**GLOBAL INSOLVENCY PRACTICE COURSE 2023/2024**

*Prof. dr. Omar Salah – Norton Rose Fulbright / Tilburg University*

**Case Study I**

Assignment questions

**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?**

Based on the available facts the financial distress at the Flow Management group (the **Flow Management Group**) may have been caused by psychological factors have caused, more in particular by managerial perception and managerial cognitions.[[1]](#footnote-1) In November 2013, when the initial signs of financial distress were disclosed to the banks of Flow Management Group, one of the causes of the initial losses was, among others, the large management bonuses (approx. € 3 million) that had been wrongfully issued to the CEO and CFO of Flow Management Holding B.V. This seems to indicate that the managing board of Flow Management Holding B.V. was under the impression that it was doing a good job and, hence, was entitled to a bonus, whilst the company was loss-making. This may have been based on preceding years’ success (as the company was making a profit of € 9.4 million in 2011), which would indeed a ‘curse of success’ whereby success could breed confidence and arrogance.[[2]](#footnote-2)

Further, irregularities and historical errors in financial accounting are also signs of to anticipate the causes of financial distress.[[3]](#footnote-3) Also, in this particular case (i) contingency gain relating to three years was wrongfully booked as a result in 2012, (ii) book profit was made in anticipation of a ’paper gain’, whilst it was not realised, and (iii) the company failed to check real costs against the results of cost price calculation and prices charged were too low. Such financial irregularities were identified too late and were not addressed properly by the managing board.

The severity of the financial distress could have potentially been prevented, if changes to the managing board would have been implemented earlier. It almost takes half a year to appoint a Chief Restructuring Officer (**CRO**), whilst if the CRO was appointed earlier on she may have been able to address the company’s weak strategic position. Instead, the existing management board tried to increase efficiency through tactical changes such as cost cutting.[[4]](#footnote-4) Based on the ‘upper echelon theory’, early turnaround attempts by a long-tenured managing board may be ineffective as managers may fail to successfully diagnose the causes of failure.[[5]](#footnote-5)

At the same time, alignment among the bank group at an earlier stage would have allowed the four banks toa address these issues more adequately as well as appoint a CRO more early in the process. The misalignment between banks A and B, on the one hand, and banks C and D, on the other hand, caused further delay and did not allow the bank group to form a strong unity towards the company. By the time, they could come to a restructuring proposal valuable time was lost. This could have been avoided as well.

**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?**

The main advantages of an out-of-court restructuring (or informal reorganization/workout) are: (i) the flexibility that comes with the process without being bound by court rules, procedures and timelines; (ii) the silence as the restructuring is not public and benefits from being kept confidential; (iii) the level of control exerted over the process; and (v) limiting costs as fees and costs incurred will generally be less than in the event of an in-court restructuring.[[6]](#footnote-6)

When compared to a formal court-driven bankruptcy process in my jurisdiction (i.e., the Netherlands), these advantages become evident. In the Netherlands, a formal bankruptcy proceeding is opened by the declaration of bankruptcy (*faillissement*) by a court order. The court appoints a bankruptcy trustee (*curator*) and supervisory judge (*rechter-commissaris*). The bankruptcy trustee is tasked with the administration and management of the bankruptcy estate of the debtor (section 68 of the Dutch Bankruptcy Act (*Faillissementswet*), the **DBA**). The process is much less flexible compared to an informal reorganization. Also, a bankruptcy proceeding is aimed at liquidation of the company instead of reorganization (although a reorganization is possible through a restart (*doorstart*) of the company).

Further, bankruptcy proceedings are public. This means that all stakeholders (e.g., creditors, employees, supplies and customers) become aware of the financial distress of the company and may terminate contracts. Certain contracts may also terminate automatically based on *ipso facto* clauses. As a result, much value will be lost in bankruptcy proceedings.

In addition, the company will lose control over the process. In bankruptcy, the company has no longer the power to dispose off its assets and has no longer the power of administration over its estate (section 23 DBA). The company can no longer trade going concern and given that the proceeding is not a debtor-in-possession proceeding, the bankruptcy trustee will be in charge. The supervisory judge will supervise the administration of the bankruptcy estate.

Finally, a bankruptcy proceeding will lead to additional costs as the costs of the salary of the bankruptcy trustee as well as experts engaged by need to be incurred as well.

**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.**

Yes, the turnaround/reorganization approached presented in the reading material was applied in this case. Initially, costs cutting was discussed. As appears from the reading materials, cutbacks in expenditure by reducing the current expenses both in the field of costs and with regard to investments is an approach to turnaround/reorganization.[[7]](#footnote-7) The managing board tried to do that in November 2013 onwards.

Further, the banks considered the options between recovery through liquidation compared to a reorganization throughout the financial restructuring in different phases. This is also evident from the reading materials. Especially, the duality between retrenchment and recovery emphasizes these elements and shows the importance as well as the tension between them.[[8]](#footnote-8)

Further, the was also an important element of ‘stakeholders influences’ as appeared from the reading materials.[[9]](#footnote-9) The banks as important stakeholders exerted influence over the process, but the shareholder did so as well by not providing equity financing too quick to give the banks an incentive to seek alignment among themselves. Also, the appointment of the CRO leads to impact and influence from external stakeholders (e.g., the lenders) on internal stakeholders (i.e., the managing board) so that was an another approach to the workout.

Finally, from the reading materials it also appears that other turnaround strategies can be used such as asset restructuring (e.g., asset sales), managerial restructuring (e.g., removal of the CEO and appointment of the CRO), and financial restructuring (e.g., debt restructuring).[[10]](#footnote-10) Also, in this specific case, eventually a hair-cut and a debt restructuring of a waiver of an amount. Also, the attempts to sell the business through an M&A process was a way to address the financial distress, but there was no appetite in the market. Further, changes to the managing board occurred through the appointment of the CRO.

**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?**

From a rational perspective, banks C and D may have lost the trust in the credibility in the company at that point in time. The financial loss was over and over again more negative than the company had forecasted. From one side, banks C and D may have felt that the company was not transparent towards the banks and wanted to draw a line in the sand. From the other side, if banks C and D felt that the company was transparent, those banks may had the impression that the company was not in control of the situation and did not want to negotiate.

From an opportunistic perspective, banks C and D may have tried to create ‘nuisance value’ by not cooperating, as that would force the other stakeholders (banks A and B, the shareholders, the company) to buy them out. That would possibly lead to an immediate prepayment, would not lead to additional cost of capital being held due to the loan being held for a long time as a non-performing loan, and not having to spent resources on the restructuring. These reasons could have been other reasons to behave in such manner.

**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)?**

The first principle was used: Although initially it took some time, eventually banks A, B, C and D entered into a standstill and co-operated with the company in financial distress. This would give sufficient (though limited) time (a “Standstill Period”) to the company for information about the company to be obtained and evaluated and for proposals for resolving the Flow Management Group’s financial difficulties to be formulated and assessed.

The second principle was used as well: Once the standstill was in place – and *de facto* even before a formal standstill was concluded – banks A, B, C and D agreed to refrain from taking any legal steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the Flow Management Group.

The third principle was respected: It seems that the Flow Management Group did not take any action that adversely affected the prospective return of outs four banks. However, the financial position of the Flow Management Group did deteriorate during this process.

The fourth principle was *not* applied: The four banks did not appoint one or some of them as a coordinating committee to discuss the restructuring with the Flow Management Group. However, the relatively small size of the bank group did not necessarily mandate this either.

The fifth principle was respected: The Flow Management Group did give the four banks access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

The sixth principle was also applied: Different proposals for resolving the financial difficulties of the Flow Management Group and arrangements between the banks relating to the standstill were implemented. These seem to reflect applicable law and the relative positions of relevant creditors at the start date of the standstill, although concrete information about this is missing.

The seventh principle was also respected: Information obtained for the purposes of the process concerning the assets, liabilities and business of the Flow Management Group and any proposals for resolving its difficulties were made available to all four banks.

The eight principle was *not* applicable: No additional funding was provided during the standstill period or under any rescue or restructuring proposals was made available from lenders. So it was not needed that the repayment of such additional funding was accorded priority status as compared to other indebtedness or claims of the four banks. The shareholder did provide funding, but those was unsecured as it often the case with shareholder loans. However, at some point in time, the shareholders did get new security rights for new rescue funding that came in which was shared by the lenders. Whilst this is not a priming of existing liens or creation of super priority, they did give security rights to the new rescue financing.

**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?**

In my jurisdiction (i.e., the Netherlands), there is no ‘soft law’ to use in restructuring situations. However, there are ‘soft law’ rules for bankruptcy trustees (*INSOLAD praktijkregels*) as well as for pre-packs (*INSOLAD praktijkregels voor beoogd curator*). However, these rules cannot be used by the four banks of the Flow Management Group. However, internationally there are other ‘soft law’ instruments. For example, the World Bank has a ‘Toolkit for Corporate Workouts’ (pleas see [World Bank Document](https://documents1.worldbank.org/curated/en/982181642007438817/pdf/A-Toolkit-for-Corporate-Workouts.pdf)). This document could have been a ‘soft law’ instrument that the four banks could have used. Para. 2.4 of the World Bank ‘Toolkit for Corporate Workouts’ provides guidance for how to agree to standstill agreements. It took the four banks quite some time to enter into the standstill agreement. However, the World Bank ‘Toolkit for Corporate Workouts’ could have been useful to reach that point earlier.

Another international ‘soft law’ instrument is the London Approach.

The London Approach (please see [The London Approach | Bank of England](https://www.bankofengland.co.uk/quarterly-bulletin/1993/q1/the-london-approach---speech-given-by-mr-pen-kent-to-the-chartered-institute-of-bankers)) was developed in the London banking market and could have been helpful for the four banks, as it takes the banks’ perspective into account. The London Approach was encouraged by the Bank of England. The Bank of England played a significant role in individual workouts and its aim was to bring negotiations to a satisfactory conclusion.

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

The restructuring agreement entered into on 4 July 2015 in essence implements a debt-for-equity swap. This appears from the following elements which I will discuss below:

1. All operating companies of Flow Management Holding B.V. are to be accommodated in a shell subsidiary, called Flow Management II B.V. This step allows to transfer all relevant assets into a separate company that will be owned by the company which is the ‘equity-side’ of the debt-for-equity swap.

2. The shares in Flow Management II B.V. are transferred to the consortium of banks (A, B, C, D) which has financed the original working capital of Flow Management Work B.V., as well as to a number of board members (including the CRO). This step completes the ‘equity-side’ of the debt-for-equity swap. The new entity that holds the relevant assets is hereby transferred to the banks and a number of board members.

3. Flow Management Holding B.V. will be liquidated in an undisclosed manner. All claims against this B.V. will be cancelled by the banks and the shareholder of Flow Management Holding B.V. This allows the entity that is left behind to be wind down in a solvent manner to clean up the remaining entity.

4. Flow Management Holding B.V. and its shareholder will cancel all claims against Flow Management II B.V. and its subsidiaries. This step is meant to ensure that no intercompany loans remain outstanding that the liquidator (*vereffenaar*) of the solvent wind down of this entity would otherwise enforce against Flow Management II B.V. Hence, it allows to clean up the claims of the remaining entity.

5. The banks (C and D) which in the past provided Flow Management Work BV with additional working capital will waive an amount of € 32.5 million. In fact, the entire debt is written off (‘haircut’). This is the ‘debt-side’ of the debt-for-equity swap. Banks C and D seem to be willing to agree to an entire debt write-off as they are receiving equity instead in Flow Management II B.V. in consideration thereof.

6. The consortium who in the past provided Flow Management Work B.V. with working capital will waive an amount of € 97.5 million. A € 240 million claim against Flow Management Work B.V. remains. Also, this step is the ‘debt-side’ of the debt-for-equity swap. Given that the consortium of banks is receiving equity instead, they write off part of the debt so that an amount of € 240 million remains outstanding only. Presumably, the initial amount of working capital was not sustainable and an outstanding amount of working capital of € 240 million is a sustainable debt level for Flow Management Work B.V. However, as appears from step 5, banks C and D are writing more debt off than the other lenders. Whilst it is not clear from the case given that the shareholding of the new shareholders of Flow Management II B.V. are not disclosed under step 2 above, one would assume that banks C and D are receiving a higher equity stake in the shares of Flow Management II B.V. compared to banks A and B.

7. The € 55 million loan in Flow Management Work B.V. is cancelled in full. This is the ‘debt-side’ of the debt-for-equity swap as well. It allows the final outstanding loan at the level of Flow Management Works B.V. to be cancelled presumably, again, in consideration for equity in Flow Management II B.V. This also allows Flow Management Work B.V. to be subsequently liquidated in a solvent manne.

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

The informal restructuring process provides flexibility and allows parties to come to agreements consensually, even though the Flow Management Holding B.V. and Flow Management Work B.V. are based in the Netherlands with other group companies are based in Spain, France, Australia, South Africa and USA whilst the shareholders are based in the UK and the USA. However, this will be more complicated in formal restructuring and insolvency proceedings. The case explains that the centre of main interest (**COMI**) of a large part of the Flow Management Group is in the Netherlands. Once a bankruptcy proceeding – or a Dutch WHOA proceeding – is opened in the Netherlands, the question arises whether such proceedings will be recognized in the other jurisdictions that are relevant. An important question is whether the insolvency proceedings will be recognized in other jurisdictions. Under the EU Insolvency Regulation (Recast), the Dutch bankruptcy proceedings will be deemed a main proceeding as the COMI of the entities is in the Netherlands. This means that the Dutch bankruptcy proceeding – as well as the public version of the WHOA proceeding which is on Annex A of the EU Insolvency Regulation (Recast) – will be recognized automatically in the EU (e.g., Spain, France). However, in other jurisdictions – as well as the private version of the WHOA proceeding in the EU as that is not on Annex A – such as Australia, South Africa and the USA the question is whether the relevant Dutch insolvency proceeding will be recognized. Given that these three countries have adopted the UNCITRAL Model Law on Cross-Border Insolvency (1997), it is likely that the Dutch insolvency proceeding will be recognized. Further, in each of these countries, possibly an insolvency professional could be appointed. It is possible that secondary proceedings will be opened in the EU countries. This could lead to additional complexities. It also requires further coordination. Finally, enforcement action in each jurisdiction requires local law expertise and analysis which makes enforcement action difficult.

**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]**

There were a couple of reasons why a moratorium (a formal suspension of payments procedure) or restart following liquidation with the company being sold in a ‘controlled’ manner was not a good option. The banks were required to provide a bridging loan. However, the banks were not willing to provide additional funding. Further, the opening of any formal insolvency proceedings would have led to loss of control to an administrator in moratorium or to a bankruptcy trustee in a bankruptcy proceeding. It would have further complicated the financial restructuring that was concluded later on 4 July 2015. Further, the tax refunds worth of €10million that was provided as additional security would have not been available in a moratorium or bankruptcy. Also, as a result of the sale of surplus assets, sufficient incoming cash flows were expected so that additional deposits seem unnecessary. However, this would have not been available either. At this stage, the banks as a group were not happy with the constantly changing information given by the Flow Management Group, but they were content about its new management and its new CRO. The four banks also noticed a slight result improvement due to the reorganisation. For those reasons, it was not the right time to enter into formal insolvency proceedings (whether moratorium or bankruptcy for purposes of restart).

1. *See* Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), p. 32. [↑](#footnote-ref-1)
2. *See* Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), p. 30. [↑](#footnote-ref-2)
3. *See* Burigo, F., Grossel, M., Lantonnois, L., Salah, O., & Tay Kang-Rui, D., (2022). A Practical Guide to Anticipating Financial Distress: Key Issues in Avoiding Liquidation and Planning for a Cross-Border Insolvency. *Norton Journal of Bankruptcy Law and Practice*, 5(3), p. 674. [↑](#footnote-ref-3)
4. *Cf.* Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), p. 29. [↑](#footnote-ref-4)
5. *See* Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), p. 28-29. [↑](#footnote-ref-5)
6. *See* Adriaanse, J.A.A., & Kuijl, J.G. (2006). Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?. *Review of Central and East European Law*, 31(2), 145-147. [↑](#footnote-ref-6)
7. *See* Adriaanse, J.A.A., & Kuijl, J.G. (2006). Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?. *Review of Central and East European Law*, 31(2), 140. [↑](#footnote-ref-7)
8. *See* Schmitt, A., Raisch, S. (2013). ‘Corporate Turnarounds: The Duality of Retrenchment and

Recovery’, *Journal of Management Studies*, 50(7) p. 1219-1220. [↑](#footnote-ref-8)
9. *See* Pajunen, K. (2006). Stakeholder Influences in Organizational Survival. *Journal of Management*

*Studies*, 43(6), p. 1272-1275. [↑](#footnote-ref-9)
10. *See* Sudarsanam, S, Lai, J., (2001), ‘Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis’, *British Journal of Management*, Vol. 12, p. 189. [↑](#footnote-ref-10)