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Case Study I

Responses to Assignment Questions

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?

Answer:

Flow Management Holding BV's financial distress was caused by a number of issues, including mismanagement and accounting errors. In 2012, accounting errors cause the company to realize losses and suffer a negative correction. Some of the losses were the result of large management bonuses that were wrongfully issued. Others were caused by a formula error in a spreadsheet that resulted in a cost price calculation that deviated from reality. Management's failure to identify this error in a timely fashion (by failing to true up real costs against the results of the cost price calculation) resulted in a significant loss of revenue. While not entirely clear from the case study, it is possible that the failures also were the result of certain psychological factors, such as cognitive inertia and denial, as addressed in the Mellahi & Wiklinson article.

These organizational and psychological failures were preventable. Both the cost price formula error, and the company's failure to timely detect the error were internal causes of failure that could have been avoided through, among other things, the implementation of policies and procedures that require additional oversight, and regular and repeated true ups on results. If such policies and procedures did exist, then the failure could have been avoided had management been more focused on enforcement of such policies and procedures. Again, while the case study does not go into detail on how or why the large management bonuses were issued, it is possible that management was in a state of denial with respect to the company's financial position, which enabled them to wrongfully issue the bonuses.

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?

Answer:

Every distressed organization will need to analyze its own unique legal and business circumstances in order to determine whether to pursue an out-of-court restructuring or a formal bankruptcy procedure. An out-of-court restructuring is generally quicker and less expensive than a bankruptcy procedure. It also gives a distressed company more flexibility and control over the path of its reorganization. Another advantage of an out-of-court work out is that it is conducted in private, whereas a bankruptcy proceeding is public. An out-of-court restructuring is also an opportunity for a distressed organization to work with its creditors in a way that builds trust and a strong working relationship going forward. Among certain disadvantages of an out-of-court work out is that the distressed organization will need sufficient liquidity, and the participation of most if not all of its creditors, in order to propose and effectuate the restructuring. An out-of-court work out will also lose out on many of the advantages that chapter 11 can provide, as discussed below.

A formal bankruptcy process comes with numerous benefits. First, all debtors get the benefit of the automatic stay, which means that once the bankruptcy case is filed, the automatic stay prevents all creditors from continuing collection or enforcement efforts. This allows a company breathing room in order to reorganize its affairs. In addition, debtors in bankruptcy have the ability to assume or reject executory contracts. This provides a debtor with significant flexibility to manage contracts. Debtors in bankruptcy are also given the right to sell assets free and clear of all liens, claims and encumbrances. These protections for buyers make assets more attractive and can drive better pricing for such assets. Among other benefits, chapter 11 buyers are able to take assets free of transfer taxes and reorganized debtors can take advantage of certain net operating loss tax carryforwards. Disadvantages to a formal bankruptcy proceeding, however, are that an in-court, chapter 11 process can be significantly more expensive than an out-of-court work out. It can also be more time consuming as an organizations restructuring plan and exit must be noticed to all creditors and parties in interest, voted on, and approved by the bankruptcy court.

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.

Answer:
Certain approaches discussed in the reading materials were implemented in this case study, while others were not. For instance, the Adriaanse and Kuijl article, *Resolving Financial Distress,* focuses on the merits of informal (i.e. out-of-court) reorganizations. The restructuring agreement explored in this case study was an informal restructuring that implemented both a business restructuring (as all six of Flow Management Holding BV's subsidiaries were consolidated into a single new entity) and a financial restructuring (as a significant amount of the company's existing debt and equity was cancelled and new equity was issued in its place), following a chance in management at the company, and a retention of turn around professionals.

The approaches discussed in the Kalle Pajunen article *Stakeholder Influences in Organizational Survival*, however, are not addressed in this case study. Pajunen outlines, among other things, the resource dependency and stakeholder management theories, which examine relationships by describing how power is organized around crucial and needed resources and stakeholders. It posits that entities that control resource flow within a particular network have a strong influence on an organization's survival. Those in crisis must identify the influential stakeholders and alter their relationship with that stakeholder in order to make their turnaround possible and successful. Pajunen also presents the Kymi Corporation case study where key resource and stakeholder influences are discussed in relation to the impact on others important changes implemented by the Kymi Corporation, including technical improvements to production process, sales and marketing strategies and changes to the labor force, which were all altered in order to improve the company's performance. These ideas and concepts are not addressed in our case study, which instead focuses on only corporate level and financial restructurings.

Sudi Sudarsanam and Jim Lia's article entitled *Corporate Financial Distress and Turnaround Strategies* analyzes several corporate turnaround strategist, including financial restructuring, managerial restructuring, operational restructuring and asset restructuring. We can see evidence

of several of these approaches in our case study. First, Flow Management Holding BV underwent a financial restructuring, as the banks traded their debt for equity. In addition, because the banks had expressed a loss of faith in management, Flow Management Holding BV appointed a new CFO (in January of 2014) and a new CEO (in May 2014), in order to garner the banks' trust. The company also agreed to appoint a CRO, a valuable resource for any restructuring process. Flow Management Holding BV undertook various operational restructurings, as it (i) identified a cost price calculation error and increased prices in an effort to increase revenue, and (ii) implemented various spending cuts, including reduction of staff and independent contractors. Finally, when the company proposed to sell 350 cars from its fleet in December of 2013, it signaled it was willing to undertake an asset divestment in order to generate capital.

The concepts of retrenchment and recovery are the focus of Achim Schmitt and Sebastian Raisch's article *Corporate Turnarounds: The Duality of Retrenchment and Recovery*. Retrenchment, the increase of efficiency through cost and asset reductions, is observed in our case study, as noted above, through reduction of staff and spending cuts. Recovery, the improvement of a firm's market position through strategic change, is not observed, however as the case study provides that market demand already exists.

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?

Answer:
By February of 2014, Banks C and D stop cooperating with the bank group in working towards a consensual out-of-court restructuring. By March of 2014, Banks C and D seemingly lacked confidence in the company, particularly because in the six months prior, the company's accounting firm and outside consultant reported adjusted net profits that showed more significant losses than expected. The consultant also reported a significant liquidity shortfall. These factors could have caused Banks C and D to stop cooperating. Alternatively, Banks C and D could have intentionally stalled the standstill process and stopped cooperating in order to leverage more favorable treatment from the company vis-a-vis the other banks. A careful review of each Bank's debt instrument would be required in order to thoroughly understand Bank C and D's motivations.

As an advisor to Banks A and B, depending on the priority or subordination of Bank C and D's debt, I would advise my client to consider purchasing the debt of Bank C and D at a discount. In order for an out-of-court work out to succeed, all creditors must participate and agree on the proposed restructuring path. Owning all of the company's outstanding debt would give Bank's A and B control over the restructuring process, which would enable them to move more quickly towards a standstill and a consensual resolution. If Banks A and B truly believe that the company is viable, as the independent turnaround consultancy has concluded, then a purchase of Bank C and D's debt at a discount could be advantageous.

Question 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)?

Answer:
The eight principles are addressed as follows:

- First, each of Flow Management's four banks was brought in and provided with the company's financial and accounting information in order to work towards a standstill, which was eventually signed in August of 2014.
- The Banks then honored the second principle by refraining from taking steps to enforce their claims.
- With respect to the third principle, while the company did propose to sell 350 cars prior to the execution of the Standstill agreement, they did not propose to dissipate assets or shift value away from the business in a way that could dimmish the banks' returns after it had been signed.
- The fourth principle addresses coordinating a creditor response in order to streamline the restructuring process. Here, the company appears to have a relatively simple capital structure involving four bank creditors. While the banks did not select a representative, after a short period of disagreement, they eventually worked together to arrive at and execute a consensual restructuring agreement.
- The banks executed the standstill agreement in August of 2014. They signed the restructuring agreement in July of 2015. During the period of time in between, the company and its advisors drew up four potential restructuring and liquidation scenarios, and provided additional detail on its financial performance and forecasts. This information, as addressed in the fifth principle, allowed the banks to make an educated decision on which of the four scenarios was best.
- The sixth principle provides that proposals for resolving financial difficulties should reflect applicable law and the relative positions of the creditors. This principle is honored here as there is no mention of an attempt by the debtor or any of the creditors to subordinate another creditor in violation of any law or existing agreement.
- It appears from the case study that the banks were in lock step with respect to receipt of company and financial information, in satisfaction of the seventh principle.
- In March of 2014, the CEO of Flow Management Holding BV provided the company with a € 10 million unsecured loan, and proposes to lend another € 27.5 million to the company in May of 2014. According to the case study, in January of 2015, a total of €25 million is paid back to the providers of the additional working capital. It is unclear whether any portion of this payment went to the CEO on account of any priority status received in exchange for the funds lent in March and May of 2014. No other new money appears to have been provided following execution of the standstill agreement.

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?

Answer:
Yes. The United States Bankruptcy Code is implemented through both legal and equitable principles. The bankruptcy court has strong equitable powers. In fact, section 105 of the Bankruptcy Code authorizes the bankruptcy court to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code. Creditors can use

this to encourage other creditors to respect the Statement of Principles, at least to the extent that (i) the principles address equitable treatment of similarly situated parties, and (ii) the creditors recognize that a bankruptcy filing may be necessary.

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

Answer:
The restructuring agreement is a debt for equity transaction. It consolidated Flow Management Holding BV's subsidiaries into a new shell subsidiary (Flow Management II BV), which likely has the effect of substantively consolidating the assets and liabilities of all six of Flow Management Holding BV's subsidiaries into one new company. Banks A, B, C and D had originally financed the working capital of just Flow Management Work BV. But as a result of the restructuring agreement, those banks now hold interests in all six of Flow Management Holding BV's subsidiaries (i.e. FMW Spain SL, SMW France SPRL, FMW Australia Ltd., FMW South Africa Ltd., and FMW USA Ltd.), not just Flow Management Work BV. This arguable improves the banks' positions, assuming the other subsidiaries are positive performers.

Further, Banks C and D wrote off their € 32.5 million in debt against Flow Management Work BV. The bank consortium similarly waived € 97.5 million in debt. This left a € 240 million claim against Flow Management Work BV. But again, given that Flow Management Work BV has been consolidated into a new shell subsidiary with the other five subsidiaries of Flow Management Holding BV, any claim specifically against Flow Management Work BV would now be consolidated with the claims of the other five subsidiaries. This consolidation provides the banks with more avenues from which to be repaid on their remaining € 240 million claim.

The restructuring agreement also cancelled all of Flow Management Holding BV's claims and interests and provided for the banks and a few others to take possession of all of Flow Management II BV's shares. As a result, the banks now hold shares in a new entity, that has significantly reduced debt.

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

Answer:
As noted above, the Flow Management restructuring process consolidated all of Flow Management Holding BV's subsidiaries, which were entities organized under the laws of Spain, France, Australia, South Africa and the US, into one new shell subsidiary organized under the laws of The Netherlands. The consolidation of these multi-jurisdictional entities into one entity governed by Dutch law reduces the cross-border issues for the new entity, its creditors, and stakeholders because any filing of an insolvency proceeding with respect to the new entity would take place only in The Netherlands. There would be no need for the creditors to pursue recovery of their claims in each of the other subsidiaries' jurisdictions. As such, the restructuring process simplified matters for the banks and other stakeholders.

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 countries' Bankruptcy Act; be as detailed as possible]

Answer:
In October of 2014, Flow Management Holding BV's advisors drew up four possible restructuring scenarios. The fourth was a moratorium with the goal of a control sale of the company. The scenario required a bridge loan from the banks in order to succeed.

In February of 2014, a sale of Flow Management Holding BV to a financially healthy party was viewed by the banks as a good possibility. But, by July of 2014, the company's losses had risen significantly, and the company had missed its profit forecasts. A sale was no longer considered an option, by that time, as there was no interest in the market. Given the above facts, the option four moratorium would not be a good option.

Under the United States Bankruptcy Code, a chapter 11 debtor may sell significantly all of its assets either through a plan or a section 363 sale process. In either instance, the debtor must market the assets and conduct an auction. Any sale must be, in the debtor's business judgement, the highest and best offer received. Here, it appears there is no market interest in the company at all. With no interested buyers, this fourth scenario appears suboptimal as it would not generate proceeds sufficient to pay off the banks' loans. At one point in the restructuring process, the banks realized that bankruptcy would negatively affect the proceeds of the assets. In addition, the banks recognized that there was a problem with the pledges on the assets, therefore the banks may not receive any proceeds in the event of a liquidation. The banks, therefore, should pursue alternative scenarios while they solve issues related to the pledges and continue to improve the company's financial condition in order to either effectuate a going concern restructuring or better circumstances for an eventual sale.