Assignment questions

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

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

   There appears to be poor financial reporting in the company leading to highly inaccurate information. This did not permit the company to understand the plight it was in and plan accordingly. Prof Jan Adrianasse and Mr Hans Kuijl (*Resolving Financial Distress: Informal Reorganization in the Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions*) describe this as the "*presence of inadequate management information systems within the company (as a result of which important early warning signals of imminent decline are missed by management*)."

   Moreover, from the more accurate financial information subsequently given, it appears that a number of the foreign subsidiaries were unprofitable. This led to an attempt to sell the shares of companies in non-Benelux countries as well some foreign branches. This may be indicative of an expansion into territories either without proper due diligence/understanding of the market and/or proper management of the companies/branches once they were started.

   Overall, there is an indication that the Group was poorly managed.

   Despite this, high management bonuses given to both the CEO and CFO. This may not be an indication of dishonest conduct. It is more likely based on the inaccurate financial reporting and perhaps an unwillingness to accept the fact that the company is no longer performing well. The latter would be an example of threat rigidity.

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?*

   One of the main advantages of an out-of-court restructuring is the fact that it can proceed without being made known to customers and suppliers of the business. Once there is a filing in court for a restructuring process to begin (such as an application for a moratorium pending the formulation of a scheme of arrangement) this usually has a chilling effect on the generation of new business. This in turn affects the viability of the company (or companies) as a going concern. An out-of-court restructuring can avoid or at least minimize the consequence of losing business that a court restructuring entails.

   The fact that an out-of-court restructuring can proceed in a manner that is almost invisible to those outside of the company also makes it a more palatable situation for ailing Asian companies. The loss of face created by a public restructuring effort is often a factor that inhibits such companies from seeking help early when the chances of successful restructuring are much

higher. Ironically, such companies are often the companies that need restructuring the most since they are family companies run by poor or outdated management methods.

An out-of-court restructuring also permits key stakeholders (in the case of the family company, members of the company who are entrusted with the running of the company) some degree of control over the company. These stakeholders will usually prefer this over a court restructuring where even if the restructuring professionals involved are appointed by the company, they are answerable to and may be supervised by the Court which will evidently taken into account other interests.

Out-of-court restructuring offers flexibility and a wider range of options. A Court's desire to take into account the interests of all the stakeholders and to endorse an equitable solution between different groups of stakeholders may sometimes have a counter-productive effect in limiting the options and thereby delaying the restructuring.

There is consensus that the returns that may be achieved in an out of court restructuring are often higher than those in a court restructuring. The attendant costs of a court restructuring would in any event be saved in an out of court restructuring.

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.*

Messrs S Sudarsanam and J Lai (*Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis*) identify the following forms of restructuring: managerial, operational, asset and financial.

In the scenario given, there was **managerial** restructuring in the removal of the former CFO and the inclusion of the CRO. The former CFO had to take responsibility for the unreliability of the financial information given to the creditors. He was also the recipient of unjustifiable management bonuses in circumstances where the performance of the group was dismal. Whilst the CEO takes less responsibility for the poor financial reporting, he cannot be said to be absolved of it and he equally partook in the unjustifiable management bonuses. There is no mention of these bonuses being returned to the company after the true financial performance came to light. This may indicate a lack of solidarity with the stakeholders of the company. A question arises as to whether the CEO should also have been removed from his position.

There was **operational** restructuring through the price increases for the products as the former prices had been too low. Other operational changes included spending cuts such as cuts on labour cost.

There was attempted **asset** restructuring through the sales of shares of companies in non-Benelux countries as well as the sale of some foreign branches.

There was attempted **financial** restructuring in terming-out the repayment of the working capital loan and postponing the repayment of the refinancing of other loans. The bank creditors took a haircut for default interest and agreed to waive breaches for other contractual obligations. The shareholder had also then proposed to inject at least € 27.5 million into the company.

Prof Jan Adrianasse and Mr Hans Kuijl (*Resolving Financial Distress*) broadly categorize the forms of restructuring into business and financial restructuring but the former encapsulates managerial, operational and asset restructuring as is clear from the steps in each phase of the business restructuring described in the paper.

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?*

Banks C and D could simply have been frustrated by the unreliability of the information they have been given.

However, it is also possible (and its something alluded to in the scenario) that they chose to depart from taking a common stance with Banks A and B to put pressure on the company to take action. This happened when the standstill agreement was being negotiated. Inasmuch as this may have the effect of reducing the banks' negotiating power towards the company, it also puts pressure on the company to take more meaningful steps towards restructuring since without the benefit of the standstill agreement, any of the banks may decide to enforce security or take legal action. This in turn may have the effect of compelling the other banks to do likewise.

Alternatively, it is possible that the stance of Banks C and D is to secure preferential treatment for themselves as creditors. However, this would be unwise since such preferential treatment may be eventually unwound under the insolvency laws of many legal systems.

As an advisor to Banks A and B, the best course of action would be for these banks to persuade Banks C and D to see that a common position would likely yield more benefit to all the banks if the company is capable of being restructured. If it is not, any advantages that Banks C and D may get are at best marginal and at worst illusory. Banks typically understand that by breaking ranks they are creating a situation for themselves where they may find difficulty in eliciting cooperation for future restructurings. This is perhaps a point that the advisor to Banks A and B should be making clear to Banks C and D (albeit in the right way).

5. *Which of the eight principles of the 'Statement of Principles for a Global Approach to Multi-Creditor Workouts II' can be found in the workout process of Flow Management (explicit or implicit)?*

I think we see at least the 1st, 2nd, 4th, 5th and 6th principles at play in the scenario provided.

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?*

The fact that unsecured debt ranks *pari passu* means that the recovery of all unsecured creditors are similarly subject to the extent of the success of the restructuring. This is a key premise to

persuade unsecured creditors to act in a collective fashion and to explore better-than-liquidation restructuring scenarios.

In an Asian context, there is often a desire for collaboration rather than competition. This was underscored by how failed restructurings arising from the Asian Financial Crisis was attributable to non-cooperative attitude amongst creditors. The bank lenders have at least understood that such non-cooperative attitudes are ultimately unhelpful and generally seek to cooperate in restructurings.

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

Except for the aberrational performance in 2013, the main subsidiary, which is Flow Management Work BV, appears to be profitable or at least capable of returning to profitability. Its performance is however down by that of the other (foreign) subsidiaries.

The 4 July 2015 Restructuring Agreement (the "RA") allows the Banks which have extended working capital and other loans to Flow Management Work BV to partake in its future profitability (through an equity stake in Flow Management II BV). The chances of such profitability are boosted by the fact that some of the working capital loans provided by the Banks will be waived. The Banks will continue to have a claim for € 240 million against to Flow Management Work BV which will ensure that the Banks will be paid ahead of shareholders for some part of the original debt if things do not work out.

The other Banks will also share in the performance of the other operating subsidiaries which also hived off into the new company.

The CRO will be incentivised to make a success of the restructuring since he too receives an equity stake in the new company.

It is stated that the holders of the pledged assets being the financiers who provided the original working capital loans will receive part of the claim on liquidation whereas the other financiers with no security rights or subordinated security rights will receive nothing will get nothing on liquidation. This is an equitable reflection of the relative position of these financiers and as such will not operate as an obstacle to the restructuring.

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

In a liquidation scenario, there will be a need to get the liquidators appointed by the Dutch Court to be recognised in the jurisdictions in which the foreign subsidiaries operate. This may not be a smooth-sailing process since the Netherlands is not a Model Law country and recognition of the liquidators may prove problematic outside of the EU. Fresh liquidation processes may need to be commenced which will lead to increased costs and a delay in the commencement of the overall liquidation process.

Some of the creditors had pledges over assets which had legal issues. These appeared to have been addressed subsequently. In a liquidation scenario, the addressing of such security issues prior to liquidation but when the company was already insolvent may raise potential arguments

of unfair preferential treatment of these creditors (although it can be argued that the intent of the company must have been to grant legally enforceable pledges when the company was solvent and this did not change when the pledges are perfected in the company's insolvency).

These complexities to the liquidation of the company and the length of time it entails may make an out-of-court restructuring the preferred option. Further, the eventual restructuring envisages that the operating subsidiaries will be transferred to a new entity. This avoids issues of employment law that may arise in different legal systems.

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

In Singapore a moratorium may be applied for under sections 64 and 65 of the Insolvency Restructuring and Dissolution Act ("IRDA") which came into effect on 30 July 2020. The moratorium under section 64 is invoked where "a company proposes, or intends to propose, a compromise or an arrangement between the company and its creditors or any class of those creditors". Section 65 gives the Court power to extend the moratorium to a subsidiary of holding company.

The Court's power to grant the moratorium has been described by the Court as "*an extraordinary relief holding in abeyance the enforcement of the legitimate rights of creditors against the company that is seeking to restructure*". (*Re Zipmex(HC)* at [44])

The application for a moratorium may be made even if the company then does not have a concrete proposal for a compromise or arrangement and is simply exploring the possibility of such compromise or arrangement. The substantive test for whether a moratorium should be granted is whether, on a broad assessment, there is a reasonable prospect of the proposed or intended compromise or arrangement working and being acceptable to the general run of creditors (*IM Skaugen* at [57]; *Re Zipmex (HC)* at [7]). In order that a court can make this broad assessment, a moratorium application must contain sufficient particulars (*Pathfinder Strategic Credit (CA)* at [48]).

In Singapore, a moratorium thus entails a public filing with particulars which will have to disclose the dire financial position of the company alongside potentially confidential information regarding the company's operations (to explain why it can be restructured). Although some of this information may be sealed in the Court file and therefore closed from public inspection, the body of creditors or at least the key creditors will have access to the same. There will be a possibility of such information being leaked which will be a strong disincentive against making such an application.

Even if such leaks do not happen, the fact that the company has filed for a moratorium will be known to the public at large and will be inimical to the generation of new business and possibly the continuation of existing ones. This will destroy the value of the company's businesses. Therefore, the option of applying for a moratorium (with its attendant benefits) should only be resorted to when there is reasonable confidence of a turnaround that will restore the company's business.

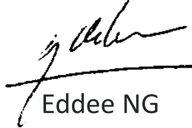
Given this, other options are often preferred.

The option of selling Flow Management Holding BV will mean that the recovery for the bank creditors will be pegged to the value the company can fetch after a few years of dismal performance. Added to this is that a buyer maybe suspicious of the financial data and seek to discount the price further.

The option of a debt equity swap if chosen will mean the bank creditors will be locked into the company as shareholders and their recovery will be depend on how the company will perform which was then highly uncertain. They will also rank subordinate to all the debt of the company which means they are giving up priority vis-à-vis other creditors.

This leaves the option the creditors eventually embarked on. This is a standstill for restructuring or a refinancing of the debts with repayment dates pushed out. This alleviates pressure on the company and makes it possible for an equity investor to come in. the deal for the investor is sweetened by the fact that he/she/it will enjoy Banks' security rights over some of the assets of the company.

Regards



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