GIPC Case Study – Flow Management

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Question 1

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

There are a number of competing theories as to why Flow Management suffered this financial distress. *According to the pure determinists, the financial decline of a company is outside the control of management and is always due to external factors (such as conditions within the industry) over which management has very little influence.*[1]

There are two different schools of thought within this philosophy of determinism – the industrial organisation perspective and the organisational ecology perspective. The first is based on three key propositions – namely that: (1) there are external pressures on restrictions placed on a firm in the industry in which it operates, (2) the strategies adopted by firms within the same industry are similar; and (3) management at all firms are presumed rational and to operate within the firm's best interests.[2]

By comparison, organisational ecology is premised on the theory that the success or failure of a firm is dependent on four factors: population density (that is, an over-crowded market place intensifies competition which leads to a higher mortality rate)[3], industry life cycle (all industries go through life cycles which model that of an individual person)[4], organisation age (older and more established firms have an advantage over newer ones)[5] and organisation size (the larger the firm, the harder it will be to fail)[6].

In sharp contract with determinism theory, proponents of the voluntaristic perspective contend that the skill and expertise of management is far more important that the external environment in which the decision is made.[7]. It would be their position that Flow Management's financial distress was directly due to management's poor performance.

Mellahi & Wilkinson adopt a more balanced and middle ground view of the reasons for the financial decline. They are of the opinion that it is a combination of external and internal factors

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[1] McGahan, A. M. And Porter, M.E. (1997). "How Much Does Industry Matter Really?' *Strategic Management Journal* 18, 15-30 [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.22]

[2] Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.23

[3] See for example, Delacroix J., Swaminathan, A. And Solt, E.M. (1989) "Density dependence versus population dynamics: an ecological study of failings in the California wine industry" *American Sociological Review,* 54, 245-262 [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.24]

[4] Agarwal, R., Echambadi, R. And Sarkar, M.B. (2002) "The conditioning effect of time on firm survival: a life cycle approach." *Academy of Management Journal*, 45, 971-994 [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.24]

[5] See for example, Barron, D. N., West, E. And Hannan, M. T. (1994) "A time to gro and a time to die: growth and mortality of credit unions in New York City 1914-1990 [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.24]

[6] See for example Barnett, W.P. And Amburgey, T.L. (1990) "Do larger organisations generate stronger competition? [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.22]

[7] [cited Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.28]

which together, produce such an outcome.[8]

I would agree with that analysis and have expanded on it below by reference to the facts in issue.

There were a number of causes for the financial distress at Flow Management which resulted in the wrongful:

- issuance of large management bonuses (€ 3 million)
- booking of the contingency gain as a result;
- recording of an anticipated book profit as having been realised; and
- Calculation of its actual cost base.

The first of these was an umbrella issue - namely that there wasn't proper financial oversight of the company's business by management,[9] or a system in place for independent verification of the company's financial position by third parties. That this was the case was confirmed on multiple occasions between 2012 and 2016 as Flow Management was continually operating on the basis of figures and assumptions which later proved to be incorrect.

Financial oversight of the business by management and independent verification by third parties both needed to occur on a regular basis. Those failures meant that each of the contributing factors set out below were not identified.

Debt/equity ratio and low profitability
The value of the equity in the company as against the total assets was too low and put financial pressure on the company. At one point it fell to just 0.1% (which was well short of the 5% minimum threshold). This was why the banks preferred an injection of cash to help address this (instead of the sale of 350 cars which would then reduce the value of the total assets and again impair the solvency rate). On that note, it is argued by some commentators that debt should not be considered homogenous and total debt should be compared with short-term and long-term debt.[10]

In any event, given the modest margins on profitability, the financial health of the business became strained when debt levels were too great. Indeed, it has been shown that lower profitability in general increases the risk of insolvency.[11]
Insufficient levels of liquidity

The company did not have sufficient liquidity to enable it to pay its debts as they fell due. As a result, the company had to consider selling its assets (350 cars) which has a consequential and detrimental effect on future revenue given those cars could no longer produce income for the business. It has been asserted that there is a negative relationship between financial distress

[8] Mellahi, K. And Wilkinson A. "Organisational failure: a critique of recent research and a proposed integrative framework" *International Journal of Management Reviews* Volume 5/6 Issue 11 at p.34. For a further discussion on internal and external factors, and the parties' behaviours in response, see Madumere, I. and Wokeh, P. (2015), "Corporate Financial Distress and Organizational Performance: Causes, Effects and Possible Prevention", see *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2670588*; and Lopez-Gutierrez, C., Sanfilippo-Azofra, S. and Torre-Olmo, B. (2015) "Investment Decisions of Companies in Financial Distress", *BRQ Business Research Quarterly* 18, 174-187

[9] Slatter, S. and Lovett, D. "Corporate Turnaround: Managing in Distress," Middlesex: *Penguin Books*, London 1999 [cited by Michalkova, L., Adamko, P. And Misankova, M. "The Analysis of Causes of Business Financial Distress" (2018), *Advances in Economics, Business and Management Research*, Volume 56 at p.49]

[10] Upneja, A. And Dalbor, M. C. (2001). "An examination of capital structure in restaurant industry." *International Journal of Contemporary Hospitality Management*, pp. 54-59. [Cited Chan K T, Yap V C and Chai S N "Factors Affecting Financial Distress: The Case of Malaysian Public Listed Firms", *Corporate Ownership & Control* Volume 8, Issue 4, 2011 at pp.346.]

[11] Campbell, J. Y., Hilscher, J. And Szilagyi, J. (2005). "In Search of Distress Risk". [Cited Chan K T, Yap V C and Chai S N "Factors Affecting Financial Distress: The Case of Malaysian Public Listed Firms", *Corporate Ownership & Control* Volume 8, Issue 4, 2011 at pp.346.]

and liquidity.[12]

Working capital vs revenue
Another problem for Flow Management was that its working capital appeared to grow faster that its revenue (part of which was caused by a higher cost base since its actual costs were much higher than its anticipated costs). This can, and often does lead to financial distress.[13]
Having regard to the above, the following measures would have helped prevent, or at the very least, would have reduced the extent of the deterioration in the group's financial position:

- Implementing systems for accurately calculating the profitability of each of the company's service lines, especially by reference to any changing market conditions. For unprofitable services, consideration should have been given to either raising prices or dropping those particular service lines all together. Had that been done, the necessary price increases could have been effected much earlier and improved the revenue for the relevant years;
- Monitoring cash flow on a weekly basis so that the company's liquidity was better understood and where possible, improved;
- Having more regular management oversight of the company's actual costs together with proactive assessments of how to reduce them;
- Obtaining financial advice on how to best treat contingency gains as well as anticipated book profit;
- Obtaining independent verification of management's assessments of the financial position of the business on a regular basis (at least quarterly);
- Having earlier engagement with the stakeholders to ensure that any financial negotiations/capital raises are done in an orderly manner without the economic or time pressure from disgruntled creditors.

Question 2
What are in general advantages and disadvantages of an out-of-court restructuring (workout) as compared to a formal bankruptcy procedure? More specific, what are the advantages versus disadvantages in your country?

Advantages
There are a number of advantages with an out-of-court restructuring as set out below.

Flexibility
Given that the process is contingent on the agreement of the stakeholders, it provides the parties with significant flexibility in relation to the terms which are to govern the restructuring. Tailor-made solutions can be created which address the relative positions of the parties. [14]So long as it is agreed to by all stakeholders, it will be given effect and implemented. There are very few situations in which that would not occur (such as if the agreement required the enforcement of an illegality).

Control and certainty
Another one of the benefits of an out-of-court restructuring is that the company retains relative control of the process. It is not forced to do anything it doesn't want to (subject to responding to any unreasonable conduct by hostile creditors) and can run the process in the way that it wishes, on its own timetable.

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[12] Chan K T, Yap V C and Chai S N "Factors Affecting Financial Distress: The Case of Malaysian Public Listed Firms", *Corporate Ownership & Control* Volume 8, Issue 4, 2011 at pp.346.
[13] Fingland, M. "Causes and Remedies of Business Distress", https://www.vantageperformance.com.au/causes-and-remedies-of-business-distress-2/
[14] Adriaanse, J., & Kuijl, H. (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 at p. 145.

More importantly, the consensual nature of the process provides much more certainty to the parties and minimises the risks associated with court litigation.

Continuity in Management
An out-of-court restructuring enables management to stay in place and continue with the running of the business (unless of course one of the demands of creditors is that management is replaced), without any of the disruption to operations that are caused by independent liquidators taking over.

Existing management are already familiar with the nuances of the business and save for any competency or fraud concerns, are usually best placed to administer the affairs of the company.

Reputational benefits
By negotiating a consensual restructuring out-of-court, it often helps keep the affairs of the company out of the public domain (although not always). However it certainly avoids the potentially material damage to a company that is associated with formal restructuring proceedings, which is clearly in the interests of the company and stakeholders alike.[15]

Legal benefits
An *ipso facto* clause can trigger some very unpleasant consequences for a company on the filing of a formal insolvency proceeding as the clause usually provides the company's counterparty to the contract with the right to terminate that contract and claim damages.

That right may even be triggered on the mere presentation of a petition (irrespective of whether a winding up order is ultimately made).

However, an *ipso facto* clause is much less likely to be triggered in relation to an out-of-court restructuring (depending of course on how widely the clause is drafted). In the case of the more narrowly construed provisions, this can be a significant benefit of avoiding formal insolvency proceedings.

Avoids the rule in Gibbs
For any jurisdictions that still apply the Gibbs rule, an out-of-court restructuring prevents the need for multiple sets of proceedings so as to comply with the effect of that principle – namely that a local court can't recognise a judgment which has compromised foreign debt.

That can be a huge obstacle in formal insolvency proceedings which doesn't arise if something can be achieved out of court.

Costs
Although there will certainly be costs associated with an out-of-court restructuring process, they are usually much lower than those of a contested formal restructuring or insolvency process where the professional fees incurred by the company and each of the various creditors can be substantial. That can be quite appealing in situations where the margins on recovery for any interested stakeholders are particularly fine.

Speed
In theory, an out-of-court restructuring can be quite quick, especially in circumstances where there are only a few creditors. If the parties are able to reach agreement on the terms early on, then the process can be completed much faster than through a formal court process.

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[15] Adriaanse, J., & Kuijl, H. (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 at p. 146.

More attractive to shareholders
In a formal restructuring, shareholders are usually at the bottom of the waterfall and invariably end up receiving nothing in an insolvent liquidation.

With an out-of-court restructuring, they will retain some sort of interest in the company (depending on what is agreed) which generally puts them in a much better position and incentivises them to try and achieve a deal.

Disadvantages
Notwithstanding these benefits, there are also disadvantages associated with out-of-court restructurings.

Need for Consensus
Out-of-court restructurings are of limited utility if you have any dissenting creditors who refuse to agree to the proposed terms that have been accepted by the majority.
As an added complication, once a minority creditor realises the position they are in, it provides them with leverage to try and impose special terms for themselves under the arrangement which others are forced to accept because of the consensus which is required to achieve a result.[16]

For that reason, it can cause creditors to deliberately hold out on what are otherwise fair and reasonable deals in the hope that they can secure special value later on. That could include the offer of new debt securities which have a greater market value than those returned in the exchange, better interest rates, or greater security. Alternatively, the offer may be one that subordinates other creditors who were otherwise on an equal footing.[17]

Unlike a court restructuring, you don't have the ability to force through a deal at the expense of the dissenting creditors.

Less relief available
An informal out-of-court restructuring doesn't allow the opportunity for independent parties to investigate any avoidance claims which arise under local legislation such as transactions at an undervalue or preference payments.[18]

Advantages/Disadvantages in the Cayman Islands

There is no specific legislation in the Cayman Islands which deals with out-of-court restructurings. They tend to be driven by the preferred approach in the onshore jurisdiction involved (most Cayman companies are part of a multi-jurisdictional group structure).[19]

As such, the advantages and disadvantages set out above would be equally applicable.

Although only tangentially relevant to this question, it is worth noting that pre-packs are dealt with in the Cayman Islands by one of three mechanisms under its existing insolvency procedure.[20]

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[16] Chehi, M., Lopez-Castro, C., Pierce, S. & Kubs, M. "An Out-of-Court Restructuring or a Chapter 11 Case: When and How to Choose" https://www.americanbar.org/content/dam/aba-cms-dotorg/products/inv/book/278736997/Chapter%201.pdf at p. 6.
[17] Chehi, M., Lopez-Castro, C., Pierce, S. & Kubs, M. "An Out-of-Court Restructuring or a Chapter 11 Case: When and How to Choose" https://www.americanbar.org/content/dam/aba-cms-dotorg/products/inv/book/278736997/Chapter%201.pdf at p. 7.

[18] For a further discussion of the disadvantages, see Garrido, J.M., (2012) "Out-of-Court Debt Restructuring" *A World Bank Study* p. 8-13, see tps://documents1.worldbank.org/curated/en/417551468159322109/pdf/662320PUB0EPI00turing09780821389836.pdf
[19] Sherwood, P. & Willis, J. (2023) "Cayman Islands: Restructuring & Insolvency Comparative Guide"at *https://www.mondaq.com/caymanislands/insolvencybankruptcyre-structuring/1270154/restructuring--insolvency-comparative-guide*.
[20] Sherwood, P. (2023) "A Comparative Look at Pre-Packs in Selected Jurisdictions" *INSOL International Special Report* at p.13

The first would be to undertake a voluntary liquidation provided that the company to be restructured is solvent (as part of the process, the directors would be required to swear declarations of solvency). That is an out-of-court process which is quite flexible with how it operates.

However, if the company is insolvent, then although it would, strictly speaking, require a Court process, it can be easily done through:

1. The appointment of a restructuring officer on the grounds that the company is insolvent and it intends to present a compromise or arrangement to its creditors;[21] or
2. The appointment of a provisional liquidator by a friendly creditor for the purposes of restructuring the company's assets.[22]

Both of these latter options would provide the company with a moratorium in conjunction with a mechanism for implementing a pre-pack but as stated above, they are of course, not out-of-court procedures.[23]

Question 3

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

A number of the reorganisation approaches suggested in the reading material were applied in this case.

For example, Adriaanse & Kuijl[24] having examined case studies of various successful and unsuccessful reorganisations, identified the following key issues that are likely to affect the outcome – namely:

- Early discussions with the key stakeholders (particularly the banks) on the current financial position of the company as well as the options which are available to it. Helpfully, the

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[21] For a further discussion of the role of the restructuring officer regime, see Engwirda, J. et al (2022), "The Cayman Islands Insolvency Reform: Restructuring Officer and Refined Scheme of Arrangement" at p. 1-12, see *https://www.harneys.com/media/bijlhsgj/legal-guide-the-cayman-islands-insolvency-reform-restructuring-officer-and-refined-scheme-of-arrangement.pdf* and Goodman, M. and Logan K., (2022) "Cayman Islands Case Study" *Global Restructuring Review* see *https://globalrestructuringreview.com/review/restructuring-review-of-the-americas/2023/article/cayman-islands*

[22] For a discussion of the role of the provisional liquidator, see Harlowe, C. and Levers, C. (2022) ""Cayman Islands" *Global Restructuring Review* see *https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-2/article/cayman-islands*; and Cowan, G., Goodman, M. and Khanbhai, H. (2018) "Restructuring & Insolvency in the Cayman Islands" *Lexology*, see *https://www.lexology.com* (subscription based service)

[23] For a discussion of the position under the English regime, see Bains, J. and Bromley-White, T., (2023) "Restructuring & Insolvency Laws & Regulations England & Wales" *ICLG Restructuring & Insolvency 2023,* see *https://www.macfarlanes.com/media/ikvj5q2m/england-and-wales.pdf*

[24] The authors are of the view that a restructuring usually consists of the following four phases:

1. Stabilising (immediate actions required to reduce outgoings and to protect or increase incomings);
2. Analysing (where the company, together with its advisors, draws up a plan which looks at the future of the company in the long term);
3. Repositioning (this involves the implementation of the steps in the reorganisation plan, and is also known as the value recovery process); and
4. Reinforcing (namely, where management's performance is assessed to determine if it is effectively implementing the reorganisation). Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 140-143.

company met with the banks in November 2013 which appears to be fairly shortly after the company discovered the error in the pre-tax profit reported for September 2013.[25]

- Indeed, Pajunen has asserted how essential stakeholder participation is to the ongoing survival of the company. Pajunen contends that it is because of the stakeholder's resources and networks that they are in best positioned to salvage the company. Pajunen is also of the opinion that the influence of the stakeholders can change during the turnaround process because of the dynamic nature of the relationship. He proposed six factors which govern that relationship so that the company can best manage its stakeholders and help ensure its survival.[26]

- Stakeholder participation proved to be of significant benefit in the present case as the shareholder and banks were continuously involved throughout the restructuring and each had substantial contributions/influences on the ultimate agreement (as well as the process leading up to it) that was signed in July 2015;

- Proactive engagement between the shareholders and management on those same matters (to the extent that they are not part of the key stakeholder group). Again, that appears to have occurred in this case given that the shareholder was certainly aware of the position by at least January 2014 but was likely to have been informed earlier once that banks had determined the necessary cash injection that was required;[27]

- Relative transparency with the financiers about the financial position of the company. This is important so that banks can make an informed decision on how to proceed and to give them confidence that the company is being properly run. In this case, although management were intending to convey an accurate overview of the company's performance, that analysis was in fact wrong (several times) which can be quite destructive towards the confidence and support from the banks (as well as for any potential investors). The company was therefore somewhat fortunate that the banks continued to support them throughout the process;

- The injection of risk-bearing capital. In this case, the shareholder ultimately provided 35m Euros which was necessary to improve the solvency rate of the Company. That was a key requirement of the banks and was one of the main reasons why a consensual restructuring was ultimately agreed.[28]

However, some of the approaches suggested by the authors were not followed in this case.

First, the reorganisation of the business was not done as quickly as it needed to be.[29] The company was first aware of a financial deterioration in its business from at least November 2013 yet a restructuring agreement was not signed until July 2015. In addition, the company's finances continued to worsen for most of that period which is all the more reason why it took far too long to reach a solution.

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[25] Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 149.

[26] The six factors identified for increasing the likelihood of a successful restructuring were as follows: (1) greater stakeholder support (2) frequent and transparent communications with stakeholders (3) the strengthening of personal relationships in a crisis where there are common interests (4) reducing any barriers between management and stakeholders (5) focus and consensus on long-term goals and (6) positive developments during the process will strengthen stakeholders' confidence in management. Pajunen, K. (2006) "Stakeholder Influences in Organisational Survival" *Journal of Management Studies*, 43(6), 1261-1288.

[27] Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 149.

[28] Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 149.

[29] Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 149.

Had the parties moved more quickly, the position might have been improved as:

1. They could have benefited by independent third party oversight of management and of the company's actual financial position at a much earlier stage. This was especially necessary given that the goalposts kept moving on its true performance;
2. The injection of extra capital would have arrived much sooner which would have had a number of long term benefits to the company such as:
    a. reducing the interest burden on the debt which continued to accrue during the 20 month negotiation process; and
    b. Increasing the prospects of finding a white knight investor before the hole in the accounts became too big;
    c. Increasing the likelihood of restoring the company to profitability at the earliest possible stage.[30]

On a separate note, there was also no joining of the processes of retrenchment and recovery, which Schmitt and Raisch believe form a duality in that they are both contradictory and complimentary. The authors argue that it is the combination of these processes which will generate a positive restructuring outcome.[31] They suggest that the application of specific learning, organising and performing strategies can improve management performance and help generate greater strategic flexibility.[32] For example, focused retrenchment unlocks resources which can be used for experimentation options in terms of outward investment. That was not followed in this case as Flow Management did not pursue any acquisitions to help it with its recovery.

Similarly, there were no growth oriented and external market focused strategies adopted by the company as recommended by Sudarsanam and Lai. The authors examined 166 potentially bankrupt firms to explain why some recovered and others did not. They observed that the recovery firms adopted many common strategies to the non-recovery firms. However the differential was that non-recovery firms did not apply them as effectively. In addition, recovery firms devoted more attention to growth oriented and external-market focused strategies whilst non-recovery firms were more concerned with dealing with problems as and when they arose.[33]

In particular recovery firms opted for investment and acquisitions to improve their financial position in contrast with non-recovery firms who were more dedicated towards operational and financial restructuring through inward looking measures.[34] In our case, Flow Management unfortunately did the latter.

The company also did not apply two of the factors identified by Pajunen as increasing the likelihood of a successful restructuring as it did not:

(1) ensure there were positive developments during the reorganisation process so as to strengthen stakeholders' confidence in management. In fact, it did the opposite as it incorrectly assessed its financial position several times with the results repeatedly getting worse;

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[30] Adriaanse, J.A.A & Kuijl, J.G. (2006) "Resolving Financial Distress: Informal Reorganisation 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) at p. 149.

[31] Schmitt, A., Raisch, S. (2013) "Corporate Turnarounds: The Duality of Retrenchment and Recovery" *Journal of Management Studies* 50 (7) pp. 216-1244.

[32] "Learning" deals with the contrasting approaches of focus and experimentation strategies. "Organising" refers to formalization and participation strategies. "Performing" is the combination of profit and breakthrough strategies. Schmitt, A., Raisch, S. (2013) "Corporate Turnarounds: The Duality of Retrenchment and Recovery" *Journal of Management Studies* 50 (7) at p. 1224.

[33] Sudarsanam, S., Lai, J. (2001) "Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis", *British Journal of Management*, Vol. 12, 183-199

[34] Sudarsanam, S., Lai, J. (2001) "Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis", *British Journal of Management*, Vol. 12, 183-199

(2) Have sufficient focus and consensus on long-term goals.[35]

Had it done both these things, it may have enabled the restructuring agreement to be signed much earlier.

<u>Question 4</u>

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 had a number of reasons as to why it might have been in their interests to frustrate the process.

Firstly, they had security over assets of the company against which they could have enforced. This enforcement can occur irrespective of whether the company is put into liquidation and the realisation of those assets would have meant that banks C and D would be paid out much sooner without having to wait for a consensual restructuring to be agreed and implemented (especially given that the recoveries following implementation would take a significant period of time to be received).

In addition to the potential time savings, that strategy would also ensure that they received 100 cents in the dollar on their debt and would avoid the need for them to compromise on that position through a consensual restructuring (where they would be required to take a haircut on their claims).

Having said that, it appears there was a problem in relation to the pledges over the assets such that there was a possibility that the security may be defective. Therefore, if banks C and D elected to pursue this option (which would have also frustrated any consensual restructuring), they were running the risk of not achieving a recovery and instead being relegated to join the ranks of the unsecured creditors (assuming the company is placed into liquidation) where they would have been paid out on a *pari passu* basis. Based on the assessment by banks A and B, it would appear that recovery through a liquidation would be for cents in the dollar and would force the banks to suffer significant write-offs on the debts owing to them. It was therefore a relatively high stakes strategy for banks C and D.

Another reason may have been that banks C and D had lost confidence in the company's management given the fact that there were repeated mistakes in the company's analysis and oversight of its own financial position. They may have decided it was better to take the risk on any challenges to the enforcement of their security rather than to pursue negotiations with a company that was badly managed.

Alternatively, banks C and D may have thought that the prospects of achieving a consensual restructuring were not great, especially given the deteriorating financial position of the company and the onerous capital injection that was required from the shareholder to improve the company's solvency rate. In those circumstances, the company would then be forced into liquidation as it would be unable to pay its debts as they fell due. That would result in a low recovery for Banks C and D and therefore could have forced them to conclude that there was no other viable options available to them outside of enforcement (if they were of the view that

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[35] The six factors identified for increasing the likelihood of a successful restructuring were as follows: (1) greater stakeholder support (2) frequent and transparent communications with stakeholders (3) the strengthening of personal relationships in a crisis where there are common interests (4) reducing any barriers between management and stakeholders (5) focus and consensus on long-term goals and (6) positive developments during the process will strengthen stakeholders' confidence in management. Pajunen, K. (2006) "Stakeholder Influences in Organisational Survival" *Journal of Management Studies*, 43(6), 1261-1288

nothing was likely to be agreed by way of an informal consensus).

Another possible reason may have been that banks C and D were concerned that if they didn't take action first, other creditors may do so instead which would then give those creditors control of any proceedings which were commenced and procedural advantages in the race to obtain repayment of their debts.

Finally, given the nature of the business, banks C and D may have been of the opinion that the longer the process dragged out, the lower the value of any possible return on the grounds that:

1. Any goodwill in the business is likely to deteriorate over time;
2. the interest burden on the debt would continue to increase;
3. The likelihood of finding a white knight investor would become less and less.

Had I been advising banks A and B, I would have recommended adopting a "carrot and stick" approach to banks C and D. I would have done that by trying to persuade banks C and D to withhold any enforcement action against any security by explaining that the security was defective and could not be realised. The result of attempting to do so however would be to push the company into liquidation since it would be unable to pay its debts as they fell due in circumstances where repayment was being demanded by the banks. Liquidation would be a bad outcome for all of the creditors (especially banks C and D) as it would mean the company's ability to trade would be detrimentally affected and creditors would ultimately only recover a fraction of their claims.

I would press banks C and D to continue to engage in a consensual restructuring as all the banks need to work together to have any hope of achieving a capital injection from the shareholder. If the banks were divided on their positions, the shareholder would have no interest or reason to provide further capital to the company.

In conjunction with that approach, I would have recommended that banks A and B ask the company to inform banks C and D of the action that the company would take if banks C and D sought to enforce their security.

The first thing which could be done would be for the company to seek urgent undertakings from banks C and D that they would not enforce. If those undertakings weren't provided within 24 hours, the company would be applying to the Courts for injunctive relief to restrain banks C and D from proceeding with any enforcement action. The test that banks A and B would need to satisfy for a proprietary injunction is that (1) there is a serious question to be tried; and (2) the balance of convenience lies in favour of granting the injunction.

The first limb of this test is satisfied provided that the company can demonstrate a seriously arguable case that it has a proprietary interest in the assets against which banks C and D are intending to enforce.

That injunction would be in support of a claim for declaratory relief that the security documents were invalid and unenforceable. The injunction (and supporting claim) would need to be brought in accordance with the governing law and jurisdiction clauses in the finance/security documents.

Question 5

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

Fortunately, a number of these principles were followed by the relevant creditors during the workout process, at least for some of the time.

The First Principle

The first principle promotes the entry by each of the creditors into a standstill agreement to allow time for the exchange of information and the sharing of proposals on how the situation might be salvaged. The purpose of this principle is to avoid a party taking action which may subsequently cause a liquidation of the business. Although there was a delay leading up to the parties execution of a 120 day standstill agreement in August 2014 (ideally that should have been entered into much sooner and ought to have commenced from the date of notice of the company's meeting to explain its financial position), it was helpful that the parties had ultimately agreed to sign one and had not taken any enforcement steps in the meantime (namely during the 9 month lead up to the formal execution of that agreement).

Further, the agreed duration of the standstill agreement of 120 days was in accordance with the ideals of the first principle, as was the fact that all the financial institutions were parties to that process.

It can therefore be said that the creditors broadly adhered to the first principle.

The Second Principle

The second principle requires that during the standstill period, the relevant creditors will refrain from taking action to enforce their claims and will maintain their relative position against other creditors so that any one of them is not prejudiced by the arrangement.

The first aspect of the second principle was adopted in this case as none of the creditors took steps to enforce their claims during the standstill period. The question does not give us any details about whether the creditors' positions relative to each other were preserved in that agreement. One would have expected to see undertakings from those creditors to:

- Refrain from seeking repayment from, or commencing proceedings against, the company;
- Refrain from attempting to improve their positions relative to other creditors or from enforcing their security;
- Continue to provide existing credit lines and facilities during the standstill period.

To the extent that there are any fluctuations of a creditor's position (for example, through the continued provision of an existing facility), the creditors can agree to make balancing payments to each other in the event of a formal restructuring, such that everyone's position as at the date of entry into the standstill agreement, is preserved.

For contingent facilities (such as currency swaps and foreign exchange services), those fluctuations are usually addressed by "marking them to market" on a regular basis. The creditors would also usually introduce provisions in the standstill agreement to account for those fluctuations.

It appears that the banks were continuing to provide their facilities throughout the process (since banks C and D had threatened to cancel them in June 2014 if the shareholder didn't move quickly enough). It is unclear though whether the relative position of the banks changed since the commencement of the standstill agreement. If not, then this principle was adhered to.

The Third Principle

The third principle promotes the rationale that the debtor should not do anything during the standstill period which might adversely affect the creditors compared with the position at the standstill date (other than doing things which are in the ordinary course of business such as paying employees).

There is no information in the question to suggest that the company did not comply with this principle.

The Fourth Principle

This encourages creditors to work together and co-ordinate their responses to a debtor through the selection of committees (where the number of relevant creditors is sufficiently large) and the appointment of professional advisers such as legal advisors, accountants and co-ordinators.

Part of this principle was applied given that for many periods during the process, the banks had a co-ordinated approach for dealing with the company. That was not always the case though (particularly in February 2014 when banks C and D stopped co-operating).

However there was no appointment of any committees in this case. Whilst the number of banks involved (4) was relatively small and therefore manageable, it would have been more streamlined if a steering committee was formed to deal directly with the company.

The Fifth Principle

This principle recommends that the debtor allow relevant creditors and their advisers access to all relevant financial information of the company during the standstill period.

There is no information in the question as to whether this occurred but it would appear that it most likely did given the frequent communications by the company on its changing financial performance.

The Sixth Principle

Any restructuring proposals should as much as possible, reflect the applicable law and the relative positions of the relevant creditors as at the commencement date of the Standstill Agreement.

In mid May, banks A and B were exploring a proposal to buy out banks C and D at a 20% discount. As there was no Standstill Agreement in effect at that time, it cannot be said that there was non-compliance with this principle.

In October 2014, four different scenarios were identified. This is after the Standstill Agreement had been signed in August 2014. None of those proposals put forward suggest that any of the banks were being offered something which differed to their relative positions as at the commencement date of the Standstill Agreement. It therefore appears that there was compliance with this principle.

The Seventh Principle

This requires that for the purposes of any out of court restructuring, all information on the financial position of the debtor (and any proposals for resolving the distress) should be provided to all relevant creditors and unless it is already publicly available, should be kept confidential.

There is no information in the question to determine whether this principle was applied in this case.

The Eighth Principle

If additional funding is made available during the standstill period or pursuant to any restructuring proposals, the repayment of it should as much as possible be on a priority basis as compared with other indebtedness.

It appears that the banks were continuing to fund the company through the negotiation process. It would be expected that such funding should have been given some form of priority (in the Standstill Agreement) in the event of a liquidation.

<u>Question 6</u>

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 instruments are generally distinguished from hard law on the basis that they are not legally binding.[36] They are usually created by leading industry organisations that are well regarded by the service providers within that industry.

In addition to the INSOL Statement of Principles, there are some other soft law sources which could be relied upon to help persuade creditors to behave in an appropriate way.[37]

One such source is the Informal Workout Guidelines and Model Standstill Agreement created by the Asian Bankers Association.[38] These guidelines have been approved by the APEC Business Advisory Council who recommends that they are applied by all financial institutions and firms in its member economies in dealing with financially distressed debtors (for the purposes of the question, I have assumed that Banks A, B, C and D are based in, or operate in, a member economy).

To help implement these principles, the ABA has also created a Model Agreement to Promote Corporate Restructuring. The Model Agreement is extremely comprehensive and contains provisions to address all the usual issues that might arise in an informal workout situation so that creditors can tailor that agreement to suit the particular scenario or to accommodate specific laws in certain jurisdictions.

The key principles from those guidelines which could be pushed in this case are as follows:

- Cooperation – all creditors should work together and with the debtor to support each other in resolving the indebtedness. Without co-operation, they should be aware that it may cause the workout to fail and destroy the position for everyone;
- Continued financial assistance – facilities should not be withdrawn during the workout

[36] See for example, Schaffer, G., and Pollack, M., "Hard vs Soft Law: Alternatives, Complements, and Antagonists in International Governance", 94 *Minnesota Law Review* 2010 at p.712; Druzin, B., "Why does Soft Law Have any Power Anyway?", 7 *Asian Journal of International Law* 2017 at p.361 [cited Wessels, B. And Boon, GJ., "Soft Law Instruments in Restructuring and Insolvency Law: Exploring its Rise and Impact" at p. 2]

[37] It is worth noting that there are numerous soft law instruments which are highly regarded however many of them relate to obligations on the company and its directors in a distressed situation or protocols in respect of formal insolvency proceedings. They don't cover the approach of creditors at the informal workout stage.

[38] It is known as the Asian Bankers Association, Asia-Pacific Informal Workout Guidelines for Promoting Corporate Restructuring in the Region and Model Agreement to Promote Corporate Restructuring: A Model Adaptable for USE Regionally, by a Jurisdiction, or for a Particular Debtor (2013).

process, even if that causes an increase in exposure for a particular creditor;
- Creditors should be kept fully informed of all relevant information relating to the financial position of the debtor and should have the ability to participate in the workout process.
- The status quo should remain in respect of the debtor's affairs prior to the meeting of creditors and up until the signing of a standstill agreement. In particular creditors should refrain from enforcement action or issuing Court proceedings during the workout period;
- These principles apply where there is a possibility of resolving the company's indebtedness and where there is a viable long term business (as is the case here);
- Creditors should appoint experienced representatives and advisers to assist during the turnaround stage and coordination committees should be formed to facilitate the discussions with the company;
- During the workout process, creditors are encouraged to maintain their positions relative to each other so that no creditor is prejudiced.

Another available instrument is the ALI-III Global Guidelines (2012). Although many of those guidelines relate to recommended protocols once insolvency proceedings have actually commenced, there are a number that apply in anticipation of that position. For example, principle 2.2 encourages the parties to avoid or minimise litigation where possible and principle 9 encourages the sharing of information between parties. It is interesting to note that the Australian Capital Territory has expressly referred to these guidelines in its Court Rules.[39]

More importantly, it can be impressed on creditors that if they don't adopt the principles in these soft law instruments, that may work against them in relation to any Court proceedings which are commenced. For example, Justice Kawaley of the Grand Court of the Cayman Islands was required to consider the application of soft law guidelines in the context of Court-to-Court cross border insolvency protocols.[40]

In evaluating the merits of a Cayman Practice direction, and the ALI/III and JIN Guidelines, the judge was of the view that "*particularities of how to advance the efficiency of cross-border insolvency proceedings at the operational case management level should be predominantly grounded in [such] soft law instruments*." [41] That would then be "*consistent with both constitutional principles of judicial independence, the more pragmatic principles of modified universalism and the even more functional inherent powers of this Court to protect the efficiency and integrity of its processes*."[42] In short, the judge opined that soft law instruments could be seen as emerging sources of law – indeed he went on to say that "*there is a starting assumption that the ALI/III and/or the JIN Guidelines are suitable guides to adopt and apply in cross-border cases*".[43]

Given judicial support for soft law instruments, they can therefore be used for the purpose of persuading interested parties to act appropriately, failing which those parties may suffer the wrath of the Court.[44]

If these options don't work, there are other techniques which can be deployed informally to try to convince the other creditors to co-operate with the soft law instruments.

One such technique would be to remind those creditors of the potential risks regarding the

[39] See Wessels, B., Soft law instruments in restructuring and insolvency law: exploring its rise and impact, Lecture at the TvOB Conference at Utrecht, the Netherlands on 9 May 2019.
[40] *In the Matter of LATAM Finance Limited et al*, FSD 105, 106 and 154 of 2020 (IKJ), Judgment dated 24 August 2020 (unreported)
[41] *In the Matter of LATAM Finance Limited et al*, FSD 105, 106 and 154 of 2020 (IKJ), Judgment dated 24 August 2020 (unreported)
[42] *In the Matter of LATAM Finance Limited et al*, FSD 105, 106 and 154 of 2020 (IKJ), Judgment dated 24 August 2020 (unreported)
[43] *In the Matter of LATAM Finance Limited et al*, FSD 105, 106 and 154 of 2020 (IKJ), Judgment dated 24 August 2020 (unreported)
[44] For a further discussion of this, see Boon, GJ. And Wessels, B. (2020) "When Soft Law Instruments Matter; OBLB Influences Cayman Islands' Judgement Approving Cross-Border Insolvency Protocol".

validity and enforcement of their security. If they ignore the protocols and choose to enforce, not only would they run the risk that the security will be held to be invalid, the company and other creditors would in any event challenge that enforcement which would delay any realisation (if at all) quite considerably and also cause those recalcitrant creditors to incur the costs (at least at first instance) of pursuing those enforcement proceedings.

Further, should that security be held to be invalid, the unco-operative creditors would then be relegated to the general body of unsecured creditors and would suffer a significant haircut in any return given the inherent destruction to the value of the company's business that would be caused by any formal proceedings. An orderly and consensual restructuring would therefore maximise the returns to those creditors.

Question 7

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

As one would expect, the restructuring agreement involved a significant amount of compromise from each of the stakeholders.

The best way to explain the substance of that agreement is by reference to the risks and rewards faced by each group of stakeholders. In short, the restructuring amounted to a debt to equity swap with compromises by all parties.

Beginning with the banks, they compromised their position by cancelling the €55m loan taken out by Flow Management Work BV and waiving repayment of €97.5m of the working capital which they loaned to that entity. In addition, Banks C and D waived €32.5 million which had been provided as further working capital. The banks also relinquished all claims which they had against Flow Management Holding BV – those claims are likely to relate to the €3m which was wrongfully paid out in management bonuses as well as other potential negligence claims against the company (and management) for its repeated errors in understanding and reporting its financial position.

In return for those sacrifices, the banks took over ownership of the business of Flow Management Holding BV. They did this in the following way – Flow Management transferred the shares which it held in the various operating subsidiaries to Flow Management II BV with the latter entity being wholly owned by the 4 banks. So in effect, it was a debt to equity swap and the 4 banks are now the shareholders in Flow Management II BV, which holds wholly owned interests in each of the underlying operating subsidiaries (namely FMW Spain, FMW France, FMW Australia, FMW South Africa and FMW USA).

In relation to Flow Management Work BV (the subsidiary of Flow Management Holding BV), the banks retain their claims against it and it is put into liquidation. Those banks can enforce those claims against the pledges which they hold on the remaining assets of Flow Management Work BV. That would give the banks a partial recovery against Flow Management Work BV. To the extent that there was any doubt about the ability of the banks to enforce against those pledges, that risk has been circumvented by the banks since all creditors (and the company) have agreed that the banks can enforce their security. This is another benefit to the banks of this deal.

Flow Management Holding BV is also being liquidated to realise any other assets which it may hold outside of its interest in Flow Management Work BV. If there are any realisations from that liquidation, they will go to the shareholders since the banks (and shareholders) agreed to forgo all claims which they had against that company. That would meant that if there was a recovery, it would be paid out to the shareholders, assuming anyone higher in the waterfall had first been satisfied such as governments (for outstanding fees and taxes) or employees (for outstanding

salaries).

The original shareholders (and other financiers) will have their claims against Flow Management Work BV subordinated to those of the 4 main banks which means they are unlikely to achieve any recovery. However, the shareholder holding company (Lease Group Holding) was given security of €45 million in return for its capital injection of €35 million. It is therefore able to enforce against that security despite any liquidation of Flow Management Holding BV and Flow Management Work BV. Any residual realisation from that enforcement would be passed to the banks as the creditors who hold priority over such recoveries.

The original shareholders of course also still retain their interest in Lease Group Holding United Kingdom Ltd which owns Lease Cayman Real Estate Ltd and Lease and Truck Repair Sweden Holding. They would be relieved though of any liabilities to the 4 main banks (to the extent that any existed either through unpaid share capital or in the event that they acted as guarantors under any of the loans).

The other benefit to the shareholders is that the loss-making part of the business (Flow Management Holding BV) is now taken over by the banks so they will now simply retain the (presumably) solvent parts of the group being Lease Cayman Real Estate Ltd and Lease and Truck Repair Sweden Holding.

The board members of Flow Management Work BV received shares in Flow Management II BV which one expects was in consideration for their continued involvement in the newly restructured business. They too were fortunate in agreeing a deal since the restructuring agreement appears to preclude any mis-management claims being made against them insofar as it relates to their management of Flow Management Holding BV is concerned. There remains some potential liability for them in respect of Flow Management Work BV.

As explained above, all the stakeholders faced some form of exposure if a suitable deal couldn't be agreed. That was either through a lower recovery if a liquidation of the business was forced through in a disorderly manner (such as for the banks – especially given there were doubts about the validity of their security), or through potential liabilities for claims such as those which existed against Flow Management Holding BV, Flow Management II BV and management themselves.

By compromising on their respective positions, the stakeholders each secured an outcome which guaranteed them some form of return.

Question 8

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

There are a number of legal and non-legal cross border issues which arise in this case.

First, there are issues concerning the duties and potential liabilities of the directors of Flow Management BV. However, in order to properly considering them, a determination will first need to be made on which laws apply to those directors in the course of their decision making throughout the turnaround process. For example, while it is almost certain that a director is bound by the laws of the place of incorporation of the company of which they are a director, if the company operates in other jurisdictions, or the directors are making decisions on behalf of group companies incorporated elsewhere, the directors may also be

bound by those local laws.[45]

Once the laws of the relevant jurisdictions have been identified, those directors need to form a view on whether the company has any reasonable prospect of avoiding insolvency or administration. Timing is key as if the directors are too slow in reaching that conclusion, they may have engaged in insolvent/wrongful trading in the meantime and be personally liable to creditors for any losses suffered. As part of that assessment, the governing law will be particularly important since different jurisdictions use different tests for assessing insolvency. For example, some countries apply the cash flow test while others also use the balance sheet test.

Another key issue will be the COMI of Flow Management Holding BV. Whilst prima facie, that would be the Netherlands (given it is the likely address of its registered office), that is a rebuttable presumption. The determination of the COMI will determine which proceedings (assuming more than one are commenced) are classified as the Foreign Main Proceedings, which then has significant implications on the rights and remedies available to creditors, the recognition of foreign proceedings and the overall efficiency of the insolvency process. This will need to be assessed in the event that a creditor contemplates initiating insolvency proceedings.

It will also be important to consider the rights of all relevant stakeholders given that some of them are likely to be afforded special status under local law. For example, debts owed to employees for unpaid salaries are usually given priority in the waterfall of recoveries. Similarly, landlords of commercial properties often have the right to seize premises and company assets to sell them and apply the proceeds against unpaid rent. Suppliers of goods to the business may have retention of title clauses in the supply agreements which would entitle them to retain their proprietary interest in the goods until they have been paid for. Such clauses generally survive insolvency because title in the goods had not passed.

The company will have to be careful in relation to certain transactions which it enters into for a defined period leading up to any insolvency as such transactions may be challenged by the liquidator if they fall into any of the following categories:

- It was a transaction at an undervalue in that the company did not receive fair market value for the sale of its asset;
- It could be construed as a preference in that the company was choosing to prefer one creditor over another in satisfying any indebtedness. Special rules apply for creditors which have a sufficiently close connection to the company (such as its affiliates);
- The grant of a floating charge that was given within a certain period of time of the insolvency event.

Another point to bear in mind is the effect of any restructuring on existing contracts with the company or with any of the group companies. To the extent that the restructuring would entitle the counter-party to terminate the contract and/or claim damages, it is important to obtain their consent to the restructuring plan. Otherwise, it would provide a counter-party with potentially powerful claims against the company which in its distressed state, it can ill-afford.

Understanding whether any of the banks have valid security will be essential to any

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[45] See McCahill D., and Willcock, S. (2007) "Directors' duties: Dealing with the Minefield in a Cross-Border Restructuring" *Thomson Reuters Practical Law,* see https://uk.practicallaw.thomsonreuters.com/0-376-6631/ at p. 1-2

restructuring. This is because it will affect the leverage that the banks have in the turnaround process (they would be in a much stronger negotiating position if they could enforce against their security, independently of whether any insolvency proceedings are commenced). That issue will also have a bearing on whether it is in their interest to initiate their own winding up proceedings against the debtor company.

Identifying the locations of all creditors and assets and the reach of the insolvency law in those jurisdictions will be another important exercise. This is because it will influence what steps can be taken by whom, and where. That will then have consequential effects on how to approach the cross-border insolvency issues that arise. For example, in the Cayman Islands, a creditor might seek to petition to wind the company up for not being able to pay its debts as they fall due, and then simultaneously apply *ex parte* for the appointment of provisional liquidators over the company to take control of its books and records and to sideline management. Guarding against these types of manoeuvres from unhappy creditors needs to be contemplated from the outset.

On a related note (and as mentioned elsewhere in this paper), the operation of the *Gibbs* rule will also be important in determining where relevant stakeholders may bring proceedings. Since the *Gibbs* rule prevents a court from recognising a compromise of a foreign law governed debt, it will make it difficult for an interested party to pursue assets where the rule applies (such as in the Cayman Islands).

In terms of some non-legal issues, the continuing changes in the company's financial position (most of which was further deterioration) together with the uncertainty on whether banks C and D were going to co-operate, would have caused a number of practical difficulties with the restructuring. The confidence of stakeholders in the viability of the business would be reduced and the likelihood of soliciting additional funding or third party investment to salvage the business, would also decrease.

There also would have been concerns over the competence and performance of management and its service providers given the many unsuccessful attempts to properly understand the company's financial position.

Question 9

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

The calling for a moratorium would have been a good idea if any of the banks (particularly C and D) had decided not to co-operate in the restructuring and were threatening to wind up the company or seeking to enforce against the security, especially in circumstances where that security was open to challenge and may not be able to be pursued independently of any liquidation. Injunctive relief could have been pursued in the interim to preserve the position and to protect the assets from enforcement by banks C and D.

A moratorium would give the company some breathing space to ensure that its assets were realised in an orderly way so as to maximise recoveries. It would have also given comfort to potential white knight investors or financiers generally as they would be more likely to considering lending in those controlled circumstances, as opposed to a situation where the company was self-destructing through a fire sale liquidation.

In addition, the moratorium would operate extra-territorially (subject to local law recognition) and under the Cayman regime, would mean the company was in the control of independent

office holders as a result of either of the two processes available for obtaining such a moratorium in the Cayman Islands.

The first of these is the traditional method - namely applying for the appointment of a provisional liquidator. A "friendly" creditor such as Bank A or B would petition to wind up the company but then simultaneously applies *ex parte* under section 104(3) of the Cayman Companies Law for the appointment of a provisional liquidator on the grounds that the company is unable to pay its debts as they fall due within the meaning of section 93 and it intends to present a compromise or arrangement to its creditors.[46] It is worth noting that in the Cayman Islands, the directors of a company are unable to cause the company to petition to wind itself up unless they are expressly authorised to do so in the company's memorandum and articles of association.[47]This is the reason for needing to bring in a "friendly" creditor who would have the requisite standing to file such a petition.

The moratorium is then triggered on the appointment of the provisional liquidator (which would usually be at the hearing of the PL application) which protects the company's assets while its affairs are being sorted out. This process is an important tool for potentially salvaging a company - particularly given that administration is not available under the Cayman Islands insolvency regime. It is also creditor led.

A more recent alternative for obtaining a moratorium is through the appointment of a restructuring officer (**RO**) under the amendments to the Cayman Companies Law which were brought into force on 31 August 2022.[48] The moratorium is engaged at the time of the filing of the papers for the RO appointment. This is a company led process (which can be initiated by its directors without the need for ratification of the company's shareholders) which is akin to the US debtor-in-possession model where the company's management would remain in control but subject to the oversight of the RO. For the purposes of foreign recognition and assistance, the RO regime is a collective insolvency proceeding under the supervision of the Cayman Grand Court. However, the main difference with it and the PL route is that it doesn't require the company to be the subject of a winding up petition in order to make use of it which negates the stigma of liquidation proceedings. As with PLs, an application could be made for recognition in the relevant foreign jurisdictions under the Model Law or their own specific regimes so as to localise the extra-territorial moratorium and the powers of the RO.

On the other hand, the calling for a moratorium would <u>not</u> have been a good idea if Banks C and D were able to demonstrate that they held valid security. This is because those banks could still enforce against that security, irrespective of whether there was a moratorium in place, pursuant to section 91 of the Companies Law.

In addition, had the provisional liquidator process been used for achieving that moratorium, it may have triggered (depending on how broadly they were worded) any *ipso facto* clauses in company contracts with third parties which would then give the requisite counter party the right to terminate those contracts and claim damages. Such an outcome would not be in the best interests of the company.

Another disadvantage of pursuing liquidation in the Cayman Islands (and obtaining a moratorium through the appointment of a PL) is that pursuant to the rule in *Gibbs*, the PL would be unable to <u>recognise</u> the compromise of any foreign law governed debt. The effect of the rule in Gibbs is frequently misunderstood as people often think, mistakenly, that it means that the

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[46] For the purposes of section 104(3), both Chapter 11 restructuring and foreign schemes of arrangement have been held as examples of compromises and arrangements.
[47] See *China Shanshui* 2015 (2) CILR 255
[48] These amendments were implemented thought the Companies Amendment Act 2021.

Cayman Court is, itself, unable to compromise foreign debt. That is not the case.

The upshot of the of the *Gibbs* principle is if parallel proceedings had been commenced elsewhere, such as in the Netherlands, and involved the compromise of, say, French debt, the Cayman Court would be unable to recognise the order from the Dutch Court since it would amount to recognition of a compromise of foreign law governed debt.

A further problem with calling a moratorium through a liquidation is that it creates a negative stigma for the company and its business. Customers would be more unlikely to engage with the company if they have reason to believe that the company may shortly collapse and be unable to honour its obligations and agreements.

Similarly, any resolution of the parties' positions would require Court involvement and approval, once the liquidation process been initiated. That could be problematic, particularly in situations where there may be multiple proceedings on foot.

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