Case Study I – INSOL Global Insolvency Practice Course

Candidate: Will Paterson

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?**

Causes of Flow’s Financial Distress

Financial distress is often the result of the interaction between external and organizational (internal) factors. To answer this question, I will use the integrative framework of determinants of organizational failure set out by Mellahi & Wilkinson.[[1]](#footnote-1) From the case study, in my opinion, the main causes of financial distress at Flow Management (Flow) are organizational factors. Although external factors (i.e., environmental, or ecological) could have played a role, they are not addressed substantively in the case study. Further, the case study states that there is market demand and the forecast for “hiring and leasing days” is accurate. If we had more information about the environmental and ecological factors, they could have been integrated into the organizational assessment made below.

First is the issue of good financial and operational processes. Management was unable to correctly report profits due to several very problematic occurrences. The November 2013 meeting with the banks was prompted by a very large reduction in profits from a reported pre-tax profit in September – a discrepancy of over EUR 13 million. Concerningly, this partially stems from large management bonuses to the CEO and CFO which were “wrongfully issued” – it is dubious why bonuses were booked when the company was due for a significant loss. Did the CEO and CFO know this? Could also signal something more nefarious which should be investigated like fraud.

In addition to the issue with the bonuses, there were also faulty accounting, financial and pricing processes in place. A large contingency gain was wrongfully booked, a book profit was booked which was not realized. Further, a spreadsheet error resulted in prices being charged which were too low – there is no mention of processes in place to be able to double-check such an important calculation.

1. Groupthink

As part of the organizational factors of failure, Groupthink[[2]](#footnote-2) could have existed within the original management team which led to the initial difficulties in November 2013. If the management team (especially the CEO and CFO) had been in place for some time, they could have missed key mistakes in their reporting processes and their plan to return to profitability could have been biased with a poor search for alternatives, ignorance of outside information or being too confident in their potential for success. Similarly, other groups of stakeholders (e.g., shareholders and banks) continued to believe the forecasts of profits, which ended-up being significant losses.

1. Upper Echelon Theory

The upper echelon theory is also useful to understand the actions of key decision makers.[[3]](#footnote-3) This theory centers around the composition of top management – homogeneity and tenure. If Flow’s original CEO and CFO had been with the company for a long time and were relatively homogenous, they may have failed to diagnose the causes of failure.[[4]](#footnote-4) Long tenured managers tend to attribute failure to “external, uncontrollable and temporary causes.”[[5]](#footnote-5) They also spend less time analyzing the problems and opportunities facing them.[[6]](#footnote-6)

Flow’s management diagnosed the problem and proposed to increase prices and cut spending (mostly on labour). However, management doesn’t mention there may be problems with processes and financial controls which require urgent remedy in their initial plans. Although an accounting firm is brought in later to investigation of procedures in the company, it’s unclear whether management or the banks brought the firm in and what procedures they will investigate. After the initial changes (price increases and spending cuts) management then expects that everything else is fine and that they will be profitable in January 2014, which is certainly not the case. They are in a crisis and do not recognize it. There is no mention until later of strategic business changes (business mix) that may need to occur. This could also include streamlining the business into leasing and, if Flow was involved in other business lines, getting away from the non-core businesses of real estate, short leasing, and truck repair. These issues with the diagnosis and remedy may have amplified the initial problem leading to the future losses.

After the initial issues were discovered, there are several management changes and successions which could have contributed to future problems. Although, the evidence of problems with managerial succession is mixed,[[7]](#footnote-7) they could still have been problematic. The CFO is replaced[[8]](#footnote-8), then four months later the CEO is replaced and a few months after that a CRO is appointed. Those are very big management changes in the span of 6 months while the company is in distress. If succession occurs during a crisis (as is the case with Flow) then it more likely will have negative effect.[[9]](#footnote-9) The case study does not mention that proper succession planning was done. However, a large body of research also posits that succession can have a positive effect on performance.

1. Curse of Success

Since it seems as though the firm was successful previously (employs 3,000 people and was profitable) the curse of success could also have been an issue. This can lead to “cautious conservatism and perhaps arrogant disdain.”[[10]](#footnote-10) Management could have not seen that their routines and habits would need change to a larger degree.

1. Threat Rigidity Effect Theory

Finally, using the Mellahi & Wilkinson framework, it would be useful to examine the psychological factors which could have played a role in Flow’s problems. Issues liked to “hidden, repressed motivations, feelings and dynamics” could have played a role.[[11]](#footnote-11) While there is little information in the case about management, it’s possible that denial[[12]](#footnote-12) was a factor as large bonuses were given to the CEO and CFO when the company was likely in fact in a crisis position. They could also be denying that there are deeper structural issues with the business given the limited remedies proposed which were focused on cost-cutting.

Beyond management, the banks and shareholder could have faced the issues described above – neglecting to properly monitor the company and management. In addition, the structure of Flow may have contributed. Although not specifically stated in the case, with subsidiaries in six countries, it may be hard to keep track of their operations. Subsidiaries seem to be part of the problem, in December 2013, the foreign subsidiaries were reposed to have made a loss of EUR 6.3 million. Management’s communication with subsidiaries could have been a problem.

Could Distress Have Been Prevented?

From the information provided, it is hard to say whether the distress could have been entirely prevented, but it could have been mitigated. A quantitative analysis is not possible given the gaps in and lack of clear financial information as well as timeline. Therefore, I engage in a qualitative analysis of the facts presented in the case.

First, clearly management’s financial reporting, controls and urgency were lacking. The string of initial negative corrections and the failure to have correct pricing could likely have been prevented. Further, if the other issues with negative corrections did not occur, the bonuses should have not been given. As described above, management also comes-up with quite simple and shallow remedies to the initial financial distress. They do not address more strategic and structural issues. They believe that with those measures taken Flow will be profitable again in January 2014.

The further distress could also have been partially prevented if the banks had acted faster and in a more cooperative manner. It took the banks almost a year to sign a standstill agreement, which may have helped the restructuring occur faster. Management and the shareholders were not willing to commit themselves until the agreement is signed. In June 2014, an even larger loss is expected – the reason given is the delay in the restructuring.

1. **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*?**

Below I describe the general advantages and disadvantages of an out-of-court restructuring. These are drawn from Adriaanse & Kuijl, 2006 (pp. 145-147) and the World Bank Toolkit for Corporate Workouts[[13]](#footnote-13).

Advantages of Out-of-Court Restructuring

* **Faster:** Out-of-court restructurings (OC) often provide for a faster process, where the parties can privately agree on a restructuring without the delay that court procedures often introduce – where the process turns into a collective one. In such a case, all creditors participate, need to receive notices, organize creditors’ committees, vote, and need time to submit claims. Parties can also raise objections and have appeals heard, which often can take weeks, even months to be finalized. In an OC, the speed of restructuring is entirely in the hands of the parties involved.
* **More Flexible:** The process and remedies are entirely bespoke. The parties can determine the steps, timing, and content of the workout on their own. Formal procedures often have prescribed milestones with deadlines, minimum voting participation of creditors, and specific elements that must be addressed in a restructuring plan.
* **Confidential:** Most OCs are confidential between the parties involved. This means that all creditors do not need to be notified. The fact that the company is facing financial difficulties stays private and the wider market does not panic, potentially exacerbating the companies’ difficulties. If the fact that the company is facing difficulties becomes public, then there could be a rush to execute on collateral and customers may stop placing orders. This could contribute to a downward spiral that could lead to liquidation when the company was viable.
* **Control:** Management continues to run the company without third party control (such as judges and insolvency administrators) during an OC. The restructuring does not have to be run on a court’s timetable (often in developing countries court hearings are much delayed) and without the need for an insolvency administrator to be appointed.
* **Cost Effective:** OCs are often more cost effective for all parties. Courts require many more lawyers and other professionals to be involved. The time savings discussed above also reduces the costs – time savings may also mean that the company can get back to more productive activities sooner, which may lead to profits increasing.

Disadvantages of Out-of-Court Restructuring

* **No automatic stay protections**: In most cases, there is no statutory stay. A meaningful number of creditors will need to agree amongst themselves to a consensual standstill agreement. If they do not, there is a risk that individual creditors with security will start to enforce on collateral or commence formal insolvency proceedings. The period while the stay is negotiated may also pose a problem if creditors start taking enforcement or other action.
* **Voluntary:** Unlike formal processes where parties are obliged to participate, parties must be willing to come to the table to negotiate an OC. There is often little pressure on them at this stage, especially creditors with less to lose.
* **Communication and Coordination Issues:** Since there is no judge or insolvency administrator to organize the proceedings, good organization and communication is required between the parties. It may be a significant challenge to organize the parties in a way where trust is developed, and communication open enough for a private arrangement to be agreed.
* **Potential Holdouts:** No cram down is provided for, so a creditor may holdout for better terms. Further, some creditors may holdout and if a fundamental change in the structure of the company’s debt is required, it may not be possible without almost all creditors taking part.
* **Voiding Upon Formal Filing:** National insolvency laws may cancel the additional security, preferences or debt haircuts if entered during a period prior to the insolvency filing. Some countries have strict requirements for directors or management to file for formal insolvency if the company is insolvent – they could face penalties upon formal filing.

Apart from the general advantages and disadvantages of an OC described above, in countries I am currently working in (Rwanda, Cabo Verde) there are a few specific issues.

* **Management stays in place:** in Rwanda, management is replaced in a formal proceeding. An insolvency administrator is appointed to restructure the company – this includes communication with creditors, advising on viability, even drafting the restructuring plan.
* **Predictability:** in many developing countries, taking a procedure to court means that there will likely be significant delays because courts are overloaded and there will be less predictability of outcome. Judges and others often do not have specialized insolvency training, and this can lead one judge to decide something that is very different to another judge.

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.**

Some of the turnaround/reorganization approaches presented in the reading materials were present in this case, while others were not. Below I examine the approaches in each of the reading materials and explain how they were applied as well as what could have been done differently.

1. Processes of Successful Informal Reorganizations

Adriaanse & Kuijl, 2006 states that an informal reorganization mostly consists of two processes: (i) business and (ii) financial restructuring.[[14]](#footnote-14) Each process will be analyzed through the facts in the case. Business restructuring has four phases, which frequently overlap: (i) stabilizing; (ii) analyzing; (iii) repositioning; (iv) reinforcing.[[15]](#footnote-15)

Stabilizing is aimed at actions which increase cash flow and allow for breathing room. In the Flow case study, proposals were presented to increase cash flow such as increasing prices, spending cuts, and selling cars. While the first two proposals were starting to be implemented in December 2013, in June 2014 they still seem to have not been fully implemented. It’s not clear how much this assisted in a short-term increase of cash flow.

Analyzing is the next phase where the company examines its long-term viability.[[16]](#footnote-16) In this phase, the contents of the reorganization plan and measures to restore long-term profitability are central. This includes examining the causes for the financial distress, the actual financial position, proposed measures to remedy the situation and cash flow projections. A turnaround expert is often hired in this process.[[17]](#footnote-17) Flow did some of these things: it looked at the causes of the loses (although some are not fully explained like the large management bonuses), hired an accounting firm to investigate the procedures as well as an independent turnaround consultancy (and eventually a Chief Restructuring Officer). Flow proposed measures to remedy the situation, including employee redundancies (although, it is not noted whether they are excess employees), increasing prices, improved loss recovery. However, strategic business changes seem to be missing from the reorganization plans all along. For example, while Flow mentions they will investigate the entire product-range, this does not appear to be followed through with in the October 2014 scenarios or the final Restructuring Agreement. Further, improving management information systems is “expected” but figures keep changing throughout the process – it is not clear whether these important elements will be part of the Restructuring Agreement.

Repositioning is the next phase, which is the time when management initiates the reorganization and recover value.[[18]](#footnote-18) After the Reorganization Agreement is signed, it appears that Flow’s management (now as Flow II) is still struggling – forecasts are still very weak – the estimated break-even result has been revised to a loss of EUR 9 million. This would do little to restore the confidence of creditors and investors. Open and timely communication, so important to success,[[19]](#footnote-19) seem to be lacking. The last phase, reinforcing, includes increasing the balance sheet of the company, transfer to a healthy company and management changes. While proposals are made by the shareholder throughout to contribute more money, they do not seem to have materialized except for the EUR 10 million at the start. Other capital injections are not forthcoming. Flow does make management changes throughout the process leading to the final Restructuring Agreement: the CFO and CEO are replaced and a CRO is brought onboard. Finally, as part of the Restructuring Agreement, a new (presumably healthy) shell company Flow Management II BV is created.

The second process discussed by Adriaanse, financial restructuring, is done to some extent in the Restructuring Agreement. For example, Banks C & D write off their entire debt against Flow Management Work BV and the consortium who provided working capital waive EUR 97.5 million, a EUR 55 million loan in Flow Management Work BV is also cancelled. The Banks will receive shares in the new Flow Management II BV. However, it does not appear as though other financial restructuring has occurred – there is no mention of reducing interest obligations, deferring payments. In particular, the EUR 240 capital claim against Flow Management Work BV remains. This may have been one of the reasons why in May 2016 Flow II incurs an operational loss.

The two processes are more successful when certain factors are also present.[[20]](#footnote-20)For example, an active attitude by management and shareholders. Flow’s management were somewhat active in that the creditor banks were invited to a meeting in November 2013 to discuss the financial difficulties that Flow was having. The creditors didn’t seem to know about the financial difficulties prior to this meeting. Although, it is unclear when management knew about the loss due to the factors in the case study. Further, management kept revising its financial outlook downwards over the course of the reorganization, which points to perhaps management not being as actively involved in the business or financials. The shareholders are not mentioned as taking many active steps until January 2014 when the shareholder announces she will decide about the strategy of Flow. The shareholder does then get more involved in the restructuring.

However, both management and especially the shareholder could have been more active earlier in the process. As Adriaanse notes, successful informal reorganizations are often due to “the company [being] able to reorganize its business operations quickly and adequately and, thereby, to restore profitability.”[[21]](#footnote-21) Lastly, there seems to be little injection of risk-bearing capital in the restructuring.

1. Strategic Investments and Innovation in the Recovery of Distressed Firms

Sudarsanam, S, Lai, J., 2001 **(**Sudarsanam) argues that firms who recover after financial distress implement strategies over time that are more growth-oriented and external market focused. Firms who do not recover engage in more internally focused firefighting strategies.[[22]](#footnote-22) Specifically, firms who recover generally engage in more capital expenditure, asset sales and acquisition activities one and two years after the distress is discovered than firms who do not recover.[[23]](#footnote-23) The asset sales of firms who are saved tend to be more part of a “strategic refocusing of their asset and business portfolio.”[[24]](#footnote-24) In the case study, we have a description of restructuring activities over time from November 2013 (the start of the distressed year) to May 2016 when Flow II is operational. Most of those activities, even after year one, are primarily operational (e.g., staff cuts, price increases, savings) and debt-related (e.g., the write offs/haircuts in the Restructuring Agreement) than growth-oriented and market focused. Although the case mentions that Flow expects its information management system to improve and that it is evaluating its business mix, there is no further mention of more asset investment type activities. For example, Flow could have investigated if there were better ways of managing its inventory of cars and trucks – perhaps with some better computerized process. Acquisitions could also have been explored to improve growth prospects.[[25]](#footnote-25)

Building upon Sudarsanam, Schmitt, A., Raisch, S., 2013 (Schmitt)’s approach shows that successful turnarounds exploit the duality between efficiency-oriented (retrenchment) and innovation-stimulating (recovery) activities.[[26]](#footnote-26) Retrenchment activities are meant to “reduce assets and/or improve operational efficiency to increase firm profitability and strengthen the firm’s industry position.”[[27]](#footnote-27) Recovery actions are “strategic changes that transform and reposition the firm for sustained growth and profitability.”[[28]](#footnote-28) Recovery is also an important method to allocate scarce resources during the initial stage of a rescue.[[29]](#footnote-29) Stakeholders may also be more likely to support short-term retrenchment arrangements if they believe that there are good prospects for long-term recovery.[[30]](#footnote-30) Schmitt argues that how the two forces are interrelated affects turnaround performance.[[31]](#footnote-31)

In the case of Flow, when the initial financial difficulty is discovered, most of the activities described are related to retrenchment. For example, ideas for change include employee layoffs, extra savings, and price increases. Not until about six months into the crisis is there a mention of more recovery related activities, such as evaluating the business mix. The June 2014 proposal by the shareholder is almost exclusively recovery oriented. Even the final Restructuring Agreement does not describe recovery actions beyond some basic structural changes. Although, the turnaround experts thought that the company is viable, it may have been good for Flow to review and provide more detailed plans about its proposals with respect to market penetration, products provided, entry into other markets (or countries), and strategic acquisitions.[[32]](#footnote-32) If Flow had engaged in more recovery activities earlier on, the banks and other creditors may have had more confidence in the company and the turnaround happened more efficiently and effectively.

1. Importance of Stakeholder Influence in Successful Reorganizations

Pajunen, 2006 (Pajunen)’s approach to reorganization is through the lens of stakeholder influences. A model is proposed that examines stakeholders through direct resource dependence and structure-based forms of power.[[33]](#footnote-33) Pajunen posits that the “survival of organizations is seen as dependent on their ability to acquire and maintain resources”[[34]](#footnote-34) and that a model for stakeholders “becomes an essential function for an organization in crisis.”[[35]](#footnote-35) Further, Pajunen shows how the influence of stakeholders may change during decline and turnaround.[[36]](#footnote-36) Finally, the paper draws six propositions summarizing stakeholder management in organizational survival.[[37]](#footnote-37)

The case does not detail what kind of stakeholder analysis the parties did of Flow. However, the main stakeholder discussions in the case seem to be with those which it had the most direct resource dependence – mainly the banks, who provided the working capital which seemed necessary for the survival of Flow. However, there could be other governing stakeholders, especially of the other subsidiaries, which were not discussed. The network perspective, which defines the structure-based analysis of stakeholders, does not seem to have been conducted.

Next, I examine if Flow followed Pajunen’s six propositions. The first two propositions involve the continuing support of governing stakeholders and the importance of communication in organizational survival.[[38]](#footnote-38) Continual, open, active communication with governing stakeholders has a positive effect on survival.[[39]](#footnote-39) In the case of Flow, although there was some degree of communication with the banks and shareholders, there likely could be much more. For example, in the many cases where forecasts had to be revised, it seemed like a surprise to the creditors – sometimes announced by press release. This information could have been communicated to them at a much earlier point in time. Further, there does not seem to be much communication with other important stakeholders such as suppliers and employees.

The third proposition is that personal relationships will help promote trust.[[40]](#footnote-40) In this regard, the case study intimates that the appointed CRO may have an existing relationship with Bank A which may increase trust. The fourth proposition is that management having an unlocked brokerage position with governing stakeholders enhances the chances to organizational survival. In the case, there seemed to be problems with the CFO and eventually CEO – they could have been hiding losses – replacing them seems to have increased trust from the governing stakeholders. Consensus on long-term goals among governing stakeholders is the fifth proposition.[[41]](#footnote-41) The goals of the governing stakeholders in the case were not that clear. For example, Banks C & D were often not cooperative, and many different scenarios were drawn-up (ranging from liquidation to a going concern sale) the long-term goal of the stakeholders did not seem aligned until the end. If they had met and aligned the goal earlier to, for example, improve the firms’ performance to get back to solvency and then sell the firm as a going concern this may have improved the restructuring.

Lastly, proposition six is that the governing shareholders’ association of management with good performance increases the probability of success.[[42]](#footnote-42) New management of Flow was brought in – CFO, CEO and CRO – which likely reset the relationship with the governing stakeholders to some degree. The banks note that though they were happy with the new management, they were still not happy with the constant change in information. For example, a few months before, another large loss (EUR 27.5 million) was expected instead of the earlier announcement of a smaller loss, or even a profit.

1. Independent Valuation and Strategy Consultants Minimize Disputes

Adriaanse, Broekema, 2022 (Adriaanse & Broekema) discusses the problems that valuation ambiguities and subsequent disputes pose to an efficient informal restructuring process.[[43]](#footnote-43) This is discussed in the context of the European Directive on Preventive Restructuring Frameworks and insights from the Netherlands. The article suggests appointing fully independent valuators and strategy consultants early in the turnaround process.[[44]](#footnote-44) In the Flow case study, several independent experts are appointed: (i) an accounting firm to investigate procedures within the company and (ii) an independent turnaround consultancy to review viability. However, it is not clear if the turnaround consultancy was a valuation expert or strategy consultant. Given Adriaanse & Broekema’s paper, it may have improved key stakeholders trust in the restructuring plan and path forward if a more thorough valuation and strategy analysis was conducted. Stakeholder consultations on the results of such an analysis may have also improved trust.[[45]](#footnote-45) These actions may have encouraged the banks to act more decisively and led to less losses.

1. **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?**

In February 2014, Banks C & D (CD) suddenly stop cooperating in the standstill agreement process. My answer below explores why that could be and what I would have done as an advisor to Banks A & B (AB).

Why Banks C and D Seem to Frustrate Process?

* **Buyout:** Opportunistically, CD may think they may recover more (or at least with more certainty) if they let AB or others buy them out. The case study discusses this possibility, although it is unclear if CD knew about this. If they did know about it, CD could also want to see if they can get a lower discount than 15-20%. Further, if CD’s estimation is that the company may end-up in liquidation and that they may not recover much (could be even zero), they may want to play into this proposal.
* **Holdout for Better Terms on Restructuring:** CD may want to work behind the scenes to negotiate better terms for their recovery during the restructuring. By holding out they may be able to recover more in the eventual Restructuring Agreement.
* **Information asymmetry**: AB may have more information or confidence in management.

The CRO appointment is instigated by Bank A. It’s likely that Bank A knows the CRO personally and may have more confidence in that person. CD may also be waiting for their own independent advisors to examine the financial and business situation of Flow.

* **Signal Frustration and Exert Pressure**: CD has a lack of confidence in Flow Management company, and they also threaten to cancel their credit (as a signal to hurry up). This could be a signal to the other parties that they are frustrated and need everyone to act faster. They are also demonstrating their power in the process.
* **Confidence in security:** there were problems with the securities (pledges) that the banks took. It is possible that CD may have better security than AB and be more confident in their ability to realize the security. The underlying security may have also appreciated in value or have a more liquid market than the security of AB.

What would you have done as advisor to AB?

* **Improve Communication:** Increase communication with CD and their advisors to try to understand the underlying reasons why they do not want to cooperate. Frequent meetings with CD, shareholders and management are perhaps required. Press releases from Flow management do not seem to be the best way to build confidence of the creditors.
* **Develop a more transparent method of valuation and strategic options**: As Adriaanse, Broekema, 2022 state, a jointly supported business valuation may decrease disputes. Introducing an open process for valuation and business strategy review may help CD understand that they will recover more through a restructuring and bring them back to the table.
* **Investigate alternatives:** See if a restructuring could be completed without the participation of CD. It’s possible that if AB have much larger claims (and would be controlling creditors), they could complete the restructuring without them.
* **Offer to buy them out:** This is already discussed in the case. If enough intelligence is obtained about the potential recovery that CD could receive in the event of a liquidation, that could inform a buy out by AB which may be cost effective if a successful turnaround can take place.

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)?**

The following elements of the eight principles can be found in the workout process of Flow Management.

1. First Principle

The First Principle regarding cooperation and a standstill period appears to be part of the workout process in Flow, although in several ways some of the parties seemed to not have acted in accordance with good practice outlined in the INSOL Statement of Principles II (Principles) Commentary (Commentary). The main creditors discussed in the case are Banks A, B, C, and D (Banks), who are the focus of the standstill discussions. The approach outlined in the Commentary notes that parties should “identify the classes of creditors which need to be included in the process…then decide which creditors in the affected classes are to be included.”[[46]](#footnote-46) It may be that there are other creditors (especially financial creditors, but also perhaps major customers, suppliers, etc.) who are needed to achieve the restructuring objective, but they are not discussed.

The Banks appear to be willing to cooperate, at least to some degree, at the beginning. For example, they agree to meet a few weeks after the problem comes to light. This cooperation may amount to an informal implicit standstill period. The Banks agree that “legal action will not yet be taken” pending the report of the consultant and that “action must be taken jointly and in a controlled manner.” Which can be seen as giving time to the debtor without enforcement or other action being taken. The Commentary states that “any arrangement under which the debtor is given a temporary breathing space in which information can be gathered…should be treated as a standstill”.[[47]](#footnote-47) However, such an arrangement seems informal, and the terms unclear since the case does not state that it is in writing, a finite duration time is not mentioned, no covenants or warranties are discussed, and default interest is charged.

During the informal standstill, while there is a process to come to a formal agreement over a standstill which begins in February 2014, Banks C and D suddenly stop cooperating. By the target date (end-March 2014), no standstill agreement has been signed. The main reason is that the banks (Banks C and D even more so) lack confidence in the Flow Management Company. After quite some time, a change in management and appointment of a CRO, the banks agree on a 120-day standstill agreement in August 2014 – approximately five months after the target date. That is eight months after the initial problems were reported to the banks in November 2013. This then allows room for the scenarios to be drawn up in October 2014 and the July 2015 restructuring plan to be signed. The parties do not seem to have followed the Commentary which states that “most importantly, time is crucial in rescues and workouts.”[[48]](#footnote-48) Eight months to agree a formal standstill agreement seems excessive and potentially damaging. The CRO states that the June 2014 larger loss is due to “delay in the reorganization to be carried out.”

No Standstill Commencement Date is discussed in the case. We can presume that the formal Standstill Agreement operates from mid-August 2014, but that is not explicit.

Finally, as noted above, the formal standstill duration is 120-days or roughly four months. The duration seems a bit long, although it is hard to tell what a reasonable length should be given the complexity of the subsidiaries. The duration ends up being enough time for the four scenarios to be drafted. However, it does not cover the almost year it takes to sign the Restructuring Agreement. There is no mention of an extension of the standstill period. The Standstill Agreement may have also benefited from a clause outlining under which conditions a premature termination would be warranted – this may have eased some of the concerns of Banks C and D and allowed the agreement to be signed faster.

1. Second Principle

If we can construe that the statements made by the Banks early in the process are an informal standstill period, then the banks do take some actions which are not compliant with the Second Principle. In fact, before the formal standstill agreement is signed several actions are taken which go against this principle. For example, Banks C and D threaten to cancel their credit, and default interest is charged – this does not allow for breathing room. During this informal standstill, apart from the Banks’ statements, there appear to be no formal undertakings by the creditors to not press for repayment, not try to improve their individual positions or enforce security or to continue to allow utilization of credit facilities during the standstill period.

We have no concrete information about what is contained in the formal standstill agreement signed in August 2014. Good practice provides that such an agreement should have included undertakings not to press for repayment, try to improve creditors’ individual positions and to continue to allow utilization of credit lines and facilities, there is no information in the case that suggests that the creditors took steps to enforce their claims. Although, it is noted that before the Restructuring Agreement is signed, EUR 25 million is repaid to providers of additional working capital. It is unclear if that is all the creditors involved. There is also no information in the case about the creditors identifying actual or perceived conflicts of interest.

1. Third Principle

The debtor should also not take action which might adversely affect the prospective return to relevant creditors. After the informal standstill, the shareholder lends the company EUR 10 million. It is unclear whether this is agreed with the other creditors and could be problematic. The debtor also makes a series of announcements about increased losses via press release after the informal and formal standstills are agreed. Again, it is not clear whether the creditors are aware that these announcements will be made beforehand – but they do seem surprised about the constant changing information.

1. Fourth Principle

Although the Banks seem somewhat coordinated (see answer in First Principle), it is not clear whether a coordinator has been appointed or a coordination committee has been created. If there are not many more creditors, it may be too much trouble to have a committee. However, a coordinator could assist in gathering information and sharing it with the other creditors. It could be that Bank A acts partially as a coordinator because the case states that they instigate the appointment of the CRO. Lastly, an independent turnaround consultancy agency is appointed in late 2013 to provide a report on whether the company is viable – it is not clear whether the Banks have appointed them and if they report to everyone or to an individual party.

1. Fifth Principle

There does not seem to be any formal process with creditors’ access to information about the debtor. However, there is an issue with the accuracy of information provided by the company to the creditors prior to the formal standstill agreement. In August 2014, the banks state that they “are not happy with the constant changing information given by the company.” This continues after the standstill agreement is signed in October 2014, as losses continue to rise the forecasts still seem to be inaccurate. The final report of the turnaround company is also not mentioned in the case study – it is unclear whether the information was provided to the banks to have their own advisors review it. Lastly, the press releases discussed above also seem problematic in that information about the state of the company seems to be communicated via press release. It is not clear whether the banks are informed before the press releases are sent out.

1. Sixth Principle

There is no explicit information in the case as to whether the proposals for resolving the financial difficulties of the debtor reflect applicable law or the relative positions of the relevant creditors. Nor is there information on the insolvency models the Commentary discusses used by the turnaround consultancy to determine viability or how it is determined that a liquidation scenario will likely have low proceeds. However, these could still be issues with applicable law given the many subsidiaries in other countries. The laws in each country could treat the standstill period and agreement differently. For example, there could be problems with enforcement in another jurisdiction. Lastly, determining the insolvency models may be challenging given the issues with the validity of the banks’ security (pledges) and the ever-changing information. Accounting assumptions and practices could also be different in the other countries.

1. Seventh Principle

There is an issue about whether the information about the unexpected or more severe losses needs to be made public through press releases or if this should remain confidential. There is no mention of a formal confidentiality agreement being entered into either, which is recommended in the Commentary.[[49]](#footnote-49)

As discussed above, there are issues with the quality of information provided to the creditors. As discussed above, profit / loss estimates keep changing even after the standstill agreement is signed. However, it seems that all the relevant creditors in the standstill receive the same information which is recommended in the Commentary.[[50]](#footnote-50)

1. Eighth Principle

The only party mentioned who is willing to provide new money during the informal and formal standstill is the shareholder of Flow Management Holding BV. The loan is provided on an unsecured basis with interest obligations being added to the principal sum of the loan. No information about priority is provide but given that it is provided on an unsecured basis from the shareholder, it likely does not have any priority over the existing debt which has security attached to it.

1. **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?**

Soft law, like the INSOL Statement of Principles, can be defined as “legally non-binding texts, often originat[ing] from so-called standard-setting organisations.”[[51]](#footnote-51) This includes the insolvency-related texts from the two international standard setters for insolvency and creditor/debtor regimes (as designated by the Financial Stability Board[[52]](#footnote-52)): United Nations Commission on International Trade Law (UNCITRAL)[[53]](#footnote-53) and the World Bank[[54]](#footnote-54), as well as insolvency practitioners’ organisations, such as INSOL International, INSOL Europe and the International Insolvency Institute.

Given that I work in many jurisdictions, I do not have a specific country or region. However, there are examples of other soft law available in other regions. For example, if the parties were in Asia, they may consider adopting the *Asian Principles of Business Restructuring* (Asian Principles), which also comes with a Guide. The Asian Principles and Guide are a joint project by the International Insolvency Institute and the Asian Business Law Institute. These are a set of nine out-of-court consensual principles which can help parties conduct a multi-creditor workout in Asia. The Asian Principles and Guide contain elements which are specific to Asia’s cultural characteristics and is a more detailed than the INSOL Principles and Commentary. Parties may want to adopt soft law which is more suited to their region – including cultural considerations and legal traditions.

Another alternative in some of the Sub-Saharan African jurisdictions I work in, and many other regions, is to use mediators and conciliators to come to a restructuring agreement and resolve debt. Some methods are informal and other hybrid, with some court involvement. The World Bank’s Principles section on micro and small enterprise insolvency (Principle D5.4) advocates for legal systems to provide for mediation, conciliation, and other alternative dispute resolution techniques. Cabo Verde’s Insolvency Law provides the framework for an out-of-court confidential mediation procedure.[[55]](#footnote-55) It is mostly informal and flexible but does have certain prescribed elements in the law. This include general principles for how the mediation sessions will run, how the process is closed and the potential for the court intervention if there are problems. Mediation is useful to bring the parties together in a neutral setting with an independent referee. Mediators in an insolvency situation should have specialized training in both mediation and insolvency concepts to be effective.

A more hybrid approach is found in the Organization for the Harmonization of Business Law in Africa (OHADA), which has a relatively new Uniform Act on Insolvency which includes a conciliation technique similar to the French procedure. This procedure is confidential and voluntary, but the final settlement agreement must be approved by a notary public or the court.[[56]](#footnote-56) The conciliator plays a similar role as a mediator.

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

The result and effect of the restructuring agreement signed on 4 July 2015 is somewhat unclear. However, I will break down what we know and what we don’t know below.

A new shell subsidiary (presumably of Lease Group Holding United Kingdom Ltd.) called Flow Management II BV (Flow II) is created and all operating companies of Flow Management Holding BV (Flow) are accommodated in it. This could mean that the six subsidiary companies in different jurisdictions originally under Flow are transferred (if this is what “accommodated” means) to Flow II. Whether they are somehow absorbed into Flow II or remain subsidiary companies of Flow II is an unanswered question. I assume they remain subsidiaries of Flow II, as in the original structure.

Next, the shares in Flow II are transferred to Banks A, B, C and D (Banks) as well as to some of the board members. No information about the share split between the Banks and the board members is provided. Therefore, who ultimately controls Flow II is not known. However, an equity stake would give the Banks some control or influence over the operations of Flow II as direct equity holders instead of just debt holders. The reason for the transfer of the shares is not clear, but it would likely be in exchange for something. Although not stated in the case, this could have been a debt-to-equity swap. In that scenario, the claims against Flow by the Banks being cancelled (discussed below) are swapped for equity. Further, the CRO could be receiving shares to entice the person to stay on.

Flow is also liquidated (although, in an undisclosed manner). All claims against Flow by the banks and the shareholder are canceled. However, it is not clear how the liquidation can take place in the middle of an informal restructuring. Opening a formal liquidation may lead to the invalidation of parts of the Restructuring Agreement and potential delays in the restructuring.

Any claims Flow and its shareholders may have against Flow II and its subsidiaries are canceled. Banks C and D, which provided Flow Management Work BV (Flow MW) with additional working capital, write off their debts (again, this could be in exchange for the shares the Banks receive). The consortium who provided Flow MW with working capital waive EUR 97.5 million. However, a EUR 240 million claim against Flow MW remains. As an original subsidiary of Flow, Flow MW has been acquired (or somehow absorbed) by Flow II. This likely means that Flow II still has this very large liability through Flow MW. The Banks therefore have both an equity stake and remaining large debt claim. Finally, the EUR 55 million loan in Flow MW is cancelled.

The Banks, as the providers of the original working capital, possess security on most assets of Flow MW and will receive part of their claim on liquidation. The subsidiaries may also be brought into the formal process, which may create cross-border issues. The other banks and shareholders have no or subordinated security rights and will (“most probably”) receive nothing from claims on liquidation. Therefore, at least the additional EUR 10 million provided by the shareholder as an unsecured loan would likely not be paid back.

The case notes that Flow II will still incur operational loses of nearly EUR 9 million in May 2015 when they expected a break-even result. This is reminiscent of all the other changes in financial results from Flow prior to the Restructuring Agreement being signed. Not good news because perhaps the company still has faulty processes and controls. Further, the actual restructuring seems to occur after May 2016, which is over a year after the Restructuring Agreement is signed. Even after the restructuring the 2016, results may be negative or just break-even.

The goal of selling Flow II as a going concern does not seem to have been achieved because of the restructuring. The talks after the restructuring with potential buyers points to the company being put into liquidation. The situation is still critical, but the parties are still – despite everything – forecasting a better future.

Given the readings in this module about successful turnarounds, it is surprising that the Restructuring Agreement seems entirely financial. There is nothing in the outline about capital expenditures, strategic business changes or acquisitions – more longer-term investments which research shows leads to a higher chance of a successful restructuring. There is also nothing of note in the Restructuring Agreement about other important stakeholders like suppliers, customers, and employees. Has there been adequate consultation and communication about the changes? There is also no mention of an implementation period in the outline of the Restructuring Agreement or any monitoring processes to give updates to the creditors and other interested parties.

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

I recognize the following legal and non-legal cross-border issues in the restructuring process:

* **The Standstill and Restructuring Agreements could possibly not be recognized in another country.** It is unclear how these agreements would be legally recognized in the subsidiaries in Spain, France, Australia, South Africa, and the USA. In addition, if the companies were to enter a formal insolvency process, the agreements may be rendered void and certain components could be reversed if they were found to be preferential or completed during the suspect period under applicable law.
* **Requirements to file for formal insolvency.** Under the other countries’ applicable laws, there could be requirement that directors of the subsidiary companies file for formal insolvency if they believe the company is insolvent under the relevant test. This may bring the subsidiary under a formal insolvency procedure while the restructuring process is ongoing and potentially greatly complicate matters. It may also expose directors of those subsidiaries to substantial financial or other penalties.
* **Structural issues in the five other countries.** The Restructuring Agreement states that the subsidiaries are “accommodated” under the new Flow II. The legal process under each subsidiary to transfer from being under the parent Flow Management Holdings BV to Flow II could be complicated and lengthy. The process of liquidating the original Flow may also be complicated because the owner is a United Kingdom-based company (Lease Group Holding).
* **International Tax**. Operating under so many different jurisdictions may mean that the effect of the restructuring could have tax implications. These could arise, for example, with respect to the tax treatment of the cancelation or haircut of debts or transfer of shares.
* **Recognition, Relief and Access in Formal Proceedings.** If there is a formal process, do the subsidiaries of the other countries have clear cross-border insolvency procedures? For example, it would be important to examine in advance whether the other countries have something like the UNCITRAL Cross-Border Insolvency Model Law (Model Law) in place. The Model Law allows for: access of a foreign insolvency representative to the courts, a simplified procedure for recognition of qualifying foreign insolvency and relief including for both main and non-main proceedings – components would be stay of actions, suspension of debtor’s rights to transfer/encumber assets. Without something akin to the Model Law, cooperation between court and foreign representatives and coordination of concurrent proceedings may be difficult, making the process uncertain, lengthy, and expensive.
* **Cultural Issues.** In terms of non-legal issues, cultural considerations should be examined. Stigma related to insolvency still exists in many countries. Further, coordination and communication amongst countries (including language issues) should be considered – what’s the best and most effective method to communicate given the goals?
* **Different Professional Standards.** Different countries also likely have differing professional standards such as accounting standards or even regulatory standards.

1. **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]**

From my understanding of the case study, the moratorium mentioned in part of scenario 4 would be to open a formal restructuring procedure under Dutch Law. Therefore, the question is why was or wasn’t calling for a formal restructuring procedure a good option given the situation. Based upon the case, this doesn’t seem to be a good option at the time for several reasons. I will also use the Rwandan Insolvency Law, 2021 to provide examples in my answer.

* **Involvement of all creditors:** since a formal restructuring is a collective procedure, all creditors must be informed of the procedure, and they are entitled to fully participate. This means that they must receive notice, file claims, vote on restructuring plans. The restructuring becomes a much larger process instead of one with select important creditors. In Flow, the Banks are those involved in the informal restructuring process. They would likely have to invite many other creditors into the process. Further, voting procedures sometimes require consent of all of the different creditor classes to pass a reorganization plan.[[57]](#footnote-57)
* **Replacement of management:** in some jurisdictions once a formal process is started, then the existing management is replaced with an insolvency administrator who takes control over the company, makes decisions about assets, communicates with parties, and even can be charged with drafting the restructuring plan.[[58]](#footnote-58) In the Flow process, they are almost at a point of deciding a restructuring agreement and they have a new management team in place. All of that may be jeopardized by a formal application.
* **Loss of control:** once the formal procedure starts, a judge and insolvency administrator are normally appointed. These parties will make decisions on timeline and fairness based upon the court’s schedule and applicable law, not the parties’ own wishes. At the beginning, the judge hears a commencement application[[59]](#footnote-59) and then sets a timetable.[[60]](#footnote-60) If the judge determines that the company is not viable, then the procedure can even be converted to a liquidation. A formal procedure can greatly reduce predictability, especially in developing countries where judges may not be as familiar with insolvency procedures.
* **Public process:** once the proceedings commence, most of the procedures are public. Normally notices are required to be public (even in newspapers[[61]](#footnote-61)). This means that suppliers, customers, and other creditors will all become aware of the financial difficulties of the company. They may stop doing business with the company, leading to even worse conditions which may prevent an effective restructuring from happening. In the case of Flow, analysis is that the company is viable, but maybe it wouldn’t be as viable if customers stop using them and their reputation is ruined.
* **Costs and time increase:** all the issues noted above increase costs and time. More professional advisors such as lawyers, accountants and valuators are normally brought into a formal insolvency process. There are also normally prescribed periods for coming to an agreement on a plan, voting and executing the plan. Parties can also appeal at any time, which could greatly delay proceedings. This all can increase the time it takes to restructure, meaning that assets may depreciate, and the environment change in the interim – leading potentially to less likely agreement on a plan. Costs also balloon with so many professionals and an extended time.
* **Probably no need for automatic stay:** formal restructuring procedures often start with an automatic time limited stay against creditor action. However, in the case, the Standstill Agreement had just been signed, which acts as a stay for the parties who signed-up.

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5. Mellahi & Wilkinson, 2004, p. 29. [↑](#footnote-ref-5)
6. Mellahi & Wilkinson, 2004, p. 29. [↑](#footnote-ref-6)
7. Mellahi & Wilkinson, 2004, p. 29. [↑](#footnote-ref-7)
8. Although, we never find out if the CFO is actually replaced or when since it is just announced that a new CFO will be appointed “soon”. [↑](#footnote-ref-8)
9. Mellahi & Wilkinson, 2004, p. 29. [↑](#footnote-ref-9)
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