements that are almost always in place when there are complex capital structures. As long as each lender is acting rationally in the context of the individual credit, rational economic decision should prevail, making and ultimately driving an approach consistent with the Principals. A common exception I see is the requirement for equity sponsors to provide junior / LILO capital.

In my experience, problems arise when the logic of portfolio management overrides the logic of loan management. Put differently, in my experience certain types of lenders will act irrationally in connection with an individual credit if it reinforces a message from the portfolio to the marketplace – the *don't mess with my institution or here's what will happen* message. This is often the case with many of my distressed credit fund clients. They occasionally send a message to the marketplace. In these situations, it becomes incredibly difficult for other parties to rely on the certainty and cooperation provided by Principles.

Question 7

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

Response:

The essence of the restructuring is to allow valid secured claims of approximately €240 million to survive the restructuring as a secured debt obligation of Flow Management Work BV. The remaining institutional debt of approximately €130 million, deemed to have defective or no security interest, is converted into equity of the new parent, Flow Management II BV. Additionally, management is provided equity as a performance incentive (assumed 10% in below illustrative).

The ultimate purpose of this structure is to provide a priority recovery to the €240 million of secured claims, as debt would be paid from sale proceeds first, and distributions to equity would only receive a recovery if ultimate going concern sale proceeds exceeded the amount of the €240 million of debt.

Illustrative Summary of Transaction Based on Interpretation of Case Narrative

(€ millions)

						Restructuring		Capitalization of Flow Holding II BV "Consolidated"	
Lender	**Borrower**	**Purpose**	**Beginning Balance**	**Interest / Shareholder Loan**	**Repayments**	**Cancelled / Equitized**	**Ending Balance / Rollover**	**Debt (€)**	**Equity % (Illustrative)**
Banks A, B, C, D	FM Work BV	Working Capital	€ 360.0	€ 22.5	€ -	€ 97.5	€ 240.0	€ 240.0	63%
Banks C, D	FM Work BV	Working Capital *(Additional)*	55.0	2.5	25.0	32.5	-	-	21%
Total Bank Debt			**€ 415.0**	**€ 25.0**	**€ 25.0**	**€ 130.0**	**€ 240.0**	**€ 240.0**	**84%**
Shareholder Loan		Bridge (*Unsecured*)	-	10.0	-	10.0	-	-	6%
Management		Incentive	-	-	-	-	-	-	10%
Total			**€ 415.0**	**€ 35.0**	**€ 25.0**	**€ 140.0**	**€ 240.0**	**€ 240.0**	**100%**

Question 8

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

Response:

As related to the initial restructuring, it appears all capitalization transactions are limited to the Dutch parent and Dutch subsidiary BVs. I would speculate that the foreign subs would be generally unaffected by these transactions.

There are two points during the process where I would predict potential for legal and/or non-legal cross-border issues. The first occurs at the time the foreign subs are transferred from Workflow Management Holding BV to Workflow Management II BV. I'm unaware of needs to modify registration of ownership in various countries in connection with a restructuring transaction, but it occurs to me the process of doing so has the potential to create issues.

The second potential opportunity for issues would arise from the contemplated liquidation, mentioned in the final sentences of the case study, once a going concern alternative is determined unviable. To liquidate Workflow Management II BV through a formal process will potentially require foreign recognition of the Dutch process. For instance, a Chapter 15 ancillary filing may be required in the U.S. if there are U.S. creditors (e.g. vendors). Similar issues could arise with the South Africa and Australia domiciled subs.

Question 9

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

Response:

I understand a 'moratorium' to share common traits with the automatic stay provisions found in U.S. Chapter 11 bankruptcies, while the primary Dutch bankruptcy provisions are more similar to a U.S. Chapter 7 liquidation. The automatic stay becomes effective immediately at the time of filing a petition under Chapter 11 and halts the ability of creditors to enforce rights or collection efforts against a debtor.

Implying from the facts of the case, one answer to this question is very simple. If a determination was made that the lenders could accomplish an equitization of the debt without requiring the special features of a Chapter 11 restructuring, there would be no reason to incur the costs, the risks, or the time to consummate an in-court restructuring. Generally, if there is not some specific meaningful incremental benefit from cleansing a debtor through a legal restructuring process it should be avoided.

I believe it was prudent for Flow Management to include this on the list of alternatives for a couple reasons. First, it requires the lenders to understand the cost of the process and what the funding requirements will be. There are material costs of the process that are generally required to cover professional fees. The cost of funding fees could alternatively be directed to making operational improvements in an out-of-court process.

The *most important* factor for the lenders in avoiding a moratorium, or equivalent process, is the potential scrutiny of the corrective measures undertaken to perfect the banks' security interest. In the U.S. these would sometimes be referred to as correction affidavits and would require at least 90 days to avoid treatment as a 'preference' and possibly a greater amount of time to avoidable transaction treatment depending on the circumstances. I'm generally familiar with TUV avoidance in Europe and suspect the corrective measures would also likely fall subject to scrutiny under that system. The impact of avoidance would be substantial and likely render some or all of the security interest invalid thus subordinating the claims to an unsecured position.