MODULE A, ASSIGNMENT CASE STUDY-1

By

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Q1. What were in your opinion the causes of financial distress at Flow Management (see e.g. Mellahi & Wilkinson, 2004)? Could the financial distress have been prevented? If yes, explain how. If no, why not?

Answer:

The causes of financial distress at Flow Management were multi-fold and they could have been checked with proper financial and operational checks and balances by the Management, and swift decision making by the higher management. The promoters of FMH BV were running the company solely on the funding from financial institutions. It seems that FMH BV was not cash rich and was using borrowed funds for future growth and current operations. The size of the company FMH BV is very big in terms of asset base, operations are spread over multiple Jurisdictions and a large employee base.

The management of finances and operations required professional approach towards spending and operational wisdom. Based upon the facts and circumstances of the given scenario the financial situation could not have solely arisen in 2013. The financial distress is a combination of many factors spread over a period of time and the signs of financial distress should have been seen by the promoters/shareholders/management or by their CFO or the company auditors and they should have taken corrective measures to bring the situation in control. These steps should have been taken prior to escalation of the situation to a level that it becomes increasingly difficult to take corrective action or rather it becomes impossible to get out of the spiral of negative cash flows and other financial and operational risk factors. As stated above the FMH BV business must have shown symptoms of financial distress which were either ignored voluntarily or the Management was inept and unprofessional to the point of not seeing the obvious.

As stated by **Mellahi & Wilkinson** there can be factors which one can control and some factors upon which one has no control like political decisions, business life cycles etc. The factors which could have caused financial distress and upon which the management had control could have been:[1]

1. Financial Mismanagement
    a. High debt - Equity ratio
    b. Poor working capital management
    c. Bad accounting practices
    d. Variance in actual performance and budget
    e. Loss of credibility of senior management
    f. Poor financial results

[1] Stuart Slatter and David Lovett "Corporate Turnaround"

2. Operational Mismanagement
    a. Operational Objectives not aligned with any strategy or being implemented
    b. Lack of strategy or ability to implement it
    c. Big Project will save the day - White Elephant
    d. Operating inefficiencies

3. Lack of effective leadership
    a. Poor working capital management
    b. In taking sound and effective decisions financially and operationally
    c. In understanding the accounting and its ramifications
    d. Inadequate financial control
    e. Leadership giving themselves reward "***for not doing their jobs"***

4. Size of the business
    a. Costs are underestimated and revenue overestimated
    b. Poor Project control
    c. External Factors

5. Organisation structural Inertia
    a. Managerial Inaction
    b. Analysis paralysis
    c. Delayed decision making
    d. Poor motivated staff
    e. Lack of accountability and responsibilities

6. Putting good money into bad business

7. Timely workout and standstill agreement

8. Creditors not adhering fully to the statement of principles of multi-creditor workout-II

The identification of problems and subsequently their analysis effectively gives us an answer to all or any of our problems. All the above causes could have been taken care of, to the extent if the Management had professionally competent people at the decision makers, who should have taken probably hard decisions to demerge or consolidate their business financially and operationally and taken timely action to execute their decision.

As per **Adriaanse, J.A.A., & Kuijl** the informal reorganisation are especially successful when the company is able to reorganise its business operations quickly and adequately and thereby, to restore profitability.

Action Points Prior to Nov' 2013

- The management should have diagnosed the problem early in the day so as to have taken prompt remedial action.

- The dependence on borrowings to sustain the business which is huge in terms of asset base and along with multiple jurisdiction is always a challenge. The positive cash flows should have been planned after servicing of loans and borrowings.

- The operational model should have been made robust. Usage of cars on return trips should have been maximised in terms of revenue to service the huge debt of the company

- Operationally the use of cars should have been maximised as static cars do not earn more revenue.

- The auditors should have raised red flags when the servicing of the loans principal and interest were expected to default. Restructuring exercise could have been undertaken by the promoters as soon as the financial distress signals were flagged by the financial auditors or CFO.

- The cars which were old and required more expenditure on their maintenance could have been disposed of.

- The change in the management could have, to a certain extent helped the organisation to remain serious and on the lookout for any symptom of distress either financial or operational.

- Essentially the organisation size should have been discussed and debated and corrective action taken so that loss making units were hived off and only profitable units retained.

Action Points Post Nov' 2013

- In terms of huge payments made to the management, those should not have been made when there was a financial distress.

- Use of wrong accounting standards should have been avoided.

- Change in Top Management; The planning and execution team to be completely overhauled since whatever was planned never actually took place, be it in terms of cash flows, projected profits and other mismatches in planned and actual facts.

- Asset Restructuring: Strategic asset restructuring could have achieved positive cash flows.

- The sole shareholder should have been advised by a professional team of financial experts to take decisions in timely and decisive manner to save the company. This shareholder/promoter was taking too much time in decision making.

- The Bank A and B should have cooperated and coordinated with Bank C and D to come to the terms of the Standstill agreement as soon as possible thereby saving on time, that would have

helped consolidate the business of FMH BV. This would thereby have decreased the cash outflow and stabilised the operational and financial hardships of FMH BV.

- Getting into an early standstill agreement with the Banks should have been a priority so as to get moratorium on outflow of cash, which in turn could have been used in further generation of revenue by augmenting operations and financial procedures and using the cash flows towards maintenance of inactive cars (if any) for further generating revenues.

- The main aim should have been to increase the revenue by increasing tariff (if viable) or getting into other segments and steps taken to control the expenditure, would have entailed more cash flows. The early standstill agreement would have also provided the company with enough cash reserves to generate future cash flows which would have kept the company as a going concern.

- The money infused by the promoters should have gone towards increasing the business or towards increasing the cash flows.

- This would have, in turn raised the value of the company on different parameters and thereafter to approach the Banks with a sound restructuring plan based upon workable cash flows (even if there was a percentage haircut for the banks, it would be still a better option for the banks to agree for restructuring rather than the company going into liquidation and the Banks taking a huge haircut on their principal outstanding).

- Further the increase in value of the company along with robust operations would be a better way to sell to a competitor or a company wanting to get into the same line of business. The value receivable shall always be more that what the company is in current scenario.

Q2. What are in general advantages and disadvantages of an out-of-court restructuring (workout) as compared to a formal bankruptcy procedure? More specific, what are the advantages versus disadvantages in your country?

Answer:

The advantages or disadvantages of a Private consensual work-out and formal insolvency proceedings will vary from country to country based upon the different laws of insolvency and rules of informal workouts.

As per Woods[2]

"the paramount and overriding advantage of private workout compared to insolvency proceedings is the ability to avoid the trauma and taint of insolvency and the effect that insolvency proceedings have on business"

Advantages of out-of-court restructuring (Work Out)

- Faster safer cheaper – time and cost benefit
- Better success rate
- No trauma of Insolvency/bankruptcy[3]
- Easy to get further finance
- Since vendors and clients are not aware, business goes on as usual
- Credit terms remain the same
- No fear of contract cancellation
- Management is not disheartened or demotivated, as in insolvency the end stares them in the face.
- Management is in full control
- Debt - Equity conversion is easy
- All actions of standstill, setoff, moratorium is consensual
- No statutory disclosure of information
- Creditors reschedule loan fearing insolvency

Dis-Advantages of out-of-court restructuring (Work Out)

- Management and shareholders have a passive attitude towards informal reorganisation[4]
- Need for all creditors to agree for successful workout
- Any single Creditor can claim his security
- Formal proceedings only way to stop all creditors
- Can not check, stop, reverse preferential transactions
- In case debtor's business is in bad shape then formal proceedings can only help.

INDIA- My Country-(situation after 2016)

In India the Formal Insolvency and Bankruptcy proceedings based upon with the UNICITRAL Model Law were legislated only in 2016 (Insolvency and Bankruptcy Code 2016) **("IBC")**. Prior to 2016 there were two insolvency acts of British era, which were completely ineffective as the proceedings took many years to complete. After **IBC,** initially the Banks (who are the main creditors) started filing insolvency

[2] Philip R Wood; "Principles of International Insolvency (Part II)"
[3] ibid
[4] 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), pg 151

petitions under the new Insolvency act. The optimism of faster recoveries, was the main contributor to such filings. However, the success rate of insolvency matters getting **turned-around or resolved is around 15%**[5] of total cases filed and the rest of the **cases resulted in liquidations and the haircuts taken by the banking sector were sometimes around 50% to 80%**.[6]

Presently the Banks have started to cooperate with the debtors in the hope that before hopping onto the insolvency bandwagon they can either restructure the debtor with moratorium on principal or interest and in some cases on both and safeguard their original investment even if it means taking a slight haircut on their rate of interest, which interestingly in India can go up to 12% - 18% pa. In many cases the Banks are also keen on One Time Settlement **("OTS")** with the debtors and the hair cut that the banks have taken under OTS, to save on time and costs is between 20% to 50%.[7]

As far as informal proceedings are concerned the Government banks (who are the biggest lenders) take a lot of time in restructuring a particular case due to lot of complicated procedures which take a minimum of six months to a year after all data of restructuring is compiled and given to the banks for vetting. This entails audit of the business and financial plan provided by the Debtor of his business, and thereafter banks vet all financial ratios and viability of the plans and send them to their senior management for approval. The decision on restructuring is taken by the Board of Directors of the Bank and finally the case is sent to an Independent Committee of the Bank comprising of Bankers, Lawyers and Judges to approve the same. This committee only sits ten times a year.

I have personally seen in many cases that the debtor has introduced an investor so as to help the debtor financially in restructuring the business with the Bank and the investor waits endlessly for a confirmation from the bank on restructuring and after a year or so he losses interest and walks out and the debtor is in a worse position than he was before investor came in.

That debtor has now no option but to hatch on to the insolvency bandwagon to try and get some relief from the predators (vendors, clients, Banks etc).

In Nut Shell the advantages of Private consensual work-out are still better than the formal insolvency procedures since it not only helps the debtors in the way stated above in the "advantages of workouts" and also ensures that the Bank, the major creditors have the option to get the minimum haircut. However, the only qualification being that the banks and financial institutions catch the debtors at the first sign of financial distress and rectify/restructure/reorganise the debtors loan, otherwise it may be too late to save the organisation from liquidation and the banks from losing a major chunk of the money they loaned out to the debtor.

[5] https://economictimes.indiatimes.com/industry/banking/finance/banking/only-15-of-the-cases-resolved-under-bankruptcy-laws-report/articleshow/71925370.cms
[6] https://economictimes.indiatimes.com/industry/banking/finance/banking/lenders-take-57-haircut-in-94-cases- worth-rs-1-75-trillion/articleshow/69161782.cms?from=mdr
[7] https://www.rediff.com/business/report/promoters-make-one-time-settlements-with-banks/20190405.htm

Q3. Were the turnaround/reorganization approaches as presented in the reading material (see e.g. Adriaanse & Kuijl, 2006, Pajunen, 2006, Sudarsanam, S, Lai, J., 2001, Schmitt, A., Raisch, S., 2013) applied in this case? If yes, explain in what way. If no, detail what in your opinion should have been done differently.

Answer:

The various turnaround approaches as described in the reading material are described here in after. The Application of respective approaches in a particular article is detailed article wise: -

1. **Adriaanse, J.A.A., & Kuijl, J.G. (2006). Resolving Financial Distress:**

This article talks about informal turnaround in Netherlands. It describes the process of business and financial restructuring. The article talks about a structured approach to the solving the problems by removing the causes. It talks about the nature of the problems and the moment the corrective action is taken is key and decisive factor for the planned restructuring of any organisation[8].

Business Restructuring:
It talks about **Stabilising** the business by improving the cash flows, organising turnover time of receivables and optimising the stock position. **Analysing** the financial position, proposed measures, cash flows projections and their future prospects. **Repositioning** – Recruitments and Reinforcing – steps to initiating steps to regenerate positive cash flows by way of mergers or introducing new management etc.

Financial Restructuring:
This entails following measures: Reducing the repayment obligations and/or reducing current debts; Reducing interest obligations; Deferring repayments; Deferring interest obligations; Converting risk-avoiding capital into risk-bearing capital (debt-equity swap); Generating new risk-avoiding financing; Generating new risk-bearing financing (e.g., in the form of a partial or complete takeover).

Application Of Turnaround/Reorganization Approaches

In the case study, the application of the turnaround approaches as described in Adriaanse, J.A.A., & Kuijl, J.G. (2006) does seem to applied to a certain extent. The Creditors were planning a business restructuring by controlling cash flows in terms of controlling the costs and trying to increase the revenue by discussions with the main clients about possible price increases. The other clients were to be notified about the price increases; and spending cuts to be implemented (with regard to labour costs in particular). This was with the intent to remove the causes which they thought were the reasons behind the poor health of FMH BV.

There causes of the downfall were described however no action was taken on the following points of the causes:

- large management bonuses (€ 3 million) have been wrongfully issued (concerning salaries of the CEO and CFO of Flow Management Holding BV);
- Wrong accounting policies
- basic principles used in the cost price calculation deviating from reality

The causes were not fully removed. The management could have been forced to repay back the large bonuses in full and part and take pay cuts, accounting policies could have been strengthened by replacing the auditors as they act as check and balances vis-à-vis the accounting staff in an

[8] 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), pg 139

organisation. No doubt a measure to report on actual cost basis was initiated but still the company was getting in further losses.

Retrenchment of staff was a good step towards decreasing the revenue, but what was the effect of the retrenchment as we will discuss later in the article by **Schmitt, A., Raisch, S.**.

Thereafter it was followed by financial restructuring with various measures being put in place in the hope of turning around the company, however the decisions were not taken on time, e.g. decision to change the CFO was taken but no action was initiated.

Overall the causes of downfall were made known however proper and timely action was not taken to redress the causes of business failure.

2. Pajunen, K. (2006). Stakeholder Influences in Organizational Survival:

This article talks about the influence of the stakeholders in the survival of the organisation. It first tries to identify the important stakeholders in the financial turnaround of an organisation and manage them during the organisational survival process. It also provides how the stakeholder management can be an effective tool in an organisational turnaround. Its emphasis, that if the organisation is more dependent on a stakeholder, that stakeholder has more power over the organisation.

Key stakeholders can be: Promoters, Creditors, Managerial staff, Market, Vendors, clients, Employees, Government, Board of Directors, Industry associations etc.

Application Of Turnaround/Reorganization Approaches

The major stakeholders who had a say in the organisation were the creditors A, B, C and D Bank. They along with the clients, Shareholders and the Management Team were the most influential stakeholders who had influence and could have changed the factual matrix of FMH BV.

Banks: As per the case study there was no cooperation and coordination between the Banks initially and they were on loggerheads, however ultimately, they jointly entered into the standstill agreement, which was done at a time when the company had almost crossed the point of no return. The Banks should have cooperated and coordinated to act as one team and taken decisions timely and jointly to help FMH BV enter into standstill agreement within six months or nine months so that the company had a fighting chance to revive itself.

Clients: The clients were cooperative as they accepted the increased pricing for a better cash flow.

Management Team: Was not able to take effective decisions and were basically trying to give themselves bonuses instead of using the money for financial and operational efficiency. The delay in infusing capital and delayed decision making resulted in cash flows going haywire and the distress increased manifold.

Shareholders: were unable to keep their part of the bargain as they were slow in infusing funds as and when required by the various plans given to them by the Bankers or their own plans to initiate financial efficiency within the organisation.

3. **Sudarsanam, S, Lai, J., (2001), 'Corporate Financial Distress and Turnaround Strategies:**

This article talks about the various strategies to effect recovery and to test the effectiveness of those strategies and to identify the underlying factors of effectiveness.

The various strategies for an effective turnaround include:

- Change in top management
- Cost reductions
- Operational restructuring in short term can generate cash flows and profits, however they differ from long term restructuring.
- Asset restructuring
- Corporate Turnaround needs swift managerial action

Application Of Turnaround/Reorganization Approaches

Most of the strategies as laid out by **Sudarsanam, S, Lai, J.** were planned in the case study, however failed to materialise into concrete results as the implementation was quite delayed and hence the company further went into financial decline. Delay in changing the top management was one of the reasons.

Cost reduction were being done to take care of cash flows but the negative spiral of losses just ate into the infusion of positive flow and cancelled the effect of cost reductions.

Asset restructuring was done by selling some cars; however, the generated cash flow was used as settlement in cash with Bank. Which was against the principles of operational restructuring (pg 185-186).

Corporate turnarounds often require swift managerial action to stop the bleeding and any inaction or inappropriate action will lead to corporate failure. (pg 187)

4. **Schmitt, A., Raisch, S. (2013). 'Corporate Turnarounds: The Duality of Retrenchment and Recovery':**

This article talks about the inter-relationship between retrenchment and recovery. Different theories that the two are contradictory forces in revival of an organisation and conversely a theory that the two are interrelated and hence need to be integrated.

Application Of Turnaround/Reorganization Approaches

The 130 staff member to be made redundant were a cost cutting measure and that reduction in staff is a way to reduce assets and improve operational efficiency and/or to increase profitability. As per Pearce and Robbins: that successful turnarounds depend on effective retrenchment activities. (Pg 1218)

The case study does not talk much about the retrenchment effects on the turnaround, however the financial situation went from bad to worse after the retrenchment so the point in case that the retrenchment of the employees did not contribute in recovery, yes there may have been multiple factors for the downward trend and it cannot be conclusively said that whether decision to fire 130 employees and Independent contractors was a wise move or not.

Q4. 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 lawyer of the other two banks?

Answer:

The first principle of Creditors workout is cooperation between the creditors as the work out will only be successful if there is collective action by the creditors and individual creditors do not take individual action against the debtor[9]. The Bank C and D in their collective wisdom did not deem fit to cooperate initially and give time for a Standstill agreement to take place, which they ultimately did, however precious time was lost and it is needless to say that **"Time is of Essence"** in informal proceedings and corrective action should have been taken by all Banks collectively as soon as possible before the debtor climbs the ladder of insolvency, **as more he climbs the harder he will fall**.

We are not sure what was the total exposure of the Bank C and D in the total working Capital loan and other loans of the consortium. The reasons for the Bank C and D not cooperating with the Bank A and B have to be deduced from reading between the lines and logical reasoning herein mentioned below:

1. The exposure of the Bank C and D towards the total loan of the consortium might be quite less than that of the Banks A and B combined and the reasoning of the Bank C and D may have been that to enforce their liability and get as much as they can from the Debtor, which was already showing signs of financial distress and operationally was not doing well and therefore the future of the debtor seemed inevitable, which could also have been based upon their own due diligence of the debtor and the future projections and cash flows.

2. The Bank C and D had been overseeing the debtor's financial and operational systems and management and after continuous mismatches between the planning and the flawed outcome of various plans, they decided not to continue with the funding.

3. That Bank C and D may have evaluated their total exposure towards the debtor and the probable liquidation value of the debtor (the liquidation value will further decrease with the passage of time as the value of the company will be further eroded on account of depreciation and other expenses), they must have taken the decision to not to cooperate with the Bank A and B and go their own way.

4. One of the causes may have been for non-cooperation of Bank C and D, non-enforcement of action points by the management and promoters of the company with regard to infusion of funds as and when required as decided in the joint meetings of Banks and the Company. Delay in the appointment of CFO and the continuing bad financial health of the company despite many plans to turnaround may have been a catalyst in their non-cooperation.

5. Probably the Bank A and B were not following the first principle of Multi-creditor workouts by not cooperating with the Bank C and D by not taking Bank C and D into confidence and not

[9] INSOL INTERNATIONAL, Statement of Principles for a Global Approach to Multi-Creditor Workouts II

sharing essential data and/or the Bank A and B were lax in communication with the Bank C and D due to their less amount of exposure in the total loan and Bank C and D may have felt that their interest in the loan may be compromised by the Bank A and B, hence all the more reason for non-cooperation.

My role as a Lawyer of Bank A and B

As a lawyer for the Bank A and B my role will be that of a facilitator. I would try and implement statement of Principle multi-creditors workouts II. That initially the principles of cooperation[10] and coordination[11] should be implemented between the Bank that I am representing and the Bank C and D.

I feel that most of the problems in the world relating to anything are caused by on common element and that is “lack of communication”. The channels of communications between Bank A and B and Bank C and D should always be open and any query from the other parties be entertained on priority and any misconception or miscommunication to be dealt with immediately to avoid confrontation, lack of trust and future non-cooperation.

Certain measures like point of contact for resolving issues between the Banks, setting up of authorities at senior management levels to escalate and settle disputes and differences be created to keep the flow of information going and keeping each other well informed of all facts, developments, information’s and concerns in respect of the debtor[12].

- This will in effect raise the comfort level of the parties involved and bring all lenders at par with all relevant and necessary information to take logical and calculated decisions vis-à-vis between lenders and vis-à-vis with debtor.
- This will help bring the debtor at a comfort level that all the lenders are concerned for their business and will take steps to put in effect the decisions reached by the lenders acting as one.
- This will make the Bank C and D that the collective efforts of all shall be better than the individual efforts and thereby extracting their cooperation.

[10] Principle One of the Statement of Principles for a Global Approach to Multi-Creditor Workouts II
[11] Principle Four of the Statement of Principles for a Global Approach to Multi-Creditor Workouts II
[12] Ibid 6

Q5. 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)?

<u>Answer:</u>

The standstill agreement was entered in August 14. In the present case scenario, some principles of **'Statement of Principles for a Global Approach to Multi-Creditor Workouts II'** can be found to be applicable partially. Let's take each principle and examine its applicability to the present case scenario.

<u>FIRST PRINCIPLE:</u> Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

> **<u>Applicable :</u>** There was cooperation by both Bank A and B on one side and Bank C and D on the other, however during the course of the period prior to standstill period in effect, Bank C and D wanted to chalk their own course of action, which probably delayed the imposition of standstill period and the debtor further went deep into debt lacking cooperation between the two sides. However, after a period of mis-trust the banks finally entered into Standstill Agreement in August 14. The time being of essence, the delays caused by non-cooperation of Creditors tend to create difficulties for the debtor's business, as is seen in the present case.

<u>SECOND PRINCIPLE:</u> During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced. Conflicts of interest in the creditor group should be identified early and dealt with appropriately.

> **Not Applicable:** This principle was not adhered to in the current scenario since In January 2015 a total of € 25 million is paid back to the providers of the (additional) working capital, which is against the intent and the letter and spirit of this principle.

<u>THIRD PRINCIPLE:</u> During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

> **Not Applicable:** This principle also was not adhered to by the debtor as the information's to creditors immediately prior to standstill agreement and post thereof were not constant and were constantly changing as per the facts. The figure of rise in losses given in October 2014 is a point to that effect.

<u>FOURTH PRINCIPLE:</u> The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

Partially Applicable: There seem to be lack of coordination between the Creditors (banks). Lack of Communication and other factors discussed in answer to Question 4[13]. However later the Banks seem to have coordinated by entering into the standstill agreement.

<u>FIFTH PRINCIPLE:</u> During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely 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.

Not Applicable: This principle also was not adhered to by the debtor as the information's to creditors immediately prior to standstill agreement and post thereof were not constant and were constantly changing as per the facts. The figure of rise in losses given in October 2014 is a point to that effect.

<u>SIXTH PRINCIPLE:</u> Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

Applicable: The terms of Standstill agreement talk about the way forward to resolve the crisis in the FMH BV. The action points mentioned in the standstill agreement are potential practicable arrangement made to get the Debtor out of the financial stress. These points were made keeping in mind the situation of the Debtor at that point in time and with the due diligence of all stakeholders.

<u>SEVENTH PRINCIPLE:</u> Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

The facts of the case don't talk about this specific principle and its applicability cannot be determined in the present case scenario.

<u>EIGHTH PRINCIPLE:</u> If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

Not Applicable: There is provision of additional funding by way of a bridging loan in the No. 4 scenario of October 2014, however the same is not reflected by any facts in the case and therefore this principle is not applicable in the present case scenario.

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[13] Please see Answer to Question 4

Q6. Suppose it is not possible to convince other creditors to adopt the Statement of Principles in a given situation, are there any other possibilities for "soft law" to use (perhaps specifically in your country/region)? If yes, explain in what way. If not, do you see any alternative (informal) possibilities?

Answer:

In India the position with respect to single creditor negotiating with the debtor is well defined. Even a consortium of Banks or other Financial Institutions negotiating with the debtors is defined as the lead banker is going to lead the negotiations.

At the day of the default, the debtor has 90 days to either rectify the default or be declared as **"Non-Productive Asset" (NPA).** After the NPA the Bank or the Lead Bank has full right under the **SARFAESI Act** to initiate action against the debtor and reclaim his assets and sell them off to get their money back.

Since everyone is aware that selling the assets shall not be profitable to the Banks as they will have to take substantial haircut, the banks along with the debtor is happy to restructure the debtor's loan as per the potential business and financial plan given by the debtor, either with modifications or without. This will entail moratorium on Principal or Interest or both depending upon the cash flows as per the potential business and financial plan given by the debtor.

The only hitch is that the credit rating of the debtors becomes very bad and no other credit is available to the debtor from any financial institution. The initial Bank funding the debtor is also very vary of providing interim finance to the debtor to run his business. It is expected that the business to run on its own by generating more revenue.

This reasoning by the banks is flawed as the business itself went into this position due to factors which may be within the control of Management or outside the control of management and they can be external or internal[14] and no effort is made to identify the causes and try and incorporate the same into the business plan or financial plan. The debtor has already extinguished his capacity to take more debts as in most of the cases he has mortgaged all his assets prior to be adjudged NPA. He has no other collateral security to raise more finances.

The only option left is to run the business on its own revenue, which is not possible in most cases or to let the business to be sold off by the Bank as a going concern. The "**catch here"** is that the whatever is received after the sale of the business including mortgaged assets, the difference in the amount lent plus interest is still to be borne by the debtor. The way out is formal Bankruptcy proceedings.

However, the debtor has an option to get into a **"One Time Settlement" OTS** with the bank and the bank is happy to take haircut on the OTS as it will still be better than sale of the assets and they will get a

[14] Mellahi, K., & Wilkinson, A. (2004)

percentage of money back. The Banks give usually twelve months to twenty-four months to get paid under OTS.

In my opinion there is another option, to let the Bank sell the business to an Asset Reconstruction Company (ARC). **In one of the matters handled by me** the ARC bought the debt from the Bank at a haircut of 33% to the Bank and offered the debtor a time frame of 5 years to pay back the ARC with favourable interest rate and balloon payment at the end of the 5th Year. This was acceptable to debtor as the Bank was giving him only 12 months under OTS to pay back the amount of debt, whereas the same debt reduced by 33% and the debtor got 5 years to pay back with interest payment every six months and principal after two year moratorium and thereafter every year a small payment of principal and a balloon payment at the end of 5th year.

This not only took care of the repayment scheduling of the debtor also since the payment period was spread over a period of 5 years, the external factors were negated and the business started to earn profits as the cash flow was quite less as compared to earlier and this save the debtor from insolvency and over a period of time he became solvent and repaid his debt obligation to the satisfaction of ARC.

Q7. Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015.

Answer:

The essence of the restructuring agreement as signed on the 4th of July 2015 is that the Banks are trying to insulate the new company FM II from the main shareholders and the original holding company and are trying to prevent any hold or lien by the old stakeholders.

The new company FM II is expected to have minimum exposure to loans and therefore expected to make profits if the total outstanding in terms of loans and liabilities is decreased so as to have less outflow of cash on account of servicing of loans and interest. In this scenario, the restructuring agreement is requiring liquidation of the FMH BV and all claims against the same shall be waived off or cancelled by the Banks and shareholders. Consequently, FMH BV shall have no claim, lien, or any sort of liability over the new company FM II.

Going Forward FMW loan given by C and D bank amounting to € 32.5 million shall be waived off to decrease the liability of FM II BV (the merged entity of which FMW is a Part). The consortium of Banks shall also waive off another € 97.5 million of outstanding due from FMW. Further another loan of € 55 million is waived off.

After all waivers of loans, the outstanding remaining on the new entity FM II BV shall be € 240 million pertaining to FMW. In effect that is what is remaining as outstanding and all dues, loans other than € 240 million outstanding have been waived off by the creditors and the shareholders. They have waived off their claims and hence the new entity is devoid of any previous relationships and outstanding loans from the previous pyramid of companies and the new entity can start afresh with an outstanding of € 240 million.

The result of this restructuring is that the new company is expected to break even in a short period of time due to less outflow of cash for loan servicing and if operationally more revenue is generated thus increasing the cash flow and getting the new company out of the red and into profits.

This shall achieve positive cash flows and the various financial ratios will be seen in a positive manner thereby strengthening the Balance sheet of FM II and consequently it will have a direct positive effect on the valuation of FM II which would help the FM II to get future loans from providers and also make the company attractive to buy to potential buyers of the new company.

However as the saying goes ***"Don't count your chickens before they hatch"***, as stated in the facts the new company FM II incurred an operational loss of € 9 million in 2015 and thereby once again bringing the careful financial planning to nought by operational mismanagement and again taking the company in red when it was supposed to be in profits as planned.

The potential investors/buyers and more specifically the players in the same segment will be eyeing the new company FM II and since the FM II is not doing well operationally, but they have client base and

fleet of cars. FM II is not being managed properly, and other things apart there is a debt of € 240 million along with the cost of assets, the buyout of the company shall be a huge burden on the potential buyers.

They have correctly assessed the situation that to buy out company will be expensive. They have wisdom in thinking to buy the company in liquidation as they will be able to get the company FM II at a much lesser price than if they were to buy the company lock, stock and barrel.

Q8. Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?

Answer:

FMH BV is a multi-national company and is a holding company for six different companies, all in different jurisdictions and operating under the local laws of their respective jurisdictions. FMH BV has its COMI in Netherlands. One of the other subsidiaries too is within the jurisdiction and laws of Netherlands. The other subsidiary companies are located in Spain, France, Australia, South Africa and USA.

All the subsidiaries are distinct legal entities and having their assets in their respective foreign jurisdictions. Consequently, the issues that can arise are:

1. **COMI of parent or Holding Company and that of the subsidiary company**.
   The COMI of Holding company and that of a subsidiary may be different. The different laws of various jurisdictions can displace or change the COMI; In *Re Zetta Jet Pte Ltd* (2019), the Singapore High Court held that the Centre of Main Interest (**COMI**) of a Singapore-incorporated company was the US. It noted that a company's jurisdiction of incorporation could be displaced as the presumed COMI jurisdiction on evidence to the contrary.

2. **Recognition of the Foreign Main Proceedings (Rule of Priority)**
   Continuing with the COMI, Various jurisdiction can lay claim to the COMI as happened in Eurofood IFSC Ltd 2006 ECJ (C-341/04). Italian court opened a main insolvency proceeding, whereas the Irish courts found Eurofoods COMI in Ireland and the matter was thereafter referred to ECJ.
   Rule of Priority: The main insolvency proceedings opened by a court of a Member State must be recognised by the courts of the other Member States, without the latter being able to review the jurisdiction of the court of the opening State. The rule of priority provides that insolvency proceedings opened in one Member State are to be recognised in all the Member States from the time that they produce their effects in the State of the opening of proceedings.

3. **How to define a group company**
   - If there exists between different group entities a relationship of financial or commercial nature that makes the entities interdependent on each other in terms of business strategy and growth. However, this would not be the case if a company is holding controlling stake in another company as a standalone financial investment and the subsidiary company is not deriving any material support from its parent company.
   - Creditors of a subsidiary company can file their claim before that company only and not before the Holding Company, as there is no concept of general group liability.
   - Another important aspect is that if a company controlled by a group is making big time profits, should that company too be put under the hammer along with loss making companies.

4. **Related Party Transactions**
   Wherein the transactions between the Holding Company and the subsidiary relates to the decisions by controlling shareholders; could impose unfavourable transactions to subsidiaries, being transactions that reflect the interest of the group, or of its controlling shareholders, but not the financial or economic interest of the subsidiary. The same could be treated as related party transactions.

Q9. In October 2014 four scenarios have been drawn up. Why was or wasn't calling for a moratorium (see scenario 4) a good option given the situation at that time? [you are allowed to give your opinion based on your own countries' Bankruptcy Act; be as detailed as possible]

Answer:
The Standstill agreement has been delayed by almost a year after the initial meeting of the creditors. The standstill agreement has been signed in August 2014. The cash flow situation has worsened to the extent that the Banks themselves are calling it a "Go or No Go" situation. In this scenario the fourth scenario drawn in October 2014 calls for moratorium on all payments to creditors seems to me as unwarranted as the standstill agreement has already been executed and the second principle of "**Statement of Principles for a Global Approach to Multi-Creditor Workouts II"** clearly outlines that:

> **"SECOND PRINCIPLE:** During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced. Conflicts of interest in the creditor group should be identified early and dealt with appropriately."

In fact, the moratorium as recommended in the second Principle should be in effect after standstill agreement and if all the creditors are following the aforesaid principle then there is no need of any specific moratorium as stated in the fourth scenario drawn in October 2014.

In India the informal workout by the banks starts immediately after 90 days of the default and the Bank officers start to force the Debtor to either workout a restructuring/reorganisation or a threat of selling the security interest by the creditors always looms large on the debtors. In India, Moratorium clause with in a restructuring agreement is not mandatory and needs to be specifically mentioned depending upon the cash flow requirements of the debtor, taking into account the future projections.

It is essential that the restructuring or reorganisation should start as soon as possible so that whatever moratorium is going to be provided in the restructuring agreement by the banks in India is addition to the cash flows that can be sustained by the debtor. If the restructuring agreement is drawn up earlier the cash flows can be managed with efficiency and realistically, however if the restructuring agreement comes at a stage that the debtor has utilised all his credit limits and the cash available to him, then the business is doomed to go down the drain as the cash flows will not be there to sustain the business.

The idea of a restructuring agreement is to help the business by initiating a moratorium to save on cash outflows and use the same in generating more business out of the cash reserve. Initiating this moratorium is very essential at a time when the business has started on a downward trend. The cash reserves generated can sustain the business and help it come out of financial crunch *(If the business is down because of causes attributable to financial issues).*

The delay in standstill agreement in the case study scenario came at a very late stage to have been effective for a business turnaround.