INSOL INTERNATIONAL

GLOBAL INSOLVENCY PRACTICE COURSE

2023 / 2024

Session 9 Materials – Workout Clinic

CONTENTS

INSOL INTERNATIONAL

GLOBAL INSOLVENCY PRACTICE COURSE

Global Insolvency Practice Course 2023/24

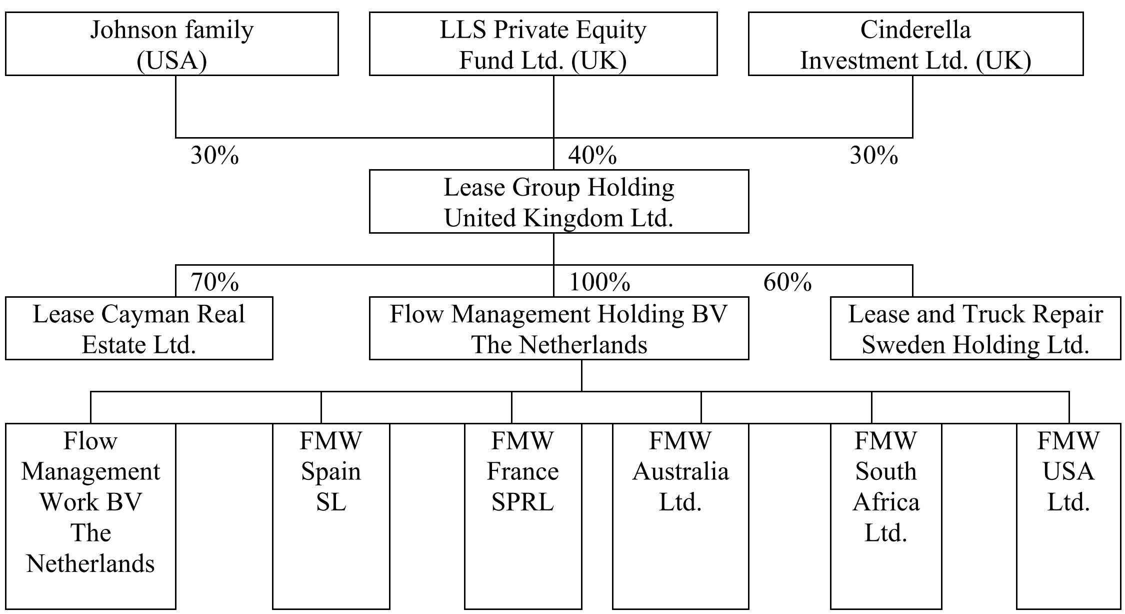
<u>Take home case study module A</u>

Please read and analyse the following case and answer the questions that follow.

Flow Management

Flow Management Holding BV – based in The Netherlands (Amsterdam) - is part of an international group of companies that leases trucks and private cars and is also active in short leasing, real estate and truck repair. The group is owned by the Johnson family, as well as two investment companies (see organizational chart below; all relevant corporate entities are shown).

Flow Management Holding BV - being a privately held company - acts as the centre of main interest of six operating companies (subsidiaries) at home and abroad; all operating under local company laws. The entire company employs over 3.000 people and has more than 200,000 cars in its fleet.



FMW = Flow Management Work

On 16 November 2013 the four banks (A, B, C and D) of Flow Management Holding BV are invited by the board of Flow Management Holding for a meeting (at that moment, financing of working capital at the main subsidiary called Flow Management Work BV totals € 360 million, other loans from these banks at Flow Management Work BV amount to € 55 million). The main reason for these talks is that the reported pre-tax profit until September 2013 of € 8 million really turns out to be a loss of € 5.4 million. In addition, faults have been found in the annual accounts of 2012. The result of € 3 million must be downgraded by € 8 million. The causes of the losses and negative corrections (as communicated by company management) are stated below:

- large management bonuses (€ 3 million) have been wrongfully issued (concerning salaries of the CEO and CFO of Flow Management Holding BV);
- a contingency gain relating to three years has been received in 2012 and has been wrongfully booked as a result in 2012. A negative correction of € 1.6 million must be made;
- in 2012, in anticipation of book profit ('paper gain') to be realised in 2013, a € 2.8 million book profit is made. This book profit was neither realised in 2012 nor in 2013;
- the 2013 loss is the result of the basic principles used in the cost price calculation deviating from reality (because of a 'formula error' in a spreadsheet, it emerges later). Since they failed to periodically check the real costs against the results of the cost price calculation, the prices charged were too low, resulting in a loss.

In order to remove the causes, management presents the following plans:

- discussions will be held with the main clients about possible price increases. The other clients will be notified about the price increases;
- spending cuts will be implemented (with regard to labour costs in particular).

Since the business structure is there and operates properly, there is market demand and the forecast for so-called "hiring and leasing days" are consistent with reality, management expects that, in view of the measures to be taken, a profit will be made again from January 2014.

Banks A, B, C and D agree to discuss the company's situation on 1 December 2013. In the meantime, an accounting firm (not being the company's auditor) is called in to investigate the procedures within the company. In addition, Flow Management Holding must report based on actual costs and turnover each month and Lease Group Holding United Kingdom Ltd. [in this case also referred to as 'the shareholder' or 'shareholder company'] is asked to pay off the equity capital so the solvency rate (equity/total assets) returns to a minimum of 5% (currently this is 3.9%). The shareholder company - represented by its CFO - proposes to sell 350 cars to improve the solvency rate. The banks however prefer an actual settlement in money.

In December 2013 it emerges that the afore-mentioned loss of € 5.4 million only concerns Flow Management Work BV. On top of that, the foreign subsidiaries have made a loss of € 6.3 million as a result of which total losses of 2013, including a loss of the holding [Flow Management] of € 11.4 million, amount to € 23.1 million. A recently hired independent turnaround consultancy agency concludes that the company is viable, with a view to the market share and achieving the estimated turnovers. Furthermore, at that moment the following measures have been taken / plans have been drawn up:

- the main clients have been visited and they agree upon the price increases. Other contacts/clients (approximately 5,000) have been informed that prices will increase; only a few negative replies were received. A result increase of € 7.8 million is forecasted on the basis of these price increases;

- 130 staff members - employees and independent contractors - will be made redundant. This will yield an annual saving of € 3.3 million;
- extra savings will be realised through improved loss recovery, higher excess premiums and savings on car repairs. The total amount of savings is expected to be € 3.9 million.

So, on the short term the firm expects an increase of € 15 million in the results. Although, the banks are shocked by the entire company's situation, legal action will not yet be taken against the company, pending the final report from the consultancy agency. It is concluded by the bankers 'not to panic'. Moreover, it is decided that action must be taken jointly and in a controlled manner. Banks are of the opinion that the board of the shareholder company must take measures with regard to management (the CFO in particular) and that the shareholder must be put under pressure to raise € 35 million in order to repay part of the debts (originally planned on 31 December 2013), and to raise an amount of € 12.5 - 15 million to further strengthen the equity capital position. Furthermore, default interest will be charged in order to put healthy pressure on the relation.

On 20 December 2013 the (adjusted) actual results for 2011-2013 are announced. They have been listed below.

In € million	**Net profit**
2011	9.4
2012	-/- 6.1
2013	-/- 36.4

The total loss turns out to be even higher than stated on 1 December 2013. Solvency, at 0.1%, is virtually zero. It is concluded that there is enough cash to fulfil the current obligations until the end of April 2014. This does not take into account a scheduled repayment of € 35 million on 31 December 2014 which will not go ahead and with regard to which the banks have given their (implicit) permission. It is (again) announced by the banks that the shareholder must contribute at least € 12.5 million in order to reduce the pressure on liquidity.

The result for 2014 is estimated to be € -/- 5.7 million. This forecast is based on an expected profit in the Netherlands of € 7.5 million, continuing losses abroad, as well as a loss of € 14.4 million in the holding (predominantly based on write-off of goodwill). It is also expected that the management information system will have been improved so that the figures will be more reliable.

Although formally the banks have sufficient legal reason to terminate the credit agreements, this is not done. The reason is that – according to the banks – bankruptcy (i.e. liquidation) of the company (in Dutch: 'Faillissement') will negatively affect the proceeds of the assets. In addition, there is a problem with the securities (pledges) on the assets established at the banks. The contracts which were concluded in this respect are probably not foolproof, so that the proceeds will be substantially lower (or even zero) in the event of liquidation. The banks attempt to solve this problem as soon as possible.

In January 2014 the shareholder announces that she will make a decision within short term about the strategy of Flow Management Holding BV. Some of the possibilities are to continue restructuring the foreign subsidiaries as well as strengthening the balance sheet by injecting risk-bearing capital. Trust is put in the company and it is announced that it will appoint a new CFO soon. The banks conclude that the company's management and the shareholder constructively work together on a solution. They also realise that a joint approach from the banks is desired and that a standstill agreement must soon be signed by the banks in order to achieve this (the expectation is that management and the shareholder will not formally commit themselves until the banks act as one party). It is agreed that an agreement will be signed no later than 31 March 2014 (in this way, there is also sufficient time to solve the legal problems with regard to the pledges).

Mid February 2014 it is clear that the process to come to a standstill agreement passes off with difficulty. Banks C and D are all of sudden not cooperating. Banks A and B are worried, since this reduces the negotiating power towards the company as a result of which, in the eyes of the bankers of A and B, required restructuring measures will possibly not be taken (the injection of necessary capital by the shareholder in particular). Furthermore, there could be (increased) discord among the now two groups of banks and the cooperation from the company could be jeopardised, so that the company's liquidation draws nearer.

On 21 February 2014, a profit forecast of € 9-10 million is announced for the Dutch subsidiary with a turnover of € 200-250 million. This is an increase compared to earlier expectations. The sale of Flow Management Holding BV to a financially healthy party is at that moment viewed by the banks as a good possibility in case the current shareholder cannot or will not contribute sufficient capital.

At the end of March 2014, no standstill agreement has been signed yet. There is still friction among the banks (A and B versus C and D), as well as among the banks as a group and the shareholder of Flow Management Holding BV about the cooperation in finding a solution. The main reason for this is the banks' general lack of confidence in the Flow Management company, considering the developments of the past six months (although most specifically felt by the bankers of C and D). In the middle of April 2014, the CEO of Flow Management Holding BV is replaced by the board of the shareholder company and at the same time she deposits € 10 million in the company as an unsecured loan, with the interest obligations being added to the principal sum of the loan. She also makes a proposal mid May 2014 to lend another € 27.5 million to Flow Management Holding BV under the same conditions.

At the same time banks A and B are investigating whether it would be possible to buy out banks C and D with a 15-20% discount, in order to act more decisively now that there (still) is no standstill agreement.

In the meantime, the following plans have been drawn up:

- the strategy must be focused on increasing turnover by itself, in combination with large cutbacks;
- the entire business mix (product-range) will be evaluated and reassessed;
- the shares of the companies outside the Benelux-countries[1] will be sold off, as well as some (non-Benelux) foreign branches (non-legal entities) controlled by Flow Management Work BV.

However, the profit that has been forecast for 2014 does not seem to be feasible. A loss of € 8.5 million is expected, but on the other hand there is an expected profit of € 30 million in 2015, although the ranges applied (positive/negative) are € 4 million and € 10 million respectively. Also based on the afore mentioned, the banks (instigated by bank A) announce they want to appoint a

[1] Benelux = Belgium, the Netherlands and Luxemburg.

certain person as CRO ('Chief Restructuring Officer') in the board of directors of Flow Management Holding BV, because she can be valuable in the restructuring process.

In June 2014 the shareholder holding company of Flow Management Holding BV makes a proposal in order to effectuate financial restructuring at Flow Management Work BV so that the equity capital, which is now negative (solvency is -/- 9.5%), returns to 5% again. The proposal is outlined as follows:

Working capital financing

- The amount of € 35 million of additional working capital which should have been repaid at the end of 2013, will be paid off in accordance with a repayment scheme from 2015.
- Refinancing the remaining working capital (€ 360 million) which is planned for November 2016 is postponed until 2019.
- Default interest is no longer charged.
- A waiver is granted for all other non-fulfilled contractual obligations.

Other loans

- Refinancing scheduled for 2017 is postponed until 2020, while repayment will be subject to liquidity, and *Cash sweeps* will take place.
- Repayments scheduled for 2014 are postponed until 2017.
- Default interest is no longer charged.
- A waiver is granted for all other non-fulfilled contractual obligations.

In addition, the shareholder will contribute at least € 27.5 million. Since a going concern sale at that moment is no longer an option (no interest) and a liquidation scenario will probably have low proceeds (a maximum of 55% of the total in outstanding debts), banks A and B are open to negotiations with regard to the proposal, provided that an amount of at least € 35 million is injected.

At the end of June 2014, it is announced in a press release by the CRO that a € 27.5 million loss is expected for 2014 despite earlier announcements and that a liquidity shortage is imminent. The reason is a delay in the reorganisation to be carried out (in respect of price increases and cutbacks among other things). At that time, banks C and D threaten to cancel the credit (it later emerges that this was somehow done to give off a signal to the company to hurry up). The shareholder is subsequently willing to deposit € 10 million in the short term and to contribute the remaining € 25 million in September / October 2014. All this on the condition that it is truly needed and that a standstill agreement will be signed.

Early August 2014, and the banks conclude that the time has come for a 'Go or No Go' in respect of the question whether financing should be continued. Although, the banks as a group are not happy with the constantly changing information given by the company, they are content about Flow Management Holding BV's new management (including the CRO) and they notice a slight result improvement due to the reorganisation. They therefore decide to pursue a standstill agreement in the short term. Nevertheless, sale scenarios are drawn up as well as a liquidation scenario. These scenarios must have been drawn up no later than September / October. The 120-day standstill agreement is subsequently signed in the middle of August 2014.

In October 2014 four scenarios have been drawn up:

1. a going concern option if the company proves viable, with shareholder and banks agreeing to an additional 180-day ‘stand still’ or refinancing. The starting point here is that the shareholder contributes another € 30 million and the banks will transfer security rights of € 45 million to the shareholder;
2. selling Flow Management Holding BV if viability is not sufficiently proven. A buyer must be found soon;
3. a Debt equity swap (conversion of debts into shares) with or without the cooperation from the shareholder;
4. a moratorium [formal suspension of payments procedure] or restart following liquidation, with the company being sold in a ‘controlled’ manner. However, banks must be willing to provide a bridging loan.

On 31 October 2014 it is announced in a press release that the expected loss for 2014 will rise to € 39 million, and that a € 10 million loss for 2015 is forecast, followed by a slight profit in 2016. Although the provision of information has improved, the banks are at that moment disappointed with the progress of the reorganisation. The company will provide € 10 million of tax refunds as additional security. As a result of the sale of surplus assets, sufficient incoming cash flows are expected so that additional deposits seem unnecessary.

Based on recent developments, the banks conclude that a going concern situation seems to be the best one. A study is held into the possibilities of a Debt equity swap. It is also scrutinised what the role of the current shareholder would be in that case.

In January 2015 a total of € 25 million is paid back to the providers of the (additional) working capital.

On 4 July 2015, a Restructuring agreement is finally signed. This is outlined as follows:

1. all operating companies of Flow Management Holding BV are to be accommodated in a shell subsidiary, called Flow Management II BV;
2. the shares in Flow Management II BV are transferred to the consortium of banks (A, B, C, D) which has financed the original working capital of Flow Management Work BV, as well as to a number of board members (including the CRO);
3. Flow Management Holding BV will be liquidated in an undisclosed manner. All claims against this BV will be cancelled by the banks and the shareholder of Flow Management Holding BV;
4. Flow Management Holding BV and its shareholder will cancel all claims against Flow Management II BV and its subsidiaries;
5. the banks (C and D) which in the past provided Flow Management Work BV with additional working capital will waiver an amount of € 32.5 million. In fact, the entire debt is written off (‘haircut’);
6. the consortium who in the past provided Flow Management Work BV with working capital will waiver an amount of € 97.5 million. A € 240 million claim against Flow Management Work BV remains;
7. the € 55 million loan in Flow Management Work BV is cancelled in full.

The contents of the financial restructuring agreement reflect the relative positions of the financiers involved. The providers of the original working capital posses pledges on most assets of Flow Management Work BV (the main partner in the group) and will receive part of their claim on liquidation. The other financiers (both banks and shareholder) have no or subordinated security rights and will (most probably) receive nothing from their claims on liquidation. As a result of this restructuring, the foundation is laid for selling the company (now being 'Flow Management II') in a going concern situation.

In May 2016 it emerges that the 'new' company incurred operational losses of nearly € 9 million in 2015, despite (revised) forecasts of a break-even result. However, as a result of the debt reduction, the net profit is positive and the equity capital is strengthened (solvency is higher than 5%). The expectation is that a slightly negative or break-even result will be achieved in 2016. The reorganisation takes place without delay. Meetings are held with three parties active in the same industry. The talks pass off with difficulty and management has the impression that the takeover candidates prefer to buy the company following liquidation. The working capital which has been made available again on the transfer of shares should be refinanced in November 2016 according to the agreement. Taking into account the negative results and the troubled takeover talks, this refinancing is postponed until July 2017 in order to prevent liquidation.

Although the situation is critical, a better future is forecast, and the parties are carefully optimistic about a good result…

<u>Assignment questions</u>

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

1. What were in your opinion the causes of financial distress at Flow Management (see e.g. Mellahi & Wilkinson, 2004)? Could the financial distress have been prevented? If yes, explain how. If no, why not?
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*?
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.
4. Banks C and D seem to frustrate the process at a certain point. What could have been the (rational and/or opportunistic) reason(s) for them to behave like that? What would you have done in that situation in your role as advisor of the other two banks?
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)?
6. Suppose it is not possible to convince other creditors to adopt the Statement of Principles in a given situation, are there any other possibilities for "soft law" to use (perhaps specifically in your country/region)? If yes, explain in what way. If not, do you see any alternative (informal) possibilities?
7. Explain in detail the essence and result of the restructuring agreement as signed on the 4th of July 2015.
8. Which (potential) legal and/or non-legal cross-border issues – if any – do you recognize in the Flow Management restructuring process?
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]

Reading material [see course platform or link]

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), 135-154.

Broekema M.J.R. & Adriaanse J.A.A. (2022), Valuation Ambiguities under the European Directive on Preventive Restructuring Frameworks: Insights from the Netherlands, The European Business Valuation Magazine 1(1): 4-10. [please click here for link]

INSOL International. (2017), *Statement of Principles for a Global Approach to Multi-Creditor Workouts II.*

Mellahi, K., & Wilkinson, A. (2004). Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, 5(1), 21-41.

Pajunen, K. (2006). Stakeholder Influences in Organizational Survival. *Journal of Management Studies*, 43(6), 1261-1288.

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

Schmitt, A., Raisch, S. (2013). ‘Corporate Turnarounds: The Duality of Retrenchment and Recovery’, *Journal of Management Studies*, 50(7) p. p. 216-1244.

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Review of Central and East European Law

Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?

Jan Adriaanse and *Hans Kuijl*

Abstract

In times of economic decline, increased attention is devoted to companies in financial difficulties. Partly as a result of this basic fact, many countries are currently working (under pressure) to improve existing insolvency legislation. This seems to be largely fuelled—as is the case in The Netherlands—by a strong desire to prevent bankruptcies as much as possible.

Statutory legislation aimed at the deferment (or remission) of debt payments is introduced or relaxed in order to provide a fresh start for insolvent companies. An alternative possibility—in the form of informal reorganization—seems often to have been overlooked by legislators. This type of reorganization, therefore, is the focal point in this article.

As far as the stimulation of rescue operations is concerned, the authors conclude that legislators must particularly focus their attention on informal reorganization. The thought is that such a policy focus for (member states in) the EU may also be of relevance (in whole or in part) for countries in the CIS/CEE/SEE regions.

> "Although centuries separate us from the Laws of the Twelve Tables—which allowed the creditor to chop the debtor into pieces—and despite the fact the legislator's attention has shifted from the body of the insolvent debtor to his assets, the view of bankruptcy as a most serious and acute problem requiring flexible, thoughtful and effective regulation still remains valid today."[1]

1. Introduction

With regard to the reorganization of a company in financial difficulties, a distinction can be made between *formal* and *informal* reorganizations. Formal reorganization includes all possibilities of reorganization laid down by the (insolvency) law or which take place by using legal methods and possibilities. In The Netherlands these are, *e.g.*, moratorium (reorganization

[1] See Andrei Iu. Bushev *et al.*, "The Theoretical Underpinnings of Commercial Law: A Russian View of Bankruptcy and Securities. Part I: The Concept of Bankruptcy and Principal Bankruptcy Procedures", in 30(2-4) *Review of Central and East European Law* (2005), 185-256, at 185.

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process), (re-start following) liquidation, as well as the so-called private person fresh start proceedings (in Dutch: *WSNP*[2]). In Russia these are both in the 1997 and 2002 bankruptcy legislation, *e.g.*, external administration (reorganization process), competition proceedings (liquidation procedure), and bankruptcy of an individual citizen.[3] An informal reorganization is understood to be a reorganization route which takes place outside the statutory framework—therefore, in *the shadow of the law*—with the objective of restoring the health of a company in financial difficulties within the framework of the existing legal entity. An informal reorganization consists primarily of *business restructuring* and *financial restructuring*.[4]

There is a burgeoning literature on the transition in the region of Central and Eastern Europe and the Commonwealth of Independent States from state and party control of the political, economic, and legal systems to ones that are more democratic, market-oriented, and based on the rule of law. A portion of the scholarly and practical work in this area deals with the issue of legal (and other) transplants.[5] As part of the transition process in the Russian Federation (RF) for example, there has been a decade-long collaboration—beginning early in the 1990s—between legal scholars, judges, and civil servants lawyers in the RF and their colleagues from The Netherlands. This has resulted in a rigorous comparative exercise—not unlike that performed by the compilers of the Imperial Russian draft Civil Code at the end of the nineteenth and the beginning of the

2 See Title 3 Dutch Bankruptcy Act. The *WSNP* has been set up as a scheme to incentivize a natural person-entrepreneur (more in general: a natural person) and her creditors to come to an arrangement voluntarily in case of financial difficulty. When such attempts are unsuccessful, the entrepreneur can then make an appeal to the *WSNP* scheme aiming a debt-relief—fresh start—within three to five years of entering the proceeding. In theory, it is still possible for the entrepreneur subsequently to offer an arrangement and to make her repayments from the revenues of her continued business operations although, in practice, little use is made of this procedure.

3 See, among others, Sidney B. Brooks, "A Restatement of the Russian Federation's Insolvency Law: A Guide to the Federal Law on Insolvency", 25(1-2) *Review of Central and East European Law* (1999), 7-31. A translation of the 1997 RF Bankruptcy Law can be found in the same 1999 Special Issue of the *Review,* at 33-122; a translation of the 2002 RF Bankruptcy Law can be found in 30(2-4) *Review of Central and East European Law* (2005), 373-579. The so-called "Observation Proceedings or Supervision" in Russian Insolvency Law (Arts.56 ff. and Arts.62 ff. in the 1997 and 2002 laws respectively) can be compared with "Temporary Moratorium" in The Netherlands (Art.215 Dutch Bankruptcy Act). As both procedures will, in fact, usually lead to a formal procedure, they will not be dealt with further in this article.

4 See sections 3.1 and 3.2.

5 *E.g.*, Gianmaria Ajani, "By Chance and Prestige: Legal Transplants in Russia and Eastern Europe", 43 *American Journal of Comparative Law* (1995), 93-117; Daniel Berkowitz *et al.*, "Economic Development, Legality, and the Transplant Effect" (2001), available at <http://www.worldbank.org/publicsector/legal/pistor-transplants.pdf>, an earlier version of which appeared in *Working Papers* (*Law and Development* No.1) of the Harvard Center for International Development.

twentieth centuries (and that of the draftspersons of the new Dutch Civil Code)—in support of the drafting of the new Russian Civil Code.[6]

In a sense, The Netherlands Civil Code—the most recent continental civil code at the time of the most intense drafting phase of the RF Civil Code—became a beacon in the 1990s for draftspersons that were charged with presenting the Russian second Constitution to the State *Duma*.[7] There was no intent on the part of the Dutch to transplant their code in Russia soil nor was there any wish (or need) on the Russian side for such an operation. Rather, this collaboration represented a thoughtful consideration of developments in foreign legal theory and practice as opposed to any kind of a reception "lock, stock, and barrel". Furthermore, after more than a decade of reforms, the exchange of thoughts and ideas among those involved in formulating law and policy in a transition jurisdiction on the one hand and one (or more) group(s) from the "developed" nations on the other hand has lost its novelty.

Yet, we believe that—while this no longer represents a novel approach in the 2000s—there is still a value which can be derived (for both all concerned) from maintaining a dialogue among those from various jurisdictions who are seeking to view the future for signs of possible (necessary) change. It is in this spirit that we put forward the observations and questions contained in this article to members of the legal, business, and policymaking communities in the CEE/SEE and CIS regions. We hope that these will represent (more) food for thought for those persons as regards developments and thinking in the area of informal reorganization; this, we believe, can also be relevant in The Netherlands and elsewhere at a (supra) national level in the EU.[8]

6 See, *e.g.*, Ferdinand Feldbrugge, "Het nieuwe Burgerlijk Wetboek van de Russische Federatie", *Rechtsgeleerd Magazijn Themis* (1997), 43-53.

7 This is not meant to ignore the collaborative efforts of the draftspersons of the RF Civil Code with professionals from other jurisdictions such as, *e.g.*, Canada, the United States, or Germany. See, for example, Peter Sahlas *et al.*, "Special Issue: The Civil Code of the Russian Federation from Foreign and Comparative Law Perspectives", 30(1) *Review of Central and East European Law* (2005), in which some of the results of the Canadian contribution to consideration of future work on the RF Civil Code are discussed.

8 One could argue, in the broad sense of the 1997 Partnership and Cooperation Agreement (PCA) between the EU and the RF, that such consideration in the RF of further developments in the informal reorganization field in the EU is part of the approximation of legislation process described in Art.55 of the PCA. See the EU/RF PCA reproduced at <http://www.eu.int/comm/external_relations/ceeca/pca/pca_russia.pdf>. The conclusion is strengthened by reading the provisions of the 1999 Common Strategy of the EU on Russia (Part I(2), Part II(2)), and Part III (involvement of eminent experts of the EU) reproduced at <http://europa.eu.int/comm/external_relations/ceeca/com_strat/russia_99.pdf>. The Road Map for the Common Economic Space contains a section on Investment (1.5) under which such activity could also be brought; see <http://europa.eu.int/comm/external_relations/russia/summit_05_05/finalroadmaps.pdf#ces>.

First of all, section 2 of this article will detail the research methodology, while section 3 includes a further description of the concept of informal reorganization. In section 4, the advantages of informal reorganization *vis-à-vis* formal reorganization are set forth. Relevant evidence from Dutch practice is described in section 5 and derived success factors of informal reorganization are presented. Subsequently, section 6 contains a discussion of a number of practical bottlenecks that can be observed during informal reorganization, after which section 7 offers to the reader our conclusions with regard to the relation between the legislative and informal reorganization routes, as well as the manner in which informal reorganizations can be stimulated.

2. Methodology

This article is based on an extensive research which was conducted in the period 2003-2005 partly at the request of the Dutch Ministry of Justice.[9] In The Netherlands—and outside—relatively little is known and recorded about informal reorganization. This, in particular, seems to stem from the (relative) silence in which this kind of reorganization processes are carried out. In order to gain an insight in the subject matter, our research has therefore been set up to be as wide ranging as possible. The central question with which we have dealt was an identification of practical possibilities used in The Netherlands in order to avoid formal procedures (*i.e.*, a moratorium on payment and/or liquidation) as well as the attendant bottlenecks. To illuminate this identification process:

(a) a literature search has been made,
(b) thirty-five case studies have been carried out among four large Dutch banks (ABN-Amro, Fortis, Rabobank, ING) and three consultancies (KPMG, Resources Global Professionals, Zuidweg & Partners),

and <http://www.kremlin.ru/eng/text/docs/88027.shtml>. The Road Map is linked to the decision taken at the St. Petersburg Summit (May 2003, see the Joint Statement at <http://www.delrus.cec.eu.int/en/p_234.htm>) to create a Common EU/RF Economic Space (CES). Similar broad language is to be seen in the EU's 2004-2006 National Indicative Programme for the RF (also adopted in May 2003, see Section 2.2: Reform in the financial sector) at <http://europa.eu.int/comm/external_relations/russia/csp/04-06_en.pdf>.

9 This research has been published under the name of Jan Adriaanse, *Restructuring in the Shadow of the Law. Informal Reorganisation in The Netherlands* (Kluwer, Deventer, 2005); see <http://www.aspenpublishers.com> for more information. See also Jan Adriaanse *et al.*, *Informele reorganisatie in het perspectief van surseance van betaling, WSNP en faillissement* (Boom Juridische uitgevers, Den Haag, 2004), available at <http://www.wodc.nl> (full governmental report in Dutch as well as a summary in English). See further <http://www.fiscaaleconomisch.leidenuniv.nl> for additional information, as well as articles by the authors in the field of informal reorganization and turnaround management.

(c) twenty-three various interested parties of companies in financial difficulties (mainly bankers and consultants) have been interviewed, and

(d) four surveys have been conducted among the Dutch trade association for credit management (*VVCM*), a (non-profit) organization which aims to provide assistance and support for SMEs (*OKB*), the Federation of Dutch Insolvency Lawyers (*INSOLAD*), and a Dutch Federation of Independent Accounting Firms (*SRA*), in that order. The surveys yielded responses of 30%, 82%, 21%, and 16% respectively.[10]

A total number of 465 questionnaires were completed and returned. The companies included in the case study research were mainly so-called medium-sized and large-scale businesses within the industrial and business services sectors. A total of twenty successful and fifteen unsuccessful informal reorganizations have been examined.

3. Description of Informal Reorganization

This section will detail the phenomenon of informal reorganization on a more in-depth basis. An informal reorganization is—as set out in the introduction—a reorganization route which takes place outside the statutory framework with the objective of restoring the health of a company in financial difficulties within the same legal entity. In the informal reorganization, a plan to reorganize (business plan) will be drawn up to reach the objective which has been set. This will mostly consist of two processes:

— business restructuring;

— financial restructuring.[11]

The idea is that it is impossible and undesirable to carry through financial restructuring without restructuring the business operations (which have, usually, led to the deteriorated financial situation within the company). Solving problems should also involve removing the causes thereof. The nature of the problems—as well as the moment action is taken in the organization—will be a decisive factor for the planned measures. First of all, business restructuring (section 3.1) will be examined; thereafter, financial restructuring will be discussed (section 3.2).

10 Non-response is a known problem with postal surveys. Since all surveys are processed anonymously, no details are known about those who have not responded.

11 See also Oscar Couwenberg, *Resolving Financial Distress in The Netherlands* (University of Groningen, Groningen, 1997), 21.

3.1. Business Restructuring

Particularly important questions when restructuring business operations are the following: which concrete strategic, operational, and financial plans have been made to reach the level of healthy and sound management; and what are the plans for the actual implementation thereof? The process is also, ideally, aimed at a restoration of confidence in the company and its management among interested parties.[12] Business restructuring—often called *turnaround* for which the process can be described as *turnaround management*—can also be defined as follows: a comprehensive plan the aim of which is to restore the (operational) profitability of a company in financial difficulties.[13] The main features of a restructuring process usually consist of the following phases: (i) stabilizing, (ii) analyzing, (iii) repositioning, and (iv) reinforcing.[14] These four phases are described below; in practice however, the different phases (and actions to be taken) will frequently overlap. Therefore, that which follows must be read in that context.

3.1.1. Phase I. Stabilizing

In phase I, the focal point is to identify the critical problems which require immediate action in order to stabilize the situation. The emphasis in this phase is on increasing the *cash flow*. This involves actions aimed at increasing the incoming—and reducing the outgoing—cash flow. In this way, the required "breathing space" can be created to meet critical financial obligations. Table 1 shows various possibilities (non-exhaustive).

Table 1: Actions to Increase the Cash Flow in the Short Term

Action	*Description*
Cutbacks in expenditure	Reducing the current expenses both in the field of costs and with regard to investments
Optimizing the stock situation	Selling off excessive stock, as well as reducing the stock (which creates both physical and financial space)
Optimizing turnover times of the accounts receivable (trade)	Quicker collection of receivables and/or reducing the payment periods

12 Sociology mostly considers confidence as the "lubricant" for interactions; it ensures that interactions run more smoothly. See for instance Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study", 28(1) *American Sociological Review* (1963), 55-67.

13 Dominic DiNapoli and Elliot Fuhr, "Trouble Spotting: Assessing the Likelihood of a Turnaround", in Dominic DiNapoli (ed.), *Workouts & Turnarounds II, Global Restructuring Strategies for the Next Century, Insights from the Leading Authorities in the Field* (John Wiley & Sons, New York, 1999), 1-20, at 2-3.

14 See, *e.g.*, Peter Faulhaber and Norbert Landwehr, *Turnaround-management in de praktijk, de snelle terugkeer naar een positieve cashflow* (Addison Wesley Longman, Boston, 1998), 23 and DiNapoli and Fuhr, *op.cit.* note 12, 13.

Asset stripping	Selling excessive assets
Optimizing of spontaneous financing	Increasing (insofar still possible) the (re)payment periods among existing financiers of the company

3.1.2. Phase II. Analyzing

In phase II, it is necessary for the company to look at its prospects in the long term. As such, drawing up a well-founded reorganization (business) plan is of vital importance, particularly *vis-à-vis* enhancing and/or restoring confidence of the relevant interested parties. In this phase, the relevant interested parties are the financiers of the company, *e.g.*, the providers of loan capital (for example, banks and large suppliers) and of equity (for example, shareholders). The "ingredients" of a reorganization plan will differ on a case-by-case basis; however, it can be said that the more extensive (qualitatively), the better. Table 2 shows topics which should, in any case, be incorporated in a proper reorganization plan.[15]

Table 2: Subject Matters within a Reorganization Plan

1	A strategic and financial analysis *ex post* to trace the causes of the negative state of affairs
2	An inquiry into the actual financial position and an assessment as to whether or not the company still offers sufficient basis for recovery
3	Proposed measures and the calculated effects thereof on long-term exploitation overviews and balance projections
4	Cash flow projections in the short and long term from which it appears that the obligations entered into (and to be entered into) can be performed
5	Cash flow projections which show a future improvement in the liquid assets

When doing so, it is important for the reorganization plan to adequately set forth the core activities of the company—including the (potential) value which they can create. In addition, consideration must be given to which specific products/services and customers can be retained (or must be axed).

The measures to be taken to restore profitability in the long term can be diverse and will depend—as can be expected—upon the specific situation. Table 3 shows various possibilities (non-exhaustive).

Summarizing, it can be stated that the company must indicate in a reorganization plan which objectives it pursues in both the short and the long term in order to halt the insolvency process and to reorganize the

15 See, *e.g.*, Peter Vos, *Kredietopvraging en insolventierisico, overlevingskansen van bedrijven in financiële moeilijkheden en de Faillissementswet* (Kluwer, Deventer, 2003), 253.

company, as well as the manner in which the company is going to pursue these objectives.

Table 3: Measures to Restore Long-Term Profitability

Adjusting strategy and marketing
Cutting overhead costs
Dismissing excessive personnel
Rationalizing the product assortment
Improving purchasing processes
Improving management information systems
Improving working capital and cash flow management
Closing loss-making business units
Capitalize (excessive) fixed assets
Selling (profitable) operations which are not part of the core activities

It is important that the plans are realistic, particularly so because the interested parties will take decisions on the basis thereof. Financiers decide on the basis of the plan whether or not they are prepared to maintain the credit facilities granted or to make new funding[16] available in order to finance the (period of) reorganization (financial restructuring; see hereafter). Suppliers of products/services decide whether or not to continue to supply (on credit). In addition, shareholders/investors will consider making or not making available (any) required (risk-bearing) capital. This involves, for instance, the depositing of (informal) capital and/or (subordinated) loans.

In order to restore the aforementioned confidence, it is often also necessary to recruit or consult persons (interim-managers, advisors, accountants) who are specialized in carrying out *turnaround processes*. After all, the management/interested parties relationship is often under pressure as a result of the deteriorated state of affairs, and the question is whether or not the interested parties (still) have sufficient confidence in the abilities of the current management to reorganize the company on their own.

The reorganization plan can somehow be compared with the so-called external administration plan (EAP) in the (formal) external administration procedure of the aforementioned Russian Insolvency Legislation, as it is intended to provide a long-term solution to restoring the company's solvency. However, the reorganization plan as described here is not necessarily a product of comprise and collaboration between all interested parties—as is required within the EAP chapter of Russian Law (Chap.5,

16 In this context, often called a "bridging loan".

Arts.68 ff. in the 1997 law, Chap.6, Arts.93 ff. in the 2002 law)—although the chances for success will, in fact, increase whenever most or all interested parties are involved and agree (see also further).

3.1.3. Phase III. Repositioning

In phase III, the management—together with (any) recruitments—will need to initialize the reorganization as outlined in the reorganization plan. This process is also called the *value recovery process*. The company has hit heavy weather, as value was reversed endangering the continuity; the process of value reversal is now stopped. It is important that the objectives which have been established are feasible and that management reports to the interested parties in an open and timely manner. After all, the process of the intended recovery of the company is also the process of the intention to restore confidence among the interested parties of the company. This is especially important, we believe, in the Russian Federation (and elsewhere in the CIS/CEE/SEE regions) where trust in old economic relationships has not always uniformly been replaced by robust relationships of trust among actors in the emerging private sectors. Supplying information during the process is, therefore, vital in all cases, in particular in transition societies.

3.1.4. Phase IV. Reinforcing

In addition to initiating the reorganization—during which the organization tries to regenerate positive cash flows from the business operations—the company will often also need to be reinforced. This is understood to mean "reinforcing" in the field of management as well as in the company's balance sheet. In addition, this can (also) be achieved by transferring the company to another (healthy) company (as a result of which future payments can be guaranteed).

As stated before, it is often necessary to involve third parties in the turnaround process, as it still remains to be seen whether the current management will be able to independently complete this operation successfully. During the reinforcement phase, the question emerges as to whether or not current management is able to successfully run the company in the future and whether or not the existing organization and management structure fits within the "new" company. Changing the organization and management structure—including position changes (or dismissal) of certain key figures in management—may be required. Situations can, of course, arise in which decisions on this subject have already been taken in a previous stage; however, a key point is that—in addition to the reorganization of the business operations—the "strength" of the organization and management structure and the current management also needs to be examined.

Reinforcing the balance sheet, as described in this phase, is interconnected with financial restructuring. Financial restructuring will be described in the following section.

3.2. Financial Restructuring

Although the reorganization plan and the initiation thereof form a basis for a successful rationalization of the company, (some degree of) financial restructuring will often also be necessary. The losses from the past have—in most cases—disturbed the balance sheet ratios to such an extent that the obligations towards the assets are excessive; as a result, (future) interest and repayment obligations cannot be (or no longer have been) met. In addition, high reorganization costs are usually involved (for example, costs for redundancies[17]). The company will not always be able to clear away the "burden" from the past with its own current cash flows. Therefore, efforts from outside the company (shareholders/creditors) will (must) often be requested. Financial restructuring within the framework of an informal reorganization can, therefore, be described as follows: forming part of the informal reorganization in which, on the one hand, the relevant creditors voluntarily commit to revised terms with regard to the funding they made available (often called a "workout agreement") and, on the other, if so required, new funding is made available by providers of risk-avoiding capital (debt) and/or risk-bearing capital (equity).

A workout agreement can be compared with the amicable settlement procedure as laid down in the 1998 CIS Model Law on Insolvency (Bankruptcy) (Chap.6, Arts.111-121) and, *e.g.*, the amicable agreement procedure in the Russian Federation's Insolvency Legislation (Chap.7, Arts.120 ff. in the 1997 law; Chap.8, Arts.150 ff. in the 2002 law), although within an informal reorganization court approval (in Russia: approval of the *Arbitrazh Court*) and cooperation of secured creditors is not strictly needed, as it is a consensual process. However, the underlying principles are more or less the same as it strongly focuses on mutual agreement.[18]

Table 4 shows various possibilities of financial restructuring (non-exhaustive).

17 In The Netherlands, ex-employees are often awarded redundancy payments in a redundancy package engineered between the company and employers' associations or through a court ruling issued with regard to the redundancies. These payments are often based on the so-called "sub-district court formula" in which the number of years of service and the employee's age play a role. See also Henriette Pellicaan, *Reorganisaties, handleiding voor de praktijk* (Kluwer, Alphen aan den Rijn, 2003), 107-108.

18 See for an elaborative description of the amicable agreement in Russian Law: Andrei Iu. Bushev *et al.*, "The Theoretical Underpinnings of Commercial Law: A Russian View of Bankruptcy and Securities. Part I: The Concept of Bankruptcy and Principal Bankruptcy Procedures", 30(2-4) *Review of Central and East European Law* (2005), 239-256.

Core of the measures within the financial restructuring consists, therefore, of deferment or remission of current financial obligations as well as generating additional liquidity. The partial (or complete) takeover of a company fits within the financial restructuring framework since the buying company will usually (in part or in whole) act as guarantor for the performance of current obligations and/or provide additional financial resources.

Table 4: Measures with Regard to Financial Restructuring

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)

4. The Advantages of Informal Reorganization

Important advantages of informal reorganizations—as found in literature and our research—compared to formal reorganizations can be summed up with the terms *flexibility, silence*, and *control*. The terms will be elaborated below.

4.1. Flexibility

Informal reorganizations can be recognized—first and foremost—by their unrestricted character. The reorganization process is less rigid than is the case with(in) formal procedures. Companies and entrepreneurs can reach mutual agreement on the actions to be taken by the company (both with regard to the restructuring of business operations and financial restructuring) and the terms and conditions under which these take place. Because of the flexible character, "tailor-made" solutions can be elaborated; and, if necessary, deviations can be engineered for the relative positions of creditors—again, by mutual agreement. In addition, it can be agreed that any new funding which is made available takes priority—separate from current positions and guarantees. Although most current laws also theoretically offer this possibility, the focal point in practice—definitely so in The Netherlands—is usually offering an arrangement under strict statutory regulations in which a certain percentage must be waived by the (ordinary) creditors. The possibilities within the framework of informal reorganizations are—in our view—(much) better; this makes the process more flexible.

4.2. Silence

Furthermore, informal reorganizations take place in relative silence. That is to say, the procedure is not made public; this is opposed to formal reorganizations, which are public, both in The Netherlands and in the CIS/CEE/SEE regions.[19] The result of these public procedures is that suppliers, financers, and (potential) clients will often approach the company with an increased degree of reserve, which may lead to unwillingness to enter into new contracts (or only be prepared to do so under the most stringent of terms). In addition, in a public context, a *race to collect* can easily develop; creditors "tumble over each other" as they seek to get paid in advance of their sister creditors. This frequently also involves petitioning for liquidation of the debtor (in order to enforce payment). However, these developments place the company in a(n) (even more) vicious circle. This phenomenon is, therefore, often seen as the *self-fulfilling prophecy-effect of a public procedure*.[20] The negative effects upon management and the missed opportunities as a result of publicity of procedures can also be characterized as *opportunity costs.*[21] In an informal reorganization, these costs are (considerably) less—especially because of the relative silence—than is the case in a formal reorganization.[22]

4.3. Control

The final important advantage for management is that—during an informal reorganization—they can continue to fully run the company independently. Neither judges nor trustees (or administrators (in Russia: arbitrazh administrators)) need be appointed in order to commence an informal reorganization. Apart from the fact that this saves costs (as a

19 See, for example, Art.47 of the 1998 CIS Model Law on Insolvency as well as Art.50 and Art. 54 of the Russian Bankruptcy Law (1997 and 2002 versions, respectively).

20 A striking example with regard to negative effects of financial difficulties in the public domain, involved the problems of a Dutch company called Mosa Porselein N.V, situated in Maastricht. Koninklijke Mosa B.V., operating in the same sector and of the same name, also situated in Maastricht, but fully independent from Mosa Porselein N.V. experienced negative effects because of adverse publicity surrounding Mosa Porselein N.V. (as result of a mix-up in names). These effects involved (threatening) to withdraw orders by existing customers, as well as hesitance among potential clients. See the Dutch financial daily: *Het Financieele Dagblad*, 27 July 2004.

21 See also Couwenberg, *op.cit.* note 10, 35; and Robert A. Haugen and Lemma W. Senbet, "The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure", 33(2) *The Journal of Finance* (1978), 383-393, at 384-385.

22 See Stuart C. Gilson, "Managing Default: Some Evidence on how Firms Choose between Workouts and Chapter 11", in Jagdeep S. Bhandari and Lawrence A. Weiss (eds.), *Corporate Bankruptcy, Economic and Legal Perspectives* (Cambridge University Press, New York, 1996), 308-321, at 313; and Karen Hopper Wruck, "Financial Distress, Reorganization, and Organizational Efficiency", in Edward I. Altman (ed.), *Bankruptcy & Distressed Restructurings, Analytical Issues and Investment Opportunities* (Beard Books, Washington, DC, 1999), 245-273, at 263-265.

result of which the proceeds for the creditors will ultimately be higher and, therefore, the recovery rate[23] increased), those directly involved will be given the opportunity to determine the speed (and the outcome) of the reorganization themselves. Costs can be saved socially since the judicial system—with all the appurtenances thereof—does not (yet) need to be called into action.[24]

It is difficult to measure the overall advantages of informal reorganization compared to formal reorganization in terms of gained or preserved going-concern value since companies which choose a formal procedure cannot be compared with themselves. That is to say, if a company decides upon, *e.g.*, external administration (Russia), it is—from that moment—impossible to measure the destruction or gain of value for the (then theoretical) situation if the company had otherwise chosen for an informal workout. However, Gilson, John and Lang have shown—by comparing the stock returns of a sample of listed companies before and after a chosen formal or informal procedure—that, in any case, the stockholders of companies in financial difficulties will generally prefer informal alternatives since these procedures (at least) generate significantly higher share returns.[25] So, in addition to the fact that management and owners, in general, will not want to lose control and will want to retain flexibility, important (market) value is to be preserved in informal reorganization. Therefore, management should always attempt to restructure—in our opinion—in an informal manner, rather than only seeking protection within a formal route. Formal reorganization must be seen as a tool rather than a goal in the process of resolving financial distress.

5. Informal Reorganization in Practice: Restructuring Measures and Success Factors

To gain more insight into the practice of informal reorganization, some important evidence from The Netherlands will be presented in this paragraph. First, the most important causes of corporate decline (*inter alia* in The Netherlands) will be shown. Thereafter, the most popular measures within Dutch informal restructuring processes will be discussed. Then, the absolute success factors of informal reorganization are presented.

Regarding the causes of financial difficulties, it can be concluded that the problems mainly relate to poor management—*i.e.*, inadequate reac-

23 Recovery rate can be described as that part of the debt which is repaid, divided by the nominal debt.

24 See, *e.g.*, Gilson, *op.cit.* note 20, 311-313.

25 See Stuart C. Gilson et al., "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default", in Altmann, op.cit. note 20, 77-124, at 109.

tion of management on both internal weaknesses and strengths, even as external threats and opportunities—and excessive cost structures (fixed and variable costs), as well as the presence of inadequate management information systems within the company (as a result of which important early warning signals of imminent decline are missed by management). The results, particularly those regarding poor management correspond to foreign studies by, among others, the Association of Business Recovery Professionals (R3) in the United Kingdom, as well as the European Federation of Accountants (FEE); the latter also identifies a dire need for adequate management of the company on the basis of financial information, and this confirms the identified causes in the field of (poor) management information.[26] The popular belief to the contrary notwithstanding economic circumstances are often not the (major) cause of the problem, at least in The Netherlands. It frequently seems to be an excuse rather than a real root cause.

With regard to business restructuring, it can be concluded that appointing (specialized turnaround) consultants, taking measures to improve the efficiency of the company, and improving the management information system are some of the most important recovery measures. This is in line with the causes identified above. Financial restructuring is mainly aimed at deferring repayments and proposing workout agreements with remission. In addition, companies often look for an injection of risk-bearing capital in order to improve the balance-sheet ratios and to generate additional liquidity. Furthermore, during an informal reorganization, banks are often prepared to provide additional risk-avoiding capital (debt) in order to improve the chances of success.

The results with regard to business (and financial) restructuring also correspond with the results of foreign studies. For instance, the aforementioned study by R3 showed that cost reduction, debt restructuring, raising new equity, and negotiating with banks, as well as improved financial controls and a change of management—including the appointment of consultants—are measures frequently taken in British turnaround situations. A study by Franks and Sussman is also in line with this.[27] They

26 See European Federation of Accountants (FEE), "Avoiding Business Failure. A Guide for SMEs" (2004), 7 ff., available at <http://www.fee.be>; Survey R3, "9th Survey of Business Recovery in the UK" (2000), 13-21, available at <http://www.r3.org.uk>. For more supportive evidence in this respect, see Stuart Slatter and David Lovett, *Corporate Turnaround, Managing Companies in Distress* (Penguin Books, London, 1999), 21 ff.; Henry A. Davis and William W. Sihler, *Financial Turnarounds: Preserving Enterprise Value* (Prentice Hall PTR, Upper Saddle River, NJ, 2002), 27 ff.

27 See Julian Franks and Oren Sussman, "The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies" (2000), available at <http://www.insolvency.gov.uk>.

concluded, for instance, that management changes, asset sales, new finance and guarantees given by management are some of the popular measures. They also conclude that these measures generally affect the willingness of banks to help out the company in a positive manner. It is remarkable that the factors regarding adjustments of the company's strategy and marketing tactics have only been identified to a (relatively) minor extent. This is all the more remarkable since the poor state of affairs is often caused by lack of insight—as a result of poor management—into the market and the existing (and potential) needs of (current and potential) clients. This conclusion is also in line with for instance the studies by R3 and Franks and Sussman.[28]

On the basis of case studies of both successful and unsuccessful informal reorganizations, an examination has been made of the factors that determine the success of a rescue operation. They have been listed below.

- active attitude by management and shareholders with regard to the informal reorganization;
- involvement of important interested parties (financiers) in the reorganization process;
- adequate and speedy reorganization of the business operations (preferably with the help of third parties);
- transparency (towards financiers) with regard to the financial situation and the intended informal reorganization;[29]
- injection of risk-bearing capital (equity), (*e.g.*, via a takeover).

It appears that informal reorganizations are especially successful when the company is able to reorganize its business operations quickly and adequately and, thereby, to restore profitability. However, this process must often go hand-in-hand with the introduction of additional risk-bearing capital (as noted above, possibly by way of a takeover). In this way, a foundation can be laid for the future since this positively restores the balance-sheet ratios (relation between equity/debt). Involved creditors are generally prepared to cooperate within an informal reorganization provided that the focal point (in first instance) is the deferment—rather than the remission—of payments (repayments).

A good relationship between the company and its primary stakeholders (usually, banks and/or primary suppliers/vendors) appears to be vital. Informal reorganizations only have a chance of success when these interested parties can be convinced of the (future) viability of the

28 See Survey R3, *op.cit.* note 24, 21; and Franks and Sussman, *op.cit.* note 25, 2.

29 See, also Survey R3, "The Ostrich's Guide to Business Survival" (2002), available at <http://www.r3.org.uk> which confirms this fact for the United Kingdom, and Slatter and Lovett, *op.cit.* note 24, 180 ff.

company and the abilities of management. A transparent approach to the problems—often with the help of specialized advisors in the field of business restructuring, in combination with realistic prognostications—are important in this respect. The case studies indicate, for example, that Dutch banks are virtually always prepared to continue financing (not to withdraw credit or levy execution) provided these aforementioned conditions are met. Of course, as we consider the possibility of whether or not some ideas and insights can be transplanted from The Netherlands to one or more jurisdictions in the CIS/CEE/SEE regions, the attitude of bankers who serve businesses in those areas will obviously need to be factored into the chances for success (or the lack thereof) in informal reorganizations there.

Yet in jurisdictions which we have examined in more detail, when the parties involved can be convinced—by means of management actions in line with the aforementioned success factors—that the *going concern value* is higher than the *forced-sale value,* the willingness to cooperate and, as a result, the chances of success of a rescue operation will always increase. This elementary "formula" should, we believe, also be attractive to bankers in the CIS, for example, even though they are reputed to have (wildly) different practice than their sisters in, *e.g.*, the EU. The surveys and interviews support the above findings with regard to Dutch practice. In international literature supportive evidence can also be found for this conclusion (See, *e.g.*, research results from the United Kingdom, Germany and the United States.[30])

6. Practical Bottlenecks During Informal Reorganization

> "Many companies recognize the need to restructure too late, when fewer options remain and saving the company may be more difficult."[31]

By taking a closer look at bottlenecks in practice, interesting information can be found as regards decisive failure factors of informal reorganization.

30 Non-exhaustive: Ralf Elsas and Jan Pieter Krahnen, "Universal Banks and Relationships with Firms", 20 *CFS Working Paper* (2003); Stuart C. Gilson *et al.*, "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default", *Journal of Financial Economics* (1990), 315-353; Gilson, *op.cit.* note 20, 308-321; John Flood, "The Vultures Fly East: the Creation and Globalisation of the Distressed Debt Market", in David Nelken and Johannes Fest (eds.), *Adapting Legal Cultures* (Hart Publishing, Oxford, 2001), 257-278; John Armour and Simon Deakin, "Norms in Private Insolvency Procedures: The 'London Approach' to the Resolution of Financial Distress", *ESRC Centre for Business Research Working Paper* (2000), 173; Franks and Sussman, *op.cit.* note 25. Such surveys, if they have not yet been conducted in, *e.g.*, the CIS with regard to this aspect of informal reorganization, we would urge that such work be undertaken in determining the fertility of the local ground for transplanting (parts of) the informal reorganization techniques discussed herein.

31 Stuart C. Gilson, *Creating Corporate Value through Corporate Restructuring* (John Wiley & Sons, New York, 2001), 7.

In addition, supportive evidence can (most probably) be discovered as regards the defined success factors. In this paragraph therefore, practical bottlenecks—as found in the case studies—will be detailed.

In our research sample, the main bottlenecks appeared to be (for the most part) in the field of potential investors/takeover candidates who pull out at a late stage—frequently following lengthy, yet unsuccessful, negotiations as well as due diligence research—and an insufficient supply of information from the company to its stakeholders during (and about) the progress of the informal reorganization. Other major bottlenecks have been found in relation thereto, indicating an (impending) *breach of trust* between the company and its creditors. Striking examples are: financial results which structurally deviate from prognostications, management failing to observe (restructuring) agreements (with creditors) and, more generally, the (imminent) absence among the creditors of confidence in management and/or viability of the company. It would further appear that (strategic and operational) reorganization measures often have insufficient effect so that a loss-making situation continues to persist. In addition, it has been frequently noted that management has ultimately proven not to be up to the task; as a result, the informal reorganization has failed. The bottlenecks, which have been discovered in the course of our research, can be summed up as follows (to be described as failure factors):

— management and the shareholders have a passive attitude towards the informal reorganization;
— (as a result) insufficient strategic, operational and financial measures are taken;
— the company is unable to provide sufficient insight into the actual financial situation;
— the company is unable to find risk-bearing capital (*e.g.*, in the form of a takeover) (in time).

It is striking to see that the failure factors are in fact opposite and, consequently, supportive to the success factors as found in the group of successful informal reorganizations. Furthermore, the bottlenecks with regard to reorganizations tend to stem from the execution rather than the process itself; the behavior of management regarding the problems is most important both in successful and unsuccessful informal reorganization routes.

With that, we believe it is justified to put forward the basic conclusion that insolvency legislation, in itself, does not have a significant impact on the chances of success of a rescue operation. This is an important conclusion, not only for legislators in The Netherlands but for international practice as a whole (and perhaps for the CIS and CEE/SEE regions in particular). Legislation to promote reorganization and rehabilitation simply has limited effects. It is not—and will in our opinion never be—a panacea to prevent companies from going bankrupt as, in the end, economic principles and managerial behavior really make the difference. This does not mean, of course, that we think that in rescue operations legal rules can never be of value, yet their impact should not be overstated.

In this context, it is for example interesting to take notice of the fact that, for instance, Dutch legislation lacks the legal possibility to oblige entrepreneurs and their stakeholders to be focused on taking timely measures to prevent bankruptcy procedures. This as opposed to, *e.g.*, Russian Insolvency Legislation (1997/2002) in which a so-called Prevention Chapter is to be found.[32] Legislators in international practice could learn from experiences in Russia with regard to these articles as this legal instrument could—in theory—be of no small significance; it forces entrepreneurs to look for and recognize potential financial distress at an early stage ("early warning").

The aforementioned conclusion remains the same, however, because an early warning always has to lead to the taking of strategic, operational, and financial measures by management in an informal and relatively peaceful environment, in order to improve the chances of success. Once again, (insolvency-related) legislation is a *tool* rather than a *goal* in the real recovery process of companies in financial distress.

7. Conclusions

Looked at as a whole, the success of rescue operations largely depends on the question of whether or not management is able and willing to take action at an early stage and to adequately reorganize business operations. Equally important in the recovery process is that the directly affected parties—particularly important suppliers and financiers—are involved in the reorganization. When they, too, have confidence in the company's business plan, the chances of success will rise. Informal reorganizations, in that respect, have the advantage that they can take place outside the public domain. When prompt action is taken—regardless of whether or not it has been instigated by the principal banker—this process can usually also take place while continuing to service existing financial obligations. That is to say, there is no direct need to try and carry through a rescheduling of debts during which creditors must waive (part of) the amounts they are owed. Apart from the fact that this can be morally justified, the

[32] See Art.26(30) ("prevention measures") and Art.27(31) ("pretrial or out-of-court sanation"). It is striking to notice that the specific defined Articles cannot be found in the CIS Model Law (1998). It is not in scope of this article to further investigate this fact, however it is interesting to us for future research.

practical results are also significant. Namely, an uncontrolled race to collect—in which each creditor pursues her own interests demanding direct payment—can be prevented. After all, such a process always causes a self-fulfilling prophecy resulting in a considerable loss in going-concern value as significant insecurities arise. Clients and (other) suppliers no longer know what to expect; as a result, they (too) leave the company for what it is and will conduct their business elsewhere.

Laws are mere beacons. If legislators—those, for example, in the EU but, especially, in countries in the CIS/CEE/SEE regions—truly wish to (help to) prevent more companies from going bankrupt,[33] they will need to become aware of the advantages of informal reorganization. Apart from any changes in the law, they also need to be geared towards stimulating informal rationalization routes. This is possible, for example, by institutionalizing a code of conduct through cooperation—preferably monitored by the national bank or a (to be institutionalized) Federal Body on Insolvency Matters[34]—among representatives of the business sector in general and the banking sector in particular. This can enhance work on a rescue plan in a peaceful and controlled manner without all the problems being immediately put out on the street. The Statement of Principles of INSOL International—in this respect—could serve as a framework from which to work. In fact, these principles can be seen as the instrument *par excellence* through which to achieve a situation where the success factors are fully met.[35] When a country has a clear set of insolvency regulations at

33 One could argue that—once informal reorganization becomes (more firmly) anchored in the EU—legislators in those jurisdictions which have Partnership and Cooperation agreements with the EU (such as the 1997 EU/RF PCA) have, in theory, already agreed to implementing such a mechanism. See EU/RF PCA, Art.55, "Approximation of Legislation" provisions.

34 For the Russian Federation, this task could be performed *par excellence* by the Russian Federal Service for Matters of Insolvency and Financial Rehabilitation. For this governmental body has (had at least in the 1999 legislation governing its activities), *inter alia*, the specific task "to participate in the formation and realization of federal and inter-state programs envisioning measures for the restructuring and financial rehabilitation of insolvent organizations". See Statute on the Russian Federal Service for Matters of Insolvency and Financial Rehabilitation (Art.4(1)) in *e.g.*, 25(1-2) *Review of Central and East European Law* (1999), 129-137, at 131.

35 In 2000, INSOL International introduced the so-called "Statement of Principles for a Global Approach to Multi-Creditor Workouts" which—according to the documents at the time of publication—was at least endorsed by the World Bank, the Bank of England, a number of international commercial banks and consultancy agencies, as well as the British Bankers' Association (with 320 banks as members; established in more than 60 countries). The core of the Statement of Principles—consisting of eight principles which can be regarded as a best practice for informal reorganizations—is recognized in various "local" versions.

The Statement of Principles was published in order to bring the different globally used informal procedures (voluntary rescue frameworks) more in line with one other and to formalize them in a consistent system. It was drawn up by more than 150 experts from as many (mainly banking) organizations and consists, as mentioned, of eight principles which could/should be used during an informal reorganization/workout in order to increase the chances of success.

its disposal[36]—as well as a structured framework for informal reorganization—the primary ingredients for success are present.

We hope that legislators—including those in The Netherlands but also those in countries in CEE/SEE and CIS jurisdictions—will realize this and will, appropriately and specifically, increasingly shift their focus towards the institution, implementation, and promotion of a robust regime for informal reorganization in the business sector of their countries. After all, legal reform strategies should not only aim at improving legality by carefully choosing formal rules but also—if appropriate and necessary—by choosing informal rules the meaning of which can be understood and the purpose appreciated by domestic law makers, law enforcers, and economic agents who are the final consumers of these rules.[37]

Finally, the institutionalization of informal reorganization routes is, in fact, one which is not new; regimes of this kind have existed in one form or another in ancient history. The aforementioned Law of the Twelve Tables, for example, gave the debtor breathing space (in those days, literally ...) and the possibility to negotiate a workout agreement. Table III, Law VIII said:

> "In the meantime, the party who has been delivered up to his creditor can make terms with him. If he does not, he shall be kept in chains for sixty days; and for three consecutive market-days he shall be brought before the Prætor in the place of assembly in the Forum, and the amount of the judgment against him shall be publicly proclaimed."[38]

Although different in *practice*, the underlying principles—negotiation between debtor and creditor(s), in relative silence and towards a consensual solution—remain the same.

The eight principles confirm the success factors of informal reorganization as mentioned in §5 and can be described, in brief, as follows:
(1) Deferment of payment is voluntarily agreed to ('standstill period' by creditors);
(2) The debtor ensures that the relative positions of the creditors are maintained;
(3) The debtor refrains from any action that may jeopardize the proceeds for the creditors;
(4) Creditor committees are set up, if so required;
(5) The debtor provides the creditors with relevant information;
(6) Reorganization proposals are made in the light of the applicable law;
(7) The parties treat all information confidentially;
(8) New financing during the process will be given priority status.
For more detailed information see <http://www.insol.org>.

36 That is to say, bankruptcy legislation should be seen as a "fundamental element underlying the ability to enforce 'hard budget constraints' on enterprises—that is, to force them to pay their debts and to operate within their ability to generate income to meet them". See Sarah J. Reynolds, "The Legal Regulation of Bankruptcy: Russian Legislation and Models for the CIS", 25(1-2) *Review of Central and East European Law* (1999), 1-5, at 1.

37 See Berkowitz *et al.*, *op.cit.* note 4, 16 (freely interpreted).

38 See, *e.g.*, <http://www.yale.edu/lawweb/avalon>.

INSOL International

STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO MULTI-CREDITOR WORKOUTS II

INSOL International™

International Association of Restructuring, Insolvency & Bankruptcy Professionals

STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO MULTI-CREDITOR WORKOUTS II

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INSOL International™

I am delighted to introduce the second edition of the INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts. This revised edition of the Statement of Principles represents the culmination of significant work on the part of the INSOL International Lenders' Group and they are to be congratulated on producing what will continue to be a major contribution to the reorganisation of financially troubled companies.

The Statement of Principles was first published 16 years ago and endorsed by the Bank of England, the World Bank and the British Bankers' Association. These letters of endorsement are included in the Appendix to this edition.

Since its publication, the Statement of Principles has facilitated rescues and workouts around the world and is still regularly referred to by governments and financial institutions and is referenced in both the UNCITRAL Legislative Guide on Insolvency and the World Bank Principles for Effective Insolvency and Creditor/Debtor rights.

The world of finance has of course changed significantly since its publication 16 years ago and with this in mind the INSOL International Lenders' Group, which includes representatives from 15 different investment banks and hedge funds from around the world, has revisited and updated the Statement of Principles to ensure that it reflects today's cross-border world of ever more complex financial restructurings.

We are honoured that the World Bank and the Bank of England have again endorsed the Statement of Principles in its revised form as the enclosed letters show.

Mark Robinson

Mark Robinson
President, INSOL International

BANK OF ENGLAND

Mark Carney
Governor

Mark Robinson
President
INSOL International
6 - 7 Queen Street
London, EC4N 1SP

14 November 2016

Dear Mr. Robinson,

The Bank of England welcomes the release by the INSOL Lenders Group of an update to their Principles for Global Corporate Workouts. The INSOL Lenders Group continue to lead the global discussion around best practice for creditors of a financially distressed company. Experience suggests that a collective approach, such as the one advocated, can help preserve value, to the benefit of the creditors as a whole and other stakeholders in the company.

Sincerely,

The World Bank
Washington D.C. 20433
U.S.A

Gloria Grandolini
Senior Director – Finance &
Markets Global Practice

August 1, 2016

Mr. Mark Robinson
President
INSOL International
6-7 Queen St,
London EC4N 1SP
England

Dear Mr Robinson:

Principles for Multi-Bank Workouts

On behalf of the World Bank Group, I would like to thank you for the opportunity to review the recently completed update of the *Principles for Multi-Bank Workouts,* which was developed under the auspices of INSOL International by the INSOL Lenders Group and in cooperation with, among other institutions, the World Bank Group.

As the global standard-setter, together with the United Nations Commission on International Trade Law, for insolvency and creditor/debtor rights (ICR), the World Bank Group recognizes the importance of the timely and effective resolution of non-performing loans. Indeed, the resolution of such loans has been shown to be critical to addressing both the need to increase access to finance for firms and the broader macroeconomic stability of national economies.

The World Bank Group has been addressing the problems of corporate financial distress on a systemic level in emerging markets, particularly in light of the recent global financial crisis. In this regard, we have welcomed INSOL's membership in, and contributions to, our ICR Task Force and its partnership in such key initiatives as the Africa Round Table.

In 2000, the World Bank Group was proud to endorse the original INSOL *Principles* for Multi-Bank Workouts, and we are pleased to again endorse this vital update. The 2016 update reflects many of the experiences of the World Bank Group in providing technical assistance to governments that aim to implement frameworks for consensual workouts. Indeed, we believe that these revised principles will provide an excellent companion to our forthcoming *Toolkit on Out-of-Court Workouts*, and that they provide more granular guidance on the implementation of the workout-related principles in the World Bank's ICR Principles

INSOL is to be commended for this timely contribution to the evolving debate regarding the design and operation of insolvency systems, as well as for its longstanding commitment to the global enhancement of awareness and best practice within the international professional community.

Sincerely yours,

Gloria Grandolini

Acknowledgement

The Statement of Principles for a Global Approach to Multi-Creditor Workouts II is the product of the INSOL International Lenders' Group project to update and revise the original Statement of Principles published in October 2000.

INSOL International would like to thank Derek Sach, Chair of the INSOL International Lenders' Group for leading this project and the members of the Group for their invaluable work in updating the Principles. A list of the members of the INSOL International Lenders' Group is found at page v.

The INSOL International Lenders' Group has been helped enormously by Joe Bannister and Margaret Kemp of Hogan Lovells, London, who have undertaken the legal drafting of the revisions to the Principles and the Commentary.

INSOL International also owes a debt of gratitude to the INSOL International Lenders' Group Sub-Committee for their detailed work in reviewing the revised Statement of Principles and contributing their comments and insights throughout the process.

The sub-committee comprised:

Derek Sach	Chair, INSOL International Lenders' Group
Joe Bannister	Hogan Lovells
Alastair P. Beveridge	AlixPartners LLP
Neil Cooper	Past President, INSOL International
Margaret Kemp	Hogan Lovells
Paul Kirkbright	KPMG LLP
William Needham	KKR
Sean Pilcher, *Fellow, INSOL International*	Royal Bank of Scotland, Restructuring
James P. Seery, Jr.	River Birch Capital, LLC
John Short	Short Partners LLP

In addition, INSOL international would like to thank the World Bank Group for their input in relation to the revisions.

INSOL International Lenders' Group

Andy Davis	Lloyds Bank *United Kingdom*
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Christophe Dalmais	BNP Paribas *France*
Christopher Hojlo	CVC Capital Partners *USA*
Derek Sach	Chair, INSOL International Lenders' Group *United Kingdom*
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Guilherme Ferreira	Jive Investments *Brazil*
Guy Isherwood	Standard Chartered Bank *Hong Kong*
Ian Copp	Commonwealth Bank of Australia *Australia*
Jacinta Nielsen	Australia and New Zealand Banking Group *Australia*
James P. Seery Jr.	River Birch Capital, LLC *USA*
Jason Webster	Lloyds Bank *United Kingdom*
Nick Ram	Lloyds Bank *United Kingdom*
Sean Pilcher	Royal Bank of Scotland, Restructuring *United Kingdom*
Thomas Biaggi	Bank of America *USA*
Tim Williams	National Australia Bank Ltd *Australia*
William Needham	KKR *United Kingdom*

Contents

Introduction

The eight principles (the “Principles”) set out in this report should be regarded as statements of best practice for all multi-creditor workouts. This document also contains a commentary on the Principles generally and on each Principle separately.

The Principles should be equally applicable in all jurisdictions and form the basis on which local multi-creditor workout principles are formulated having regard to local customs, law and practice. While the commentaries should not be taken as definitive or necessarily appropriate in all respects to all jurisdictions, they are, nevertheless, intended to help with the interpretation of the Principles and their application in practice.

The Principles are regularly referred to by governments and financial organisations around the world and are referenced in and, in their revision, draw upon the UNCITRAL Legislative Guide on Insolvency and the World Bank Principles for Effective Insolvency and Creditor/Debtor Rights.

PART I
THE PRINCIPLES

FIRST PRINCIPLE: 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.

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.

THIRD PRINCIPLE: 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.

FOURTH PRINCIPLE: 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.

FIFTH PRINCIPLE: 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.

SIXTH PRINCIPLE: 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.

SEVENTH PRINCIPLE: 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.

EIGHTH PRINCIPLE: 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.

PART II
COMMENTARIES

General

Over the years, there has been a growing recognition amongst the world's financial institutions that, as creditors, they can achieve better returns through supporting an orderly and expeditious rescue or workout of a business in financial difficulty than by forcing it into formal insolvency. This realisation has coincided with efforts by certain regulatory and official authorities to encourage financial institutions to co-operate with each other when dealing with debtors to whom they are collectively exposed, particularly in cases involving large exposures.

In some parts of the world, local regulatory or official authorities have, for a number of reasons, helpfully supported initiatives designed to encourage financial creditors to take a collective approach to debtors in difficulty. These include their wish to avoid the social and economic impact of major business failures where viable alternatives exist, to limit the damage to financial institutions that can result from unexpected and major debtor defaults (both directly and to lenders to those financial institutions) and generally to assist in the avoidance of more widespread economic damage.

While the advantages to be gained from a co-ordinated response by creditors to debtors in financial difficulty have been most apparent in periods of economic recession (when successive business failures can place very severe strains, not only on the financial institutions but also on the affected national economies), the methods used have gained more general acceptance. If nothing else, the co-ordinated response gives time to help manage the impact of debtor defaults, but most importantly such approaches create an opportunity to explore and evaluate the options for consensual agreement outside a formal insolvency process.

Although there is a continuing international trend in the development of local insolvency laws to facilitate the rescue and rehabilitation of companies and businesses in financial difficulty (as opposed merely to closing them down through liquidation), it is a truism that, no matter how debtor-friendly and "rescue"-orientated local insolvency regimes may be, there are often material advantages for both creditors and debtors in the expeditious implementation of informal or contract-based rescues or workouts (particularly in cases of debtors having cross-border businesses or complex capital structures), compared with the unpredictable costs and uncertainties of a formal insolvency.

It should be noted that the Principles will be most successful in facilitating rescues and workouts if an appropriate legal, regulatory and governmental policy framework supports them. The existence and prospective implementation on a consistent basis of a well-designed insolvency law, by providing financial creditors with effective means of recourse against unco-operative debtors, encourages debtors to co-operate with financial creditors with a view to negotiating an agreement outside a formal insolvency in an acceptable timeframe. In addition, the effective implementation of laws that allow for the creation and enforcement of security and for priority agreements between creditors can provide an important means of encouraging the availability of new financing during the workout process. In the regulatory area in many countries, by virtue of requirements that public companies provide frequent, transparent and internationally consistent information, financial creditors are better placed to reach more rapid and sensible workout decisions.

Finally, and most importantly, time is crucial in rescues and workouts. When a debtor is experiencing financial difficulties, delay prolongs commercial uncertainty, increases the costs of the process and potentially erodes value. The Principles are designed to expedite rescues, and therefore increase the prospects for success, by providing guidance based on hard-earned experience, so that the debtor and the creditors can move the process to a resolution speedily and in a relatively structured manner.

FIRST PRINCIPLE: 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.

Commentary:

All relevant creditors: Although the main impetus and interest in developing a global approach to multi-creditor restructurings has come from the financial community, regulators and other official bodies, the approach advocated by the Principles can be applied to creditors other than financial institutions in appropriate cases.

The main objective of the global approach is to assist in the process of rescue or orderly workout. Accordingly, the approach should ideally be applied to all creditors (and their permitted transferees) whose co-operation is needed in order to make any attempted rescue or workout succeed. On the other hand, there is usually merit in limiting the number of participants to the minimum necessary to see that objective achieved. Taking these two ideals together, it is necessary first to identify the classes of creditors which need to be included in the process and then to decide which creditors in the affected classes are to be included. This could include major customers, supplier creditors, credit insurers and others involved in the provision or management of credit. However, it must be recognised that the identity of relevant creditor classes will vary from case to case and with the passage of time. In certain jurisdictions, for example, the significance of the company's or group's pension fund has increased and the role and requirements of the pension trustees and any pensions regulator as creditors should be considered from the outset of any restructuring.

With banks and other financial institution creditors, it is usual to include all the financial creditors (including those creditors providing interest rate, foreign exchange and other hedging or derivative products to the debtor) in the class regardless of the size of their exposure or the nature of their facilities (unless their exposure is so negligible that it is clear that their inclusion would serve no practical purpose or their position is such that they are not required to assist, and cannot frustrate, the process).

One rationale for including all financial creditors is that, even though in a particular case one financial creditor might be less exposed than others and therefore have less interest in any rescue attempt, this relative position might be reversed in another case. Accordingly, the long-term and mutually beneficial advantages to be gained by financial creditors supporting and co-operating with each other with regard to a co-ordinated approach to debtors in difficulty are reasonably clear. Financial creditors should, as a matter of principle, be prepared to support other financial creditors' attempts to rescue businesses unless it is to their commercial disadvantage to do so.

Where it is proposed to include creditors who fall outside the traditional categories of financier in the rescue process, the argument for including all creditors within a class diminishes and it is usually simply a question of deciding whether or not the particular non-financial creditor has to be included to enable the rescue to progress.

Where bonds or traded debt are involved in the rescue process it is seldom possible to involve all the bond or debt holders. Quite often ad hoc committees are formed by some of the debt holders. As these debt holders usually have the same economic interest as other holders their views are likely to be representative and they are therefore able to make an important and helpful contribution to the process. Where in the Principles or the Commentaries reference is made to "all relevant creditors", this should in the case of rescues involving bond holders or other tradable debt issues, be construed as a reference only to those of the bond or debt holders that participate actively in the rescue process.

With the increasing use of credit insurance and credit derivatives, in addition to the creditors of record there may be other parties whose consent or involvement will be necessary for any rescue or workout proposal to succeed. Wherever practical, an early disclosure of such situations should be made by the creditors of record to the other relevant creditors.

Where the identity of relevant creditors changes during the process (e.g. through the trading of debt in the secondary market) the successors should participate in and be included in the process in the same way as the original creditor.

Giving time to the debtor (the Standstill Period): Where a debtor is in financial difficulties, its creditors tend to have two main strategies. The first is to press the debtor for immediate repayment of the debt or the provision of security in the hope of removing or reducing the exposure. In some jurisdictions, attempts by a creditor to pressurise a debtor close to insolvency into giving it favourable treatment compared to other creditors can be open to legal challenge on the basis of preference. In others, however, pressurising a debtor in this way protects the creditor from a preference challenge and therefore, if a creditor is successful in persuading a debtor to pay it off or to give it security, it may well be able to keep the benefit deriving from its tactics.

The problem with the “each creditor for itself” approach is that, even if such a strategy can in theory benefit the creditor in a way which avoids subsequent legal challenge, the likelihood is that it will, either by itself or by provoking other creditors into following a similar approach, result in the debtor being forced into formal insolvency, thereby destroying any prospective advantage the creditor was seeking to gain.

This reality has caused the experienced financial creditors to conclude that their interests will usually be better served by a co-ordinated and measured response to the debtor in difficulty. It has also led debtors and their advisers to realise that giving in to pressure by one creditor usually destroys any chance of persuading the other creditors to hold off and give time for a rescue attempt.

During the Standstill Period, the creditors, with the co-operation of the debtor, should obtain and evaluate information about the debtor, its business operations and its capital structure and, if there is a commercial case for doing so on the basis of the information that has been obtained, formulate and assess proposals for resolving the debtor's financial difficulties (see commentary on the **Fifth Principle**).

The Standstill Period - Commencement: One of the more problematic areas is the determination of the date from which the Principles are to begin to operate and the standstill arrangements commence ("Standstill Commencement Date"). Any arrangement under which the debtor is given a temporary breathing space in which information can be gathered and assessed and, where appropriate, further terms negotiated should be treated as a standstill for the purposes of these Principles and the Commentary.

The relevant creditors will often choose as the Standstill Commencement Date the date on which the financial creditors as a group (or at least some significant group or class of their number) were first notified by the debtor or by another financial creditor of a meeting called to allow the debtor to explain its position to the relevant creditors. Although a financial creditor has no duty to inform other financial creditors if it believes a debtor is in difficulty, where confidentiality restrictions permit this often does occur and quite frequently one financial creditor will press the debtor to make a presentation to all its financial creditors so that standstill arrangements can be put into effect.

In some cases, one or more financial creditors may have anticipated the problems of the debtor and managed down their exposure to a significant extent before other creditors have realised the potential difficulties and before any meeting of financial creditors has been called. Such a creditor may well benefit in the short term, but, particularly in cases where dramatic changes have occurred in its exposure over a relatively short period, it may experience difficulty in persuading others to lend their support to a rescue.

The Standstill Period – Duration: The length of the Standstill Period will vary from case to case, depending on the complexity of the information to be gathered and the nature of any restructuring proposals, but should be no longer than necessary for the carrying out of the above process in each particular case, since any unnecessary delay is likely to prejudice the prospects of a successful outcome. It is customarily for an initial period of weeks or months, usually with a capacity for extension if all relevant creditors so agree. Sometimes the Standstill Period will be agreed for a period of, say, three months, but on the basis that the relevant creditors can, by a predetermined majority (e.g. a majority in number or a majority in both number and value of claims) elect to terminate the Standstill Period prematurely, either at their discretion or following agreed events of default.

Although having a Standstill Period capable of premature termination at the discretion of a majority of the relevant creditors may appear to provide less assurance to the debtor, it has the advantage of flexibility and overcomes the difficulties of drafting and agreeing events of default which are suitable in a situation where the debtor is on the brink of collapse and the extent of its financial difficulties are such that "usual" event of default triggers would be inappropriate. Equally, while the relevant creditors may as a matter of principle be prepared to lend their support to the attempt at rescue or orderly workout, they will be concerned to ensure that, if the position deteriorates to their apparent disadvantage, they should be free to protect themselves and should not be locked into a deteriorating position. In practice, the approach adopted to this issue tends to depend upon the nature and degree of the difficulties facing the debtor.

Unless such a course is inappropriate etc: The suggested approach to multi-creditor workouts does not mean that the relevant creditors will in all cases agree to give time to a debtor to pursue the possibility of rescue or workout. Not all companies or businesses can be saved. In some cases, it may be obvious that no rescue or workout is feasible; in others, the debtor's management may have acted fraudulently and thereby have lost the trust and confidence of the relevant creditors.

If a creditor has reasonable grounds for preferring formal insolvency to any attempted rescue or workout, it is entitled, and can be expected, to elect for formal insolvency. If, however, giving time for the position to be properly evaluated has no apparent disadvantage for the creditor concerned, it should not refuse to co-operate simply to be obstructive. What will constitute reasonable grounds for a creditor refusing to give time to a debtor will depend on the circumstances of each case.

A creditor wishing to press for formal insolvency and unwilling to give time for any evaluation of the position should be encouraged to explain its reasoning to other creditors (assuming the debtor lifts any confidentiality restrictions which would otherwise prevent communication between creditors) and should at least consider representations from other financial creditors before reaching a final conclusion.

Reluctance on the part of a financial institution creditor to participate in a co-ordinated approach due to the relative size or nature of its exposure or a desire on its part to terminate the relationship with that debtor is not regarded as legitimate justification for its exclusion.

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.

Commentary:

Refrain from taking any steps etc: The initial objective of any attempted rescue or workout is to achieve stability. To attempt a rescue or restructuring against a backdrop of instability (e.g. political, general economic or creditor instability) is extremely difficult. While certain jurisdictions provide for a statutory moratorium which allows "breathing space" to a debtor before the onset of formal insolvency, in many jurisdictions a statutory moratorium on creditors' claims is available only as part of a formal insolvency process.

Even in jurisdictions which provide for a statutory pre-insolvency moratorium on creditor claims, there is often still advantage to both creditors and the debtor in adopting an informal or contract-based approach so as to avoid the costs and publicity associated with any formal process.

The confirmation of a "standstill" provides some reassurance to the debtor's management that their attempts to achieve a rescue or orderly workout through the provision of information about the debtor to its creditors and their advisers and negotiation with them will not be immediately undermined by enforcement actions by those creditors; and also to the relevant creditors to the effect that the others of them are prepared to proceed on a co-ordinated basis while the evaluation process occurs.

In many jurisdictions, the "standstill" of the relevant creditors will be the subject of an agreement between the relevant creditors and the debtor. Typically such standstill agreements will include undertakings by the relevant creditors:

(a) Not to press for repayment of the amounts due to them or issue or pursue proceedings against the debtor during the Standstill Period;

(b) Not to try to improve their individual positions relative to other creditors by obtaining or enforcing security or seeking additional financial rewards or preferential treatment during the Standstill Period; and

(c) To continue during the Standstill Period to allow utilisation of existing credit lines and facilities, at least at the exposure levels existing at the Standstill Commencement Date.

While the continuation of facilities by relevant creditors is usually an essential feature of standstill arrangements, in some cases the termination of certain open derivative contracts may assist the rescue process by removing the volatility associated with such contracts. In other cases the continuation of swaps or hedges may be necessary to preserve value in the business concerned. Each case will need to be considered on its merits in this regard.

In certain jurisdictions, an agreement by the debtor with all or some of its creditors which provides for a moratorium on the payment of debts will itself trigger formal insolvency. In such cases it may still be possible for the creditors to agree between themselves (rather than with the debtor) to operate a moratorium on their claims against the debtor and for the debtor separately to agree not to take steps which might prejudice the relevant creditors during an agreed period.

As stated, debt trading does not infringe this **Principle**. It is more fully discussed in the commentary on the **Seventh Principle**.

Their position relative to other creditors and each other will not be prejudiced: One of the main objectives of standstill arrangements is to try to ensure that, during the Standstill Period, the relevant creditors are not prejudiced relative to each other or relative to their position at the commencement of the process. While the issue of the eventual outcome for creditors may be uncertain at this stage, the standstill arrangement will usually contain a number of covenants and warranties which are designed to ensure that the position of the relevant creditors does not deteriorate, at least due to any deliberate acts or omissions on the part of the debtor during the Standstill Period (see commentary on the **Third Principle**).

Of more complexity and subtlety tend to be the arrangements between the relevant creditors themselves, which are designed to try to ensure that their relative exposures do not change during the Standstill Period. To this end, the more sophisticated standstill agreements (or separate linked inter-creditor agreements) will contain provisions which seek to address fluctuations in exposure that often occur during the Standstill Period where loan facilities provided by one or more relevant creditors are revolving or fluctuating in nature. In relation to such loan facilities, the relevant creditors may agree (under so-called “loss-sharing” or "equalization" provisions) to make balancing payments to each other in the event of a collapse, such as are necessary to redress any relative gain or loss to relevant creditors resulting from such fluctuations as compared to the position at the Standstill Commencement Date.

Even greater difficulties arise in relation to facilities which are contingent in nature. There is a growing trend amongst financiers to seek to value their exposures under contingent facilities (e.g. foreign exchange facilities, interest rate and currency swaps and other forms of derivatives) by means of “marking them to market”, often on a daily basis. Standstill agreements quite often seek to address the issue of fluctuations in exposure based on “marked to market” calculations under these types of facilities in a similar way to those on revolving loan facilities, although the potential volatility in exposures can require very sophisticated arrangements in order to limit the effect of such volatility on arrangements amongst the creditor group. Such loss-sharing provisions also seek to rectify variations in comparative exposure, although in many cases this issue will not be covered until a formal restructuring proposal is agreed and only limited adjustment mechanisms (if any) will be agreed at the standstill stage of the process.

Additional difficulties may arise because of the nature of the debt obligations subject to such loss-sharing arrangements. For example, where an issue of widely-held public debt is involved, it may not be practical to obtain the agreement of the requisite number of holders. All parties should recognise that efforts should be made by those parties involved in the negotiations to devise arrangements, to the extent possible, to give all holders of debt the benefit of such loss-sharing arrangements, so as to facilitate ultimate agreement on a consensual restructuring.

In certain cases, one or more of the creditors may enjoy an existing advantage compared to other participating creditors, either in the form of security or by virtue of the comparative number of companies in the debtor group against which it has recourse (whether by way of direct claims, guarantees or indemnities). Once again, the inter-creditor arrangements entered into at the standstill stage will often allow for the retention of these advantages. (Other forms of advantage which individual creditors may enjoy include set-off rights, liens, the benefit of documents of title associated with trade finance or bill purchase facilities, guarantees and insurance from third parties). The ultimate treatment of these advantages will typically be addressed in an inter-creditor agreement forming part of a contractual restructuring and is often the subject of extensive negotiation among the creditors.

When the claims of relevant creditors are denominated in a number of different currencies, movements in exchange rates during the Standstill Period can affect the relative position of creditors. Standstill arrangements often use assumed fixed exchange rates to determine certain inter-creditor issues (e.g. voting and risk sharing) although realisations may still be shared by reference to actual exchange rates and end of day balancing adjustments may be required to cover exchange rate fluctuations.

Conflicts of interest: actual or perceived conflicts of interest can damage confidence in the restructuring process and can arise in a number of situations. It is expected that such conflicts will be identified by the relevant institution and appropriate steps taken to address any actual or perceived conflict of interest.

THIRD PRINCIPLE: 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.

Commentary:

In return for support from the relevant creditors, the debtor should agree not to take any action which will disadvantage relevant creditors during the Standstill Period, apart from paying employees and trade and other (non-relevant) creditors in the ordinary course of business. Examples of such prejudicial action would be offering security in the form of charges, mortgages, liens, guarantees or indemnities to non-participating creditors, transferring assets or value away from the companies to which participating creditors have recourse, selling assets to third parties at an undervalue or to creditors who, because they are already owed money, will not pay for them, or otherwise running down or shifting value from its business so that the prospects of repayment to the relevant creditors are diminished. Incurring new additional borrowings or credit from persons who are not relevant creditors can also be an issue of sensitivity, as can the use of techniques such as factoring or leasing to raise new finance.

In some cases, the relevant creditors will insist that security be given to them at this stage for their collective benefit in return for their support during the Standstill Period. This is usually a topic for negotiation in connection with the standstill. If at this stage, however, additional funding (i.e. in excess of existing levels) is requested by the debtor from relevant creditors, the granting of security for such additional funding would be quite usual (see commentary on the **Eighth Principle**).

FOURTH PRINCIPLE: 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.

Commentary:

Although in some cases the number of relevant creditors involved in an attempted rescue is sufficiently small that a steering committee is unnecessary and a single co-ordinator may suffice, in most cases the result of a proliferation of borrowings by the debtor and/or the difficulty of identifying or making contact with, say, individual bondholders will be that the use of a co-ordination committee will greatly assist the process of attempted restructuring.

To assist with the co-ordinated approach, it is usual for the relevant creditors to appoint one or more representative committees to progress dialogue with the debtor and to help manage the evaluation process and the standstill arrangements.

Where bond or other tradable debt issues are involved, ad hoc committees are often formed by a number of bond or debt holders whose views may be expected to be representative of the bond or debt holders as a class.

Co-ordination committees (or the relevant creditors themselves) may select one or more of their number to act as the main co-ordinator(s). Such a co-ordinator will take first line responsibility for much of the administrative burden of the process and will also normally chair the meetings of the co-ordination committee.

The responsibilities and purposes of co-ordination committees and co-ordinators (hereafter together referred to as "co-ordinators") will be determined by the relevant creditors.

Co-ordinators do not usually represent the relevant creditors in the sense of having authority to commit them to any particular course of action. Co-ordinators will also not wish to incur legal liability to the relevant creditors or to the debtor by assuming a representative role.

Co-ordinators are best described as facilitators of the negotiation process and co-ordinators of the provision of information to the relevant creditors (with appropriate professional advice). The appointment of co-ordinators should, in any case, be for the convenience of the parties and the efficiency of the process.

Co-ordinators can help resolve disputes or disagreements between the relevant creditors by facilitating discussions among those concerned. The co-ordination committees act as sounding boards, not only to the co-ordinator (if any) but also to enable the debtor to obtain an indication of the likely reaction of the relevant creditors to developments and to any proposals which the debtor may be thinking of making.

All parties should bear in mind that the role of the co-ordinator and the co-ordination committee is to facilitate the process, not to make commercial decisions on the part of others.

The advantages and efficiencies of channelling communications between the debtor and relevant creditors through co-ordinators are considerable but the process can be time-consuming, both for the creditor representatives on the co-ordination committee and particularly for the co-ordinator. For this reason it is usual for the co-ordinator and co-ordinating committee members to receive appropriate recompense, not only to reflect the time they are likely to have to spend in discharging their role but also for travel, accommodation and other disbursements they incur. These expenses will be for the debtor's account initially, perhaps pre-funded by the debtor or covered by a loss-sharing or similar negotiated agreement among the relevant creditors as a group.

The co-ordinators are often given delegated authority to instruct outside professionals such as accountants, lawyers and valuers to provide advice for the benefit of the relevant creditors as a whole. Where practicable, the choice of such professionals will be discussed and approved with all the relevant creditors. It is important that such advisers have the relevant experience and skills and will be able to provide impartial advice for their collective benefit. Such professionals will assist in the preparation and evaluation of information and documentation relevant to the process in all its various stages. Once again the costs of such professionals will be for the account of the debtor, but pre-funding or a loss-sharing or similar negotiated agreement may be required as a back-up.

Another advantage of using co-ordinators is that it helps to ensure that all the relevant creditors receive the same information and advice during the rescue process. A single set of shared advisers for the relevant creditors as a whole is often preferable from a debtor's perspective and may work in some cases, but often creditors who are parties to different forms of credit facilities (such as bank loans, privately-placed notes and public bonds) will require that separate legal advisers be retained to represent the interests of relevant creditors of a particular class. Because workouts often present inter-creditor issues, not just issues between the debtor and the relevant creditors as a group, and because different creditor classes typically have different legal, regulatory, policy and other issues to address, it would be unusual for a single legal adviser to be able to represent all the relevant creditors with respect to all the issues involved. Even in such cases, however, it is often possible for the main burden of information-gathering, processing, evaluation and due diligence to be borne by accountants and lawyers acting for or representing the interests of the relevant creditors as a whole. All advisers should be independent of the debtor.

Where advisers are appointed by the co-ordinator or the co-ordination committee, the co-ordinator/committee should ensure appropriate costs estimates are obtained in advance and that each professional adviser provides a regular costs update during the transaction to ensure costs can be actively managed throughout the transaction.

Where the relevant creditors agree that there is no material difference of interest between them, but individual creditors still wish to have the benefit of separate advice (e.g. on the impact of any proposals upon their individual positions in contrast to others), the cost of such separate advice will usually have to be borne by the creditor concerned and cannot be passed on either to the debtor or the other relevant creditors.

Importantly, each of the relevant creditors will be expected to make its own assessment and decisions regarding any information, advice or proposals it receives either directly or via co-ordinators with regard to matters related to the restructuring process. Co-ordinators will have no duty or liability to other creditors or the debtor with regard to the accuracy or completeness of such information or advice or with regard to any proposals or their acceptance or rejection of them. It is important, however, that co-ordinators ensure that information they receive is made available to all relevant creditors and that they do not assume liability or responsibility to other relevant creditors either expressly or by any course of conduct (see commentary on **Seventh Principle**).

While co-ordinators can expect the identified costs and expenses they incur relating to the restructuring process to be recoverable from the debtor or, in the event of the debtor's default, covered by pre-funding or a loss-sharing or similar agreement with the relevant creditors as a whole, open-ended and general indemnities are likely to be resisted by the relevant creditors. Increasingly, co-ordinators and each member of the co-ordination committee require that the nature of their position and role be defined in writing with the relevant creditors and the debtor.

In some cases, the differing interest groups amongst the financial creditors can be accommodated within a single co-ordination committee by ensuring that the co-ordination committee is sufficiently representative of the different interest groups within the relevant creditors as a whole. In such a case, its composition should reflect the individual types and classes of creditors and, if possible, include the true beneficial owners of the facilities involved, rather than the nominal owners or holders of legal title only. However, in situations where a relevant creditor class does not have an agent (for example, an issue of private notes or public debt securities), the representative of that class may be a designee such as an attorney or accountant who in turn has been appointed by an ad hoc group of holders of private notes or public debt securities.

In other cases, the extent and nature of the different interests can mean that a single co-ordination committee will not be appropriate and in this event, two or more co-ordination committees may be appropriate with each having its own co-ordinator who will work with the other co-ordinator(s) to progress the process while at the same time being representative of their separate constituencies.

The choice of co-ordinator is made by the constituency from which the committee is selected. Very often the co-ordinator will be a representative of the financial creditor which has the greatest or one of the greatest exposures to the debtor, and will be an individual with relevant experience, skills and seniority. In rare cases, creditors may prefer that the co-ordinator be an independent person.

The obvious advantage of the co-ordinator being a creditor with significant exposure to the debtor is that the reaction of a co-ordinator to proposals is likely to be indicative of the reaction of relevant creditors generally. On the other hand, a self-interested co-ordinator may in some cases have significant differences of view from other creditors, which may harm the process. The choice should lie with the relevant creditors.

Co-ordination committees usually operate on the basis of consensus rather than majority voting, particularly as they have no actual authority to bind the relevant creditors as a group.

FIFTH PRINCIPLE: 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.

Commentary:

Reasonable and timely access to all relevant information: During the Standstill Period, the debtor should allow relevant creditors and/or professional advisers appointed to represent them access to all relevant information regarding its assets, liabilities, business and prospects. This is important, not only to enable the relevant creditors to assess the financial position of the debtor at the Standstill Commencement Date and during the Standstill Period, but also to enable them to evaluate any proposals which the debtor may wish to make for its rescue, workout or reconstruction.

The relevant creditors will need to receive information which they can place reliance upon and have evaluated by their advisers. For this reason the information will have to be obtained, or at least be capable of due diligence, by independent advisers acting for the relevant creditors. The advisers to the relevant creditors can in some cases work from information provided by the debtor or its advisers but issues of reliance and liability can cause difficulty in this regard and, where asset valuations are needed, it will usually be necessary for the relevant creditors to commission such valuations themselves. The location and nature of assets can necessitate special due diligence techniques.

The debtor should accept that the advisers to the relevant creditors will be expected to review the accuracy of accounts, projections, forecasts and business plans related to any proposals for rescue or reconstruction and also to estimate the consequences of the relevant creditors refusing to agree to the proposals being put to them. The relevant creditors will also wish to gain reassurance that, as between themselves, their relative positions have not and will not be prejudiced by any proposals which are being made.

Any proposals to be made to relevant creditors: The nature of the proposals which the debtor may wish to make for its rescue, restructuring or workout will of course depend on the circumstances. They may only involve the provision of temporary additional liquidity, but in other cases debt write-offs, exchange offers for bonds, debt to equity conversions or asset for debt exchanges may be necessary to restore balance sheet solvency to the debtor. In some cases, the proposed arrangements can be effected by contractual arrangements between the debtor and the relevant creditors alone. In others, the proposals will need the sanction of the courts (e.g. in the case of schemes of arrangement or Chapter 11 reorganisations) and in such cases it is usual for the debtor and relevant creditors to try to ensure that, so far as practicable, the outcome of any formal procedure is known in advance.

SIXTH PRINCIPLE: 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.

Commentary:

The objective of the information-gathering, due diligence and evaluation processes during the Standstill Period is to enable the relevant creditors to evaluate the debtor's position, to assess any proposals which the debtor may put to them and to satisfy themselves that they are receiving equitable treatment relative to the other relevant creditors.

In making their assessments, creditors will need to compare the outcome they could expect from any proposals made to them against the returns they might expect to achieve in a formal insolvency process or from other options available to them. Accountants or other financial advisers acting for the relevant creditors frequently provide advice of this nature that is based upon insolvency models for the debtor group. These models operate by reference to certain stated legal and accounting assumptions (e.g. as to the validity of security, guarantees, rights of recourse, rights of set-off etc). These will in turn be based upon the information generated through the due diligence process.

Such insolvency models should take account of all relevant claims and entitlements (e.g. the claims of the relevant creditors and other creditors, inter-company and subrogated claims and dividend entitlements) which would be counted in any insolvency of the debtor and of all relevant insolvency laws.

Insolvency models can either be used simply to identify where realisations are likely to go in the event of an insolvency (applying usual insolvency principles) or can be more sophisticated and seek to predict the likely return to creditors in an insolvency using assumed realisation values and assuming a contemporaneous liquidation and asset realisation by all companies in the debtor group. Because of the assumptions as to value and time used in these models they only serve as estimates but they are nevertheless helpful as a basis for both negotiation and evaluation.

When applied to groups of companies, insolvency models will consider the position of each debtor company separately and then aggregate the result on a group basis and by reference to each relevant creditor so that the net expected return to each relevant creditor can be determined.

In the case of larger groups, the insolvency models can be extremely complex and will need to take account of differences in the various insolvency regimes of the different jurisdictions involved.

The output from the insolvency models can, amongst other things, be used to identify the claims that relevant creditors may have against each debtor company; to estimate the likely return to such creditors from their claims and to estimate the proportion of the indebtedness due to relevant creditors which appears to be covered by assets (as opposed to uncovered). These calculations can in turn be used when considering such issues as debt to equity conversion or debt write-offs.

Because the benchmark for the approach advocated under the Principles tends to be the position as at the Standstill Commencement Date, relevant creditors will also wish the insolvency model and the assumptions upon which it is based to have regard to issues such as the validity of claims of relevant creditors, the validity of any security they may hold, the validity of any exposure reductions which occurred in the period prior to the Standstill Commencement Date and the advantages which the holders of guarantees may enjoy by virtue of their ability to make claims against both principal debtors and guarantors. For this reason the due diligence exercise carried out on behalf of relevant creditors quite often applies not only to the debtor but also to the claims and entitlements of the relevant creditors.

SEVENTH PRINCIPLE: 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.

Commentary:

Confidential Information: It is preferable that during the rescue process all relevant creditors are provided with the same information regarding the assets, liabilities and business of the debtor and see all the proposals put by the debtor. This should be so even where differing proposals are being put to differing constituencies within the relevant creditor group as a whole and even if differences in the position between the relevant creditors mean that separate professional advice is required for separate constituencies.

Where the creditor group solely comprises regulated financial institutions whose exposure arises under the same debt instrument, they will often (with the agreement of the debtor) all receive the same information at the same time, even in cases where the co-ordinator first processes information so that it is put into a form suitable for evaluation by each of the relevant creditors. This is partly linked to the fact that regulated creditors, in many jurisdictions, have either contractual or implied duties of confidence to their debtor customers. Hence those creditors are accustomed to receive and hold price-sensitive and confidential information.

Where relevant creditor groups include creditors who either are not subject to express or implied duties of confidence or cannot accept confidential information without prejudicing their ability to trade debt (which in the case of debt-traders and many bondholders will be unacceptable except for relatively short and defined periods), the position can be more complicated and special arrangements will need to be made. The confidential information is often evaluated either by an ad hoc group formed from their number who are prepared to be restricted from trading or by the co-ordination committee and in each case by professionals acting for them (such as their legal advisers) until proposals have been fully formulated and it is either possible to publish the information or for the information to be passed to the intended recipient on the basis that it will be published within an agreed period whether or not the rescue proposal is approved. By this method the confidential and price-sensitive information is “cleansed” in the sense that publication will enable debt-traders or professional bondholders then to trade the debt which they were not able to do while they held confidential information which was not available to the rest of the market.

In all cases it is recommended that a formal confidentiality agreement should be entered into by each relevant creditor.

Debt Trading: In many jurisdictions the trade in secondary debt is a well-established practice and secondary debt trading has become an important feature of the financial marketplace as creditors manage their credit positions and realise the values associated with that position. Debt trading also enables creditors to achieve an exit where they do not wish to participate in the rescue process.

The main sensitivities associated with debt trading are that it can lead to an increase in the number of, and a change in the identity of, creditors who have to be involved in the rescue process. The use of professional advisers and co-ordinating committees to progress negotiations with the debtor and to receive and analyse confidential information relating to the debtor may reduce the sensitivity associated with debt trading by obviating the need to transmit confidential information to the main body of relevant creditors until the rescue proposal has been fully formulated and the implementation mechanism initiated. This technique tends to be of most assistance when the rescue proposal is to be implemented using some form of scheme of arrangement or reorganisation which requires publication of the proposal and court approval. It is of less help where it is necessary to gain the voluntary agreement of each debt holder to the proposal.

As noted in the commentary on the First Principle, where the identity of the relevant creditors changes during the process (e.g. through the trading of debt on the secondary market), the successors should participate in and be included in the process in the same way as the original creditor.

Where the intention is to avoid any formal procedure to implement the proposal and/or to keep the details of the proposal confidential, the relevant creditors may include in the standstill arrangements some mechanism for regulating the trading of debt during the Standstill Period.

EIGHTH PRINCIPLE: 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.

Commentary:

If additional funding is provided: During the Standstill Period and/or in the immediate aftermath of any rescue or restructuring, additional funding (often referred to as "New Money") is often required. While other ways may be found of providing such funding or of easing the debtor's financial pressures (e.g. through the release of asset disposal proceeds), New Money may also be necessary to enable the debtor to overcome a temporary shortfall. The relevant creditors will normally wish to be satisfied both that any New Money funding is genuinely necessary and that repayment is adequately provided for. They may therefore be reluctant to see New Money funding of material amounts in advance of some assurance about the debtor's financial position.

As noted in the commentary on the **Second Principle**, the standstill arrangements are intended to preserve the relative position of relevant creditors as between themselves. The benchmark for comparison will be the position as at the Standstill Commencement Date.

Where a debtor requires New Money funding, relevant creditors will be concerned that such New Money will, so far as practicable, be given priority of repayment compared with other debts in the event of the failure and insolvency of the debtor.

The simplest method of ensuring the priority of repayment for New Money is usually by the obtaining of security for its repayment over assets of the requisite value. In some cases, however, negative pledges in favour of third parties or other legal complications will either prevent the granting of security for New Money or render the benefit which will result from such security uncertain. While there are various techniques for ameliorating such problems (e.g. asset purchase arrangements, placing assets into newly formed and "ring-fenced" borrowing entities and sale and leaseback arrangements) in some cases relevant creditors will have no option but to fall back on loss-sharing arrangements between themselves designed to ensure that the New Money will be accorded priority of repayment status (e.g. by agreeing to "pool" recoveries from any insolvency of the debtor and to apply them in repayment of the New Money first or, in certain jurisdictions, by the use of subordination agreements).

Identifying New Money is, as indicated in the commentary on the **Second Principle**, not limited simply to the provision of additional loan facilities. It can also apply to other forms of increase in exposure levels (e.g. under derivative or contingent facilities) when compared to the position as at the Standstill Commencement Date. The treatment of such increased exposure levels will be a matter for commercial negotiation among the relevant creditors.

The provision of New Money (including increases in exposure which are to receive New Money treatment) can impact upon the position of relevant creditors. This is because its priority treatment may affect the prospects of other non-prioritised debt being repaid.

Ideally, where appropriate, all relevant creditors participating in the process should be given the opportunity to participate in the provision of, and should accept the risks associated with, the provision of New Money on a proportionate basis (i.e. proportionally to the perceived exposures which each of them has to the debtor as at the Standstill Commencement Date). Banks and other financial institutions may be able to provide New Money funding directly (either on a bilateral or syndicated basis) but other relevant creditors may only be able to underwrite such New Money exposures and some only to a limited degree.

Some relevant creditors may not be able to agree to any increase in their overall exposure and will only be able to support the provision of New Money either by subordinating their existing debt to its repayment (this technique may not work in all jurisdictions) or by agreeing to share dividends or other recoveries so as to give the New Money priority of repayment (i.e. a form of loss-sharing provision).

The basis on which benefits associated with the provision of New Money will fall to be shared between relevant creditors where only some of them are able to provide the New Money lending to the debtor directly will be the subject of commercial negotiation between the relevant creditors.

New Money lending will generally be provided on the same basis so far as demand or cancellation is concerned as other facilities (e.g. such demand may only be made during the Standstill Period with the agreement of a majority of the relevant creditors). In many jurisdictions, however, a lender of New Money (or indeed a provider under any other facilities) should not be obliged to lend further amounts after a petition for liquidation or bankruptcy has been lodged against the debtor unless such additional lending has been approved by the courts, as otherwise it may not be recoverable in a subsequent liquidation or bankruptcy.

Appendix - Original Letters of Endorsement and Acknowledgement

The World Bank
Washington D.C. 20433
U.S.A

KO-YUNG TUNG
Vice President & General Counsel

October 2, 2000

Mr. Neil Cooper
President
INSOL International
2-3 Philpot Lane
London EC3M 8AQ
England

Dear Mr Cooper:

ILG Principles for Multi-Bank Workouts

On behalf of the Bank, I would like to thank you for the opportunity to review the recently completed *Principles for Multi-Bank Workouts* developed under the auspices of INSOL International by the INSOL Lenders Group.

The World Bank has been addressing the problems of corporate financial distress on a systemic level throughout the transition experience in Central and Eastern Europe and in the more recent financial crisis context in emerging markets. The Bank places paramount importance on these issues as being fundamentally important to sustain and promote effective markets and growth in developing countries and to maintain stability within financial systems. In this regard, the Bank has been working in collaboration with INSOL, the International Bar Association and international financial institutions to develop principles and guidelines for effective insolvency systems in developing countries. The INSOL *Principles* are an important complement to that broader initiative and other global efforts in this field.

INSOL is to be commended for this timely contribution to the evolving debate regarding the design and operation of insolvency systems and for its long standing commitment to the global enhancement of awareness and best practice within the international professional community.

Sincerely,

Ko-Yung Tung

Ko-Yung Tung

The Governor
BANK OF ENGLAND
LONDON EC2R 8AH

5 October 2000

The Bank of England welcomes this initiative by the INSOL Lenders Group to develop a set of Principles for Global Corporate Workouts. Past experience suggests that a collective approach by creditors to a debtor company in financial difficulty can help preserve value, to the benefit of the creditors as a whole and of others with an interest in the company.

The Rt. Hon. Sir Edward George

BBA BRITISH BANKERS' ASSOCIATION

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

Tim Sweeney
Director General

Neil Cooper Esq
President
INSOL International
2-3 Philpot Lane
London EC3M 8AQ

6 October 2000

Dear Mr Cooper

ILG Principles for Multi-Bank Workouts

The members of the British Bankers' Association, comprising as they do some 320 banks from more than 60 countries, have been involved in the great majority of multi-bank workouts which have been undertaken over recent decades, not just in the UK but around the world.

They recognise the value of the principles, which have now been published by INSOL. Indeed, as a member of the INSOL Lenders' Group, the BBA has been an active participant in their development.

We therefore commend them to the international community, as a statement of best practice which we believe can make a major contribution to financial stability.

Yours sincerely,

Tim Sweeney
Director-General

ACKNOWLEDGEMENT

INSOL International would like to thank the INSOL Lenders Group and all others who have been involved in this project.

The Statement of Principles for a Global Approach to Multi-Creditor Workouts is the product of a number of meetings and conferences and much correspondence among a large group of interested persons over an extended period of time. In all, representatives from over 150 institutions have been involved in one stage or another of this project, whether as panelist, working group member, commentator or conference participant, including many of the largest banking institutions, insurance companies, institutional investors, hedge funds, secondary market and distressed debt purchasers, investment bankers and insolvency and finance professionals, plus Government representatives and regulatory authorities in many countries. The list is far too long to acknowledge each contributor individually, but suffice to say that the Principles are truly the product of a global effort by the people who deal with these issues on a daily basis.

The work of the INSOL Lenders Group has been led successively by Eddie Theobald (then of Barclays Bank Plc), David Havelock (then of National Westminster Bank Plc) and currently Adrian Marriette of HSBC and Terry Bond of Barclays Bank Plc.

They have been helped enormously by Richard Gitlin and Barry Russell of Bingham Dana LLP, New York and Nicholas Frome and Christopher Hanson of Lovells, London, who have undertaken the legal drafting of the Principles.

The INSOL Lenders Group Steering Committee has included many senior lenders in the last five years. The members of the Steering Committee as at October 2000 comprise

Adrian Marriette, Chairman	HSBC
Terry Bond, Vice Chairman	Barclays Bank Plc
Steven Barningham	Royal Bank of Scotland
Geoff Cruickshank	National Westminster Bank Plc
Rene Poisson	J P Morgan
Peter Ryan	The Industrial Bank of Japan
John Short	Deutsche Bank
Peter Stevens	Credit Agricole Indosuez
John Thirlwell	British Bankers Association

In addition, INSOL International owes a debt of gratitude to Richard Gitlin and John Lees for convening many of the meetings at which the Principles were developed.

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INSOL International would like to thank the members of the Group of Thirty-Six whose ongoing support has enabled us to publish and distribute the Statement of Principles II.

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Organizational failure: a critique of recent research and a proposed integrative framework

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There is a long-running debate in the business literature on the causes of organizational failure. On the one hand, classical industrial organization (IO) and organization ecology (OE) scholars have typically assumed a deterministic role of the environment and argued that managers are constrained by exogenous industrial and environmental constraints leaving them with little real strategic choice, and hence managers' role should be ignored. On the other hand, the organization studies (OS) and organizational psychology (OP) literature takes a more voluntaristic perspective and argues that managers are the principal decision makers of the firm and, consequently, their actions and perceptions are the fundamental cause of organizational failure. This paper addresses the major deficiencies observed in the diverse body of literature covering this field, suggests an integrative framework and identifies the specific theoretical and methodological challenges ahead for researchers seeking to advance knowledge in the field of organizational failure.

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Introduction

Since Whetten's (1980) call for more research on organizational failure, there has been a steady increase in research investigating this area (see Wilkinson and Mellahi forthcoming). However, literature on failure remains dispersed in various and wide areas of study, ranging from industrial organization (IO), organization ecology (OE) and organization studies (OS) to organizational psychology (OP). So far, theoretical and empirical research on failure has reflected a clear divide along the deterministic (IO/OE) and voluntarist (OS/OP) schools. This divide has been sustained by assumptions that the theoretical and methodological differences across these two schools are insurmountable (Witteloostuijn 1998). As a result, the two schools of thought have evolved independently with little synergy, resulting in theoretical and practical gaps in researchers' understanding of organizational failure.

There is an obvious need to review the current body of literature. First, while the literature on organizational failure continues to grow, proportionately less time has been devoted by scholars to reviewing or capturing the ever-increasing body of knowledge on this topic. Secondly, we believe that the continued accumulation of fragmented and contradictory findings adds little to researchers' understanding of organizational failure. Thirdly, the review highlights a potential direction for future research efforts.

In this endeavour, we first define the domain of organizational failure. We then organize and review the extensive literature on organizational failure across the two broad IO/OE and OS/OP theoretical perspectives. The review identifies key theoretical linkages, empirical conclusions and overall strengths and weaknesses of each perspective. We then propose a framework that represents a start towards building an integrative framework of organizational failure. Finally, we discuss the theoretical contributions of the integrative framework and offer an agenda for future research.

Defining the Domain: What Is Organizational Failure?

There is no clear consensus within disciplines as to what organizational failure is, how it occurs and its consequences (Cameron *et al.* 1988; Weitzel and Johnson 1989), let alone agreement between disciplines. Several terms have been used in the literatures: organization mortality, organizational death, organizational exit, bankruptcy, decline, retrenchment, downsizing and failure. In this review, we exclude literature on retrenchment and downsizing because we believe that, although, they could be caused by failure, they should not be conceptualized as failure (see Greenhalgh *et al.* 1988), as they are also associated with the activities of successful organizations. Indeed, because of the recent legitimization of downsizing as an acceptable strategic management tool, managers are increasingly using it during growth periods (McKinley *et al.* 2000). We also believe that, although bankruptcy filings provide a public record of a firm's demise (Sheppard 1994, 1995), they reflect only a small portion of business failures. Thus, the large body of accounting and financial management literature seeking to develop financial and accounting models to predict organizational bankruptcy (cf. Altman 1970, 1984; Aziz *et al.* 1988; Dambolena 1983; Dimitras *et al.* 1996; Johnson 1970; Mcgurr and Devaney 1998; Wilcox 1971) will not be part of this review.

Despite the lack of a precise definition of failure, there is a broad consensus on the meaning of failure. Cameron *et al.* (1988, 9) define it 'as a deterioration in an organization's adaptation to its microniche and the associated reduction of resources within the organization'. The result of this could be total exit from the market or turnaround. We shall be using exit, death, mortality and failure interchangeably in this paper. Symptoms of organizational failure include shrinking financial resources (Cameron 1983), negative profitability (D'Aveni 1989; Hambrick and D'Aveni 1988), shrinking market (Harrigan 1982), a loss of legitimacy (Benson 1975), exit from international markets (Burt *et al.* 2002; Jackson *et al.* 2005) and severe market share erosion (Mellahi *et al.* 2002; Starbuck *et al.* 1978). This broad definition incorporates a number of assumptions: (1) failure generally has negative consequences, even though the final outcomes of failure may be positive, i.e. firms learn from failure (Miner *et al.* 1999); (2) the definition does not specify the causes of failure. It takes into consideration both organizational and environmental factors.

The Deterministic View: The IO/OE Perspective

While IO and OE scholars disagree on several issues (see Barron 2001; Boone and Witteloostuijn 1995; Geroski 2001[1]), they coalesce around the idea that, when it comes to failure, the industry matters more than the firm. They agree that organizations are embedded in their environments and, therefore, external factors have more explanatory power than firm level factors (see McGahan and Porter 1997; Rumelt 1991). That is, failure is caused by external factors over which management has little or no control.

The Industrial Organization Perspective

Grounded in economics, the IO perspective is underpinned by the Schumpeterian thesis of 'creative destruction'. According to Schumpeter (1942), jolts in the external environment generate waves of organizational failure. These jolts could be caused by changes of a technological, regulatory, economic or demographic nature (Scott 1992). For instance, shifts or shakeouts (Nelson 1995) in the external environment created by revolutionary technological innovation, such as the Internet, radically change industrial orders, leading to new entrants to the market, such as Amazon.com, and leaving incumbents that are unable to adapt to the new business environment to exit the market. Several studies (cf. Sull *et al*. 1997; Tushman and Anderson 1986) found that, during fundamental transformations of the environment, new firms initiate competence-destroying discontinuities to overthrow incumbent firms.

The IO perspective reflects three underlying assumptions. First, the external environment is assumed to impose pressures and constraints on firms' strategies that would lead to failure. Secondly, most firms operating in the same industry, or within a certain segment of an industry are assumed to pursue similar strategies. Thirdly, organizational decision makers are assumed to be rational and committed to acting in the firm's best interest and, therefore, failure could not be caused by them alone.

The IO literature suggests a range of primary causes of organizational failure. These include turbulent demand structure due to brand switching by core customers, changes in consumer tastes, cyclical decline in demand, strategic competition due to rivalry among existing competitors or new entrants (Baum and Singh 1994; Frank 1988; Jovanovic and Lach 1989; Lippman and Rumlet 1982; Sheppard 1995). Slater and Narver (1994) added technological uncertainty due to product innovations and or process innovations to the list of external causes of failure. Dess and Beard (1984) explain the relationship between organizations and the environment by three factors: dynamism, munificence and complexity. Dynamism refers to 'change that is hard to predict and that heightens uncertainty for key organizational members' (Dess and Beard 1984, 56). Uncertainty is a concept frequently associated with the 'inability to predict or foresee' (Anderson and Tushman 2001, 683). Anderson and Tushman (2001, 683) argue that dynamism increases organizational mortality rates for two reasons. First, because during uncertain times firms have difficulty accurately predicting circumstances that might effect their future activities, they are more likely to make wrong investments (Ghemawat 1991; Gemawat and Nalebuff 1985), sacrifice long-term survival strategies for short-term tactics (Smart and Vertinsky 1984) and run high risk (Rosenbloom and Christensen 1994). Secondly, uncertainty may lead to fluctuations in demand which subsequently cause higher organizational failure (see Anderson and Tushman 2001, 682–689, for a review).

Munificence refers to 'the extent that resources available to firms are plentiful or scarce' (Anderson and Tushman 2001, 689). Industrial organization scholars suggest an adverse relationship between failure rates and availability of resources. Further, they propose a positive correlation between environmental complexity and organizational mortality rate (Anderson and Tushman 2001, 69). Organizational complexity refers to the complex linkages both within the firm and with external bodies such as competitors, stakeholders and institutions (Dess and Beard 1984).

The Organizational Ecology Perspective

Organizational ecologists use the dissolution of a firm as the sign of organizational failure. Freeman *et al*. (1983, 694) describe dissolution as the state at which an organization 'ceases to carry out the routine actions that sustain its structure, maintain flows of resources, and retain the allegiance of its members'.

Over the past 25 years, organizational ecologist scholars have developed a set of statistical

IJMR
March 2004

tools for examining firm failure (Hannan and Carroll 1992; Hannan and Freeman 1977, 1989). These tools have been used to assess characteristics that may cause the failure or promote the survival of organizational populations (rather than individual firms). The organizational ecology approach has been validated by several studies in a number of industries, including automobile manufacturers (Hannan 1997; Hannan *et al*. 1998), breweries (Carroll and Swaminathan 2000), newspaper publishing (Carroll and Delacroix 1982) and the hotel industry (Baum and Mezias 1992).

Although Hannan and Freeman (1977) defined their field of study as population ecology, the terms *population ecology* and *organizational ecology* quickly became synonymous, and are often used interchangeably (Scott 1998). Organizational ecology derives its ideas from organization theories of the 1950s called *human ecology* (Hawley 1950). The underlying theoretical foundation of this approach is the natural selection model (Hannan and Freeman 1978). The model attempts to explain long-term social evolution, especially the rise and fall of organizational populations. A population comprises organizations sharing a common form or strategy which makes them respond in similar ways to environmental forces (Hawley 1950). A key emphasis of OE scholars is that other organizations play a role in affecting the chances of success or failure for an organization. Baum and Singh (1994, 5) state that the main purpose of organizational ecology is 'to understand the mutual interactions within and among the populations and communities comprising organizational ecosystems and the mechanisms and processes underlying their growth, regulation and decline'.

According to OE scholars, four factors determine the chances of success or failure for organizations: population density (Delacroix *et al*. 1989; Hannan and Freeman 1988; Hannan *et al*. 1991; Peterson and Koput 1991), industry life cycle (ILC) (Agarwal *et al*. 2002; Balderston 1972), organization age (Baron *et al*. 1994; Bruderl and Schussler 1990; Fishman and Levinthal 1991; Levinthal 1991; Stinchcombe 1965) and organization size (Barnett and Amburgey 1990; Hambrick and D'Aveni 1988; Wholey *et al*. 1992), and we examine these in turn.

Population Density

The ecologist approach is built on the 'density dependence' logic (Hannan and Freeman 1989). According to this view, organizations' mortality rates depend on the total number of organizations within the relevant population. Crowding intensifies competition which, in turn, elevates mortality hazards (Dobrev *et al*. 2001, 1299). Population density is said to have two separate effects: through *legitimation* and through *competition*. The density dependency logic uses density – the number of organizations in a given population at a given time – to explain organizational failure (Hannan 1986; Hannan and Carroll 1992; Hannan and Freeman 1988, 1989). The key argument here is that the increase in density enhances the institutional legitimacy of a population and, consequently, the ability of the population's members to attract resources. Prior to acquiring and enhancing legitimation, the number of firms in the population is small, and the enticement to enter the population is low. Legitimation refers to the process by which a certain way of doing things comes to be seen as natural or taken for granted. Because legitimation gives access to resources, it increases founding rates while reducing failure rates. Further, because resources are limited, the increase in new entrants leads to a relative scarcity of resources which leads to high competition between the members of the population and cannibalization among the members of the population. That is, rising population density increases both legitimation and competition. Competition which results from the growing presence of multiple organizations has a negative impact on the survival rate of incumbents, thus decreasing the density of the population (Hannan and Freeman 1989). By combining the two opposing effects, *legitimation* and *competition*, Hannan and Freeman (1988) suggest a U-shaped relationship between density and failure. They predict that organizational mortality starts high and falls as legitimacy increases, then rises as competition increases.

According to OE scholars, density of population at the time of founding influences the risk of failure. High density at founding 'creates a liability of resource scarcity' which could prevent newly founded organizations from 'full scale operations and tight niche-packing' (Agarwal *et al*. 2002, 974). This could force newly founded firms to use resources that are inferior to those of established organizations 'and subsequently, experience higher failure rates' (Agarwal *et al*. 2002, 974). Or simply put, a high number of organizations already occupying a particular niche will make the founding of a new organization in that niche less likely to occur or, if it is founded, to succeed. In addition to the impact of the time of founding, Dobrev *et al*. (2001, 1300) found that the strategic location of the firm in the niche market has a significant impact on the likelihood of failure. They found that crowding increases the mortality hazards of organizations located in the centre more than the periphery. They argued that this is because when density increases, specialists located in the centre have nowhere to hide, whereas 'generalists whose niches span the center can potentially offset some of the deleterious effects of crowding in the center' and move to 'less competitive regions covered by their wide niches'.

Industry Life Cycle Theory

According to ILC theory, firms follow a priori sequence independent of firms' strategies and management (Klepper 1997). Its underlying rationale is that organizational failure is a natural and objective phenomenon (Balderston 1972), inherent to the efficient operation of markets. Boulding (1950, 38) notes that organizations follow the path of 'inexorable and irreversible movement toward the equilibrium of death. Individuals, family, firm, nation and civilization all follow the same grim law, and the history of any organism is strikingly reminiscent of the rise and fall of populations on the road to extinction' (see Figure 1). While not universally accepted, the concept of cyclical trends or tendencies that need to be managed or overcome is an intuitively attractive one. The ILC approach suggests that failure results from demand saturation, supply running out or a new technology that promises more value.

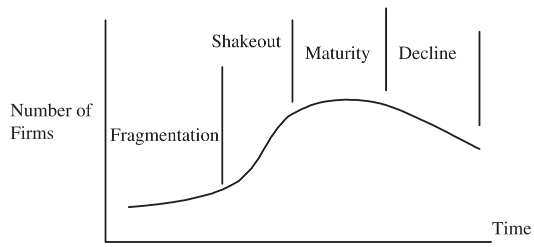

Figure 1. Industry life cycle.

Age and Failure: The Liability of Newness

Since Stinchcombe (1965) introduced the concept of the liability of newness to describe the high mortality risk facing new ventures relative to their more mature counterparts, several studies have examined the relationship between age and failure of new ventures and found that most organizations die young[2] (Bruno and Leidecker 1988; Carroll 1983; Carroll and Delacroix 1982; Duchesneau and Gartner 1990, Gaskill *et al*. 1993; O'Neill and Duker 1986; Swaminathan 1996). Freeman *et al*.'s (1983) study of National Labour Unions in newspaper publishing and semiconductor manufacturing in the US provided evidence to support the inverse relationship of age and firm failure. The liability of newness perspective argues that, because it is harder to create new routines and effective management structures than to continue with an already established one, older firms with established routines and management structure have an advantage over younger ones (Nelson and Winter 1982). Similarly, Stinchcombe (1965)

IJMR
March 2004

argues that young organizations, which are often resource-strapped, have less experience, fewer slack resources and fewer constituencies which could give them support and social capital than older organizations. Thus, according to Stinchcombe (1965), the high rate of failure of new firms arises from the required costs of learning new tasks and processes, the necessity of investing in new roles and the conflict such roles present, the absence or weakness of formal structures, and the lack of stable links with customers. Hannan and Freeman (1989) cite lack of organizational stability to engender customer trust as one of the reasons for high mortality risks of new businesses. Key constraints on young organizations included raising capital, tax laws, government regulation and competition for labour (Aldrich and Auster 1986). According to Hannan and Freeman (1984, 1989), new firms enter a Darwinian business world, in which new firms that begin wrongly are most likely to perish, despite their attempts to change their course of action and behaviour. Agarwal *et al*. (2002) link the liability of newness to the ILC concept and argue that the mortality rate of new firms is higher during the maturity stage and lower during the growth stage. This is understandable, as the disadvantages associated with newness are likely to be lower at the growth stage because barriers to entry are lower in this stage than in the maturity stage.

In addition to the liability of newness, a significant body of research argues that organizations tend to fail at a young age because of the liability of adolescence (Bruderl and Schussler 1990; Ingram 1993; Levinthal and Fichman 1988). Both the newness and adolescence perspectives argue that the early years of a firm's life are the most crucial and hazardous, and failure rates eventually decline with age (Henderson 1999). However, these perspectives differ in relation to whether firms are most likely to fail at founding or several years later (Henderson 1999). That is, while the liability of newness theory suggests that, all things being equal, failure decreases monotonically with age, the liability of adolescence theory argues that 'organizations can survive for a time with little risk of failure because they can draw on the initial stock of assets they typically acquire at founding' (Henderson 1999), such as venture capital and bank loans – this period is often termed the initial honeymoon period. As a result, firms face their highest mortality rates several years after their birth (see Bruderl and Schussler 1990; Fishman and Levinthal 1991).

Liability of newness refers not only to new ventures, but also to organizations after undertaking major change. Organization ecology suggest that, because of structural inertia, organizations tend not to change, and when they do, they respond slowly to environmental threats and opportunities, and they are more likely to disband than adapt (Hannan and Freeman 1984). Simply put, change often leads to failure. In a study of Finnish newspapers, Amburgey *et al*. (1993) found evidence to suggest changes in the content or frequency of the newspaper, increases the risk of failure. They concluded that organizational change re-exposes the organization to the liability of newness by 'resetting the clock'. Because change significantly disrupts established routines, inter-organizational relationships and organizational legitimacy, it creates new roles and new relationships similar to those of a new organization, which exposes organizations to a higher risk of failure. In sharp contrast to the above, a significant body of evidence suggests that change does not increase failure rates, rather it increases survival chances (cf. Delacroix and Swaminathan 1991; Kelly and Amburgey 1991; Stoeberl *et al*. 1998). For instance, Haveman's (1992) study of the saving and loan industry in California found that diversification into markets that are closely related to their core business improve firms' life chances and reduce their failure rate. Greve (1999) notes that organizations that are doing poorly benefit more from change than do those organizations that are doing better. Organizational change was also found to have a positive impact on performance when organizations change in order to move to an ecological niche with plentiful resources and few competitors (Barnett *et al*. 1994), fit their internal strategy with environmental conditions (Lawrence and Lorsch 1967; Miller 1992), lower their dependence on the environment (Pfeffer and Salancik 1978) or conform with institutional demands (Meyer and Rowan 1977).

Size and Failure: The Liability of Smallness

Several scholars (Freeman *et al*. 1983; Hannan and Freeman 1984; Sutton 1997) have reported that the mortality rate declines with increased size. The liability of smallness suggests that size matters, and bigger is better. In short, the liability of smallness theory suggests that expectations of success favour large firms over small ones and, on average, small firms have a higher likelihood of failure. The liability of smallness stems from the idea that small firms do not perform as well as large firms and have higher failure rates due to problems of raising capital, attracting, recruiting and retaining highly skilled workers, higher administrative costs (Aldrich and Auster 1986) and legitimacy problems with external stakeholders (Baum 1996; Baum and Oliver 1992, 1996). Conversely, large firms have less dependability on external resources (Baum and Oliver 1996) and greater access to market power (Bain 1956). Agarwal *et al*. (2002, 979) argue that the liability of smallness varies according to the stage of the ILC. They suggest that it is less of a liability during the mature stage of an industry than during the growth stage. During the mature stage, all firms regardless of size face higher mortality rates. However, during the growth stage 'there is an unequivocal growth imperative, since the basis of competition puts small firms directly against their larger counterparts' (Agarwal *et al*. 2002, 978–979).

To summarize, OE scholars believe that the industry/population matters more than the firm's strategy. They argue that, because environments change faster than organizations, the performance of the firm is determined by the environment within which it operates and not by the firm's strategic choice. Population ecologists also believe that organizations are born and die mainly as a result of environmental factors.

Critique of IO/OE Perspective

The main weaknesses of IO/OE scholars is not what they examine but what they ignore. By putting all the emphasis on external factors, it is unfortunate that little attention has been paid to dealing with the question of why it is that firms in the same industry facing the same industry-level constraints fail while others succeed (Flamholtz and Aksehirli 2000; Mellahi *et al*. 2002).

In addition, several studies have demonstrated that performance is determined by the firm strategy more than the industry (cf. Brush *et al*. 1999; Mauri and Michaels 1998). Thus, by concentrating solely on external factors to explain organizational failure, we believe the IO/OE perspective is overly deterministic, and that only the crudest and most extreme external effects can be detected by their research methods. That is, internal factors that could offer a more promising explanation of organizational failure are ignored because they are too subtle to be captured and measured adequately by the rather blunt research tools utilized by these researchers. Consequently, the IO/OE literature has problems both theoretically and empirically in explaining failure. In the next section, we turn to the internal causes of organizational failure.

The Voluntaristic View: Organizational Failure from the OS/OP Perspective

The voluntaristic perspective rejects the assumption that managers are powerless and/or rational actors. Instead, it is predicated on the assumption that managers are the principal decisions makers of the firm (Hambrick *et al*. 1996; Hambrick and Mason 1984; Szilagyi and Schweiger 1984), and their *perceptions* of the external environment have a strong effect on how they (mis)manage the firm (Mone *et al.* 1998). According to this perspective, management actions are influenced by management mental models of the organization and its environment, and constrained by their existing commitments, power and capacity to implement or enforce them (Greenwood and Hinings 1996, 1048).

The core thrust of the OS/OP literature is that *who* makes a decision is more important than the external context within which the decision is made. Larson and Clute (1979) conclude that the characteristics shared by failed firms are directly related to personal decision-based characteristics of managers. Similarly, Starbuck *et al.* (1978) locate the source of failure in the misperceptions of organizational members. Barmash (1973, 299) notes that 'corporations are managed by men; and men, never forget, manage organizations to suit themselves. Thus corporate calamities are calamities created by men.'

In essence, the OS/OP perspective argues that failure is linked to internal inadequacies in dealing with external threats. These inadequacies can be of a variety of types. Argenti (1976) identifies as causes of failure impulsive decisions that overextended the organizations assets, not responding to change, an executive who is either too powerful or poorly informed, and the taking of unnecessary risks. Macoby (2000) describes how visionary managers can frequently be narcissistic in their behaviour and increase the risk of failure when business conditions change. He argues that, when faced with a threat, these narcissist leaders isolate themselves from the advice of others, ignore words of caution, interpret criticisms as threat and frequently become myopic in their views. These behaviours and attitudes foster hubris because of 'exaggerated pride, self-confidence, or arrogance' (Kroll *et al.* 2000). As a result, in the face of internal and or external threats, decision makers will 'stick to the knitting' and reinforce well-learned past routines and procedures (Staw *et al.* 1981).

The OS/OP literature lacks a grand theory explaining organizational failure. However, several competing middle range theories are developed to explain internal causes of failure. As a result, as in other disciplines, the absence of a grand theory results in contradictory results. For instance, as explained below, a number of scholars have argued that management successions have positive consequences on performance. Equally, others have maintained that management successions lead to poor performance and failure. To illustrate the arguments concerning causes of failure at the organizational and individual level, we focus on five middle range theories. Although the five theories are related, we analyse them separately for reasons of convenience and simplicity.

Groupthink Theory

Groupthink is the term given by Janis (1972, 1982) to the tendency of decision makers in small groups to make sub-optimal decisions.[3] Janis (1982) argues that extreme pressures for unanimity can build a cohesive group that confronts serious threat and lacks norms of deliberative decision making (Peterson *et al.* 1998). Janus (1982, 243) warns that 'even individuals who are generally high in self-esteem and low in dependency and submissiveness … are quite capable of being caught up from time to time in the group madness that produces the symptoms of groupthink'. He posits that once the groupthink mentality sets in, a host of pathologies become prevalent, including self-censorship of any misgivings managers may have, collective rationalization, illusion of invulnerability, stereotypes of out-groups, poor search for alternatives, ignorance of outside information, overestimation of the group's chances of success and biased information processing. Consequently, managers miscalculate events and make decisions that could lead to failure (cf. Manz and Sims 1982; Peterson *et al.* 1998).

Upper Echelon Theory

'Upper echelon' theory (Hambrick and Mason, 1984) suggests that the characteristics of an organization's key decision makers influence strategy and subsequent organizational performance. Two factors are particularly salient with respect to failure: the composition of top management teams and managerial succession.

In relation to the former, research shows that two demographic factors affect top management reaction to failure, namely homogeneity of the top management team (Bantel and Jackson 1989; Boeker 1997; Greening and Johnson 1996; Pitcher and Smith 2001) and tenure (Mone *et al.* 1998). Homogeneity and heterogeneity of top management have been used as proxies to predict management behaviours and attitudes in organizations facing decline (Bantel and Jackson 1989; Greening and Johnson 1996; Pitcher and Smith 2001). Heterogeneous groups appear to be more effective than homogeneous groups, especially in uncertain and turbulent environments (cf. Eisenhardt 1989; Wiersema and Bantel 1992). However, Fink (1986) argues that, in a crisis situation, quick decisions need to be taken to minimise a rapidly escalating and potentially catastrophic event. He argues that, in such a situation, homogeneous groups can take quick decisions more effectively than homogeneous groups can. Mellahi and Jackson's (2002) study of Marks and Spencer shows how early turnaround attempts by a long-tenured and homogeneous management team were ineffective because managers failed successfully to diagnose the causes of failure. For instance, management tried to increase efficiency through tactical changes such as cost cutting, when the firm's weak strategic position was the cause of the failure. The latter could spiral into 'error-amplifying decision traps' (Schulman 1989) where the wrong response to a problem may inadvertently amplify the problem. A significant body of research suggests that, when organizations face an external threat such as a crisis, new managers tend to see the cause of failure as internal and controllable. In contrast, longer-tenured top managers' perceptions of the causes of organizational crisis differ from those of new managers, and this influences the manner in which they deal with the crisis (cf. Mone *et al.* 1998). In particular, longer-tenured top managers tend to attribute failure to external, uncontrollable and temporary causes. As a result, they tend to ignore internal causes of failure and subsequently exacerbate the problem. In particular, research suggests that longer-tenured top management are likely to be associated with increased rigidity and commitment to standardized practices (Katz 1982; Miller 1991), a reduction in information processing over time (Kiesler and Sproull 1982; Miller and Friesen 1984; Staw *et al.* 1981), reliance on increasingly narrow and restricted sources of information (Hambrick and Fukutomi 1991), management cohesion (Michel and Hambrick 1992) and entrenchment (Wiersema and Bantel 1992). As a result, long-tenured managers tend to spend less time analysing the threats and opportunities facing them (Miller 1993) and become more convinced of the wisdom of the organization's ways of doing things (Wanous 1980). Consequently, a long-tenured top-management team may cause organizational failure under conditions of fundamental environmental transformation by becoming entrenched and unreceptive to change (Wiersema and Banter 1992).

The evidence on the potential influence of management successions is mixed (Allen *et al.* 1979; Grusky 1963). On the one hand, studies investigating the effects of managerial succession on organizational failure suggest that managerial successions make organizational failure more likely (Brown 1982; Heather 1993). The negative effects of managerial succession are more likely if a succession takes place in small organizations (Alexander and Lee 1996; Haveman, Mukti 2003), early in a firm's life (Amburgey and Hayagreeva 1996; Carroll 1984; Haverman 1993; Singh *et al.* 1986) or occurs during a crisis (Mellahi *et al.* 2002). This is because small and young organizations lack experience in dealing with successions, especially the first succession.

On the other hand, a large body of research proposes that managerial successions have a favourable effect on performance, and hence improve organizational survival chances

(Ocasio 1993). For instance, Guest (1962) found that managerial succession reduced conflict without creating chaos and so improved performance. Similarly, Helmich (1974) and Virany *et al*. (1992) reported that succession increased growth rates and financial returns, respectively, especially when the successors were outsiders.

Curse of Success

The OS literature indicates that successful companies are susceptible to failure for a range of reasons. Miller (1990) notes that 'success can breed over confidence and arrogance'. Ranft and O'Neill (2001, 126) argue that high-flying firms, in the face of competitive pressures, develop a form of 'cautious conservatism and perhaps arrogant disdain'. This can be linked to the idea that 'success breeds failure' and 'failure breeds further failure' (Argenti 1976; Starbuck *et al*. 1978) in a spiral of decline. As Kelly and Amburgey (1991) point out, over time successful routines develop into habits and routines become traditions, with the effect of preserving the firms way of doing things. As a result, organizations that were the most successful in the past become the most vulnerable to failure in the future (Whetten 1988).

Threat Rigidity Effect Theory

Threat rigidity effect theory (Staw *et al*. 1981) argues that individuals, groups and organizations tend to behave rigidly in threatening situations, and seek to maintain the existing status quo. Keisler and Sproull (1982; quoted in D'Aveni and MacMillan 1990, 635) state that 'a crisis is expected to divert a manager's attention away from the locus of the crisis because it creates noise that may keep the manager from considering relevant information about elements in the organization's environment that are the source of the crisis'. As a result, managers will not change their focus of attention in response to an externally induced crisis (D'Aveni and MacMillan 1990); rather, they will ignore the external crisis and act as if the external crisis does not exist (Holsti 1978; Starbuck *et al*. 1978; Whetten 1980).

Organizational psychology scholars suggest that the above managerial (mis)behaviours are a result of, at least in part, factors that often exist beneath the level of conscious awareness. Although there is little direct theorizing about the relationship between psychological factors and failure, it has been demonstrated that such factors are critical in shaping management actions that cause failure. OP scholars link organizational failure to hidden, repressed motivations, feelings and dynamics. For instance the psychodynamic perspective would explain the above (mis)behaviour of managers by ego defences that tend to push managers toward a regressive retreat from a changing reality. Hodgkinson and Wright's (2002) study of a private sector organization argued that the failure of the authors' intervention to facilitate learning and strategic renewal at the company was primarily due the participants' adoption of 'a series of defensive avoidance strategies'. The latter is referred to as 'cognitive inertia'. They argue that once cognitive inertia is established, 'there is a danger that actors may become overly dependent on their mental models of strategic phenomena, to the extent that they fail to notice changes in the material conditions of their business environments until these changes have become so widespread, or significant in other ways, that their organization's capacity for successful adaptation has been seriously undermined'. They posit that, if left unchecked, the long-term consequences of cognitive inertia is business failure.

At an organizational level, ego defences could lead to failure through their influence on the information-processing effects (Miller and Ross 1975), i.e. people are less likely to perceive a relationship between their behaviour and its outcome when they fail;[4] the interpretation of information; the use of information; the storage of information and the internal recall of information (Brown and Starkey 2000).

Brown and Starkey (2000) listed five psychodynamic factors that could contribute, at least in part, to organizational failure: denial, rationalization, idealization, fantasy and symbolization. These factors have been discussed in terms of barriers to learning by organizations and individuals, but they are also relevant to organizational failure.

- *Denial* – Brown and Starkey (2000) note that through denial, individuals seek to disclaim knowledge and responsibility, to reject claims made on them, and to disavow acts and their consequences. Therefore, *denial* could have a profound implication for failure. Mellahi and Jackson (2002) described how Marks and Spencer's management rejection of customer feedback surveys, by questioning the validity of data, blinded them and led them to deny that a problem existed until the company faced a full-blown crisis.
- *Rationalization* – an attempt to justify impulses, needs, feelings, behaviours, and motives that one finds unacceptable so that they become both plausible and consciously tolerable (Brown and Starkey 2000).
- *Idealization* – a process by which some object comes to be 'overvalued and emotionally aggrandized' and stripped of any negative features (Laughlin 1970, 123, cited in Brown and Starkey 2000). In short, idealization processes help explain why managers tend to escalate their commitment to a failing course of action as they undergo the risk of additional negative outcomes in order to justify prior behaviour (Brockner 1992; Goltz 1992; McCain 1986; Ross and Staw 1993; Staw 1976).
- *Fantasy* – represents an unconscious endeavour to fulfil or gratify difficult or impossible goals and aspirations (Laughlin 1970). In organizations, fantasies are forms of collective retreat into imagination, which 'converts the ambiguities of history into confirmations of belief and a willingness to persist in a course of action' in ways that are 'destructive for the individual organization' (March 1995, 437).
- *Symbolization* – the process 'through which an external object becomes the disguised outward representation for another internal and hidden object, idea, person, or complex' (Laughlin 1970, 414) is where managers use symbols in organizations as means by which they manipulate and control their organizations (Brown and Starkey 2000).

Critique of the OS/OP Perspective

While the richness and diversity of analysis is clearly a key strength of the OS/OP approach, it is the reliance on several middle range theories without an overall 'grand theory' which is the source of its main weakness. In contrast to the OE theory, which has a well-defined aim and methodology, OS/OP scholars tend to deal with several, often uncoordinated, issues.

If this is to continue, we believe that the field of organizational failure could become chaotic and could result in a 'fragmentation trap'.[5] As a consequence, researchers, management teachers and business students would be faced with a multitude of conflicting and unorganized theories and findings. For instance, do managerial successions increase or decrease organizational failure? Although, one might argue that, in order to understand the highly complex reality of organizational failure different middle range theories are required, since most theories only highlights one aspect of the phenomenon,[6] a proliferation of middle range theories could lead the field of organizational failure to become, to borrow from Jeffrey Pfeffer (1993), a 'weed patch' rather than a 'well-tended garden'.

Another common criticism of the OS/OP perspective is its over-reliance on internal factors. By so doing, the internal perspective is limited by its inability to account for the context within which firms operate. Finally, another major defect in attempts to study the link between internal factors and failure may lie in the fact that virtually all such studies are limited to one society, the US.

Plotting a Path Towards Integration

As discussed earlier, research on organizational failure has focused so far on a single perspective

IJMR
March 2004

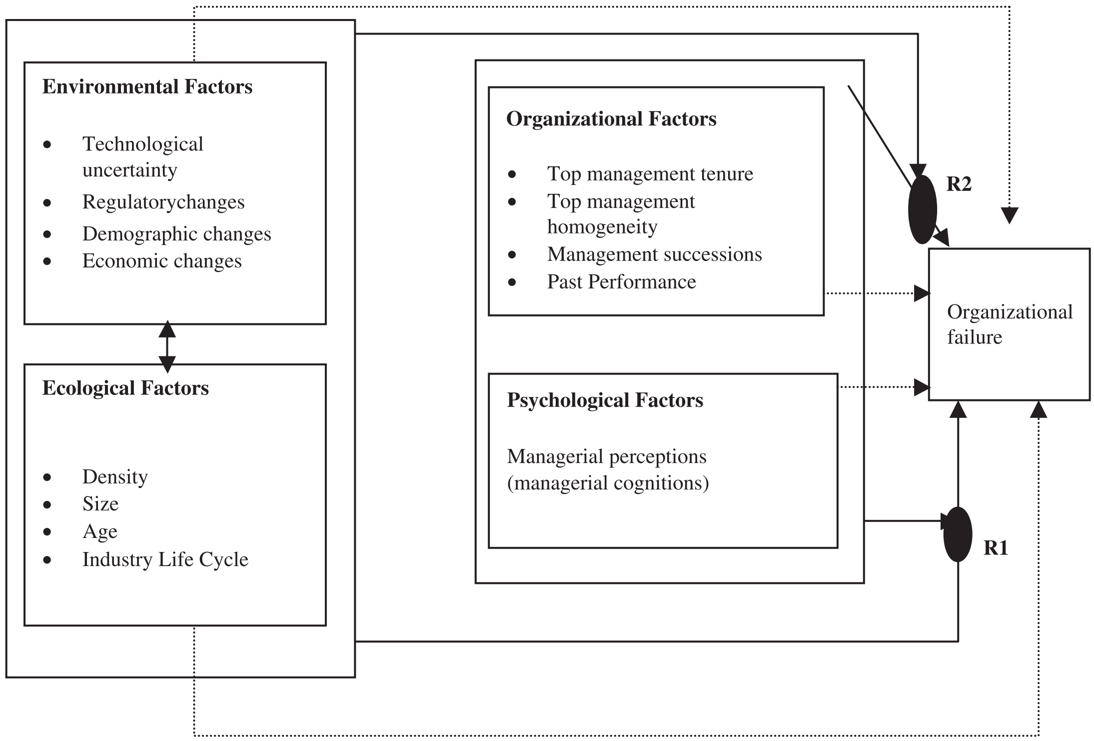

Figure 2. An integrative framework of determinants of organizational failure.

approach represented by the dotted lines in Figure 2. However, to develop a better understanding of organizational failure, we believe, it is necessary to understand how external factors and organizational factors interact to cause failure. A conceptual framework depicting the influence of and relationship between the various facets of the external and the internal environments appears in Figure 2. A fundamental axiom of the integrative framework is that the different theoretical assumptions and linkages underlying each perspective are not only reconcilable but that, together, they provide a more comprehensive understanding of organizational failure than any single perspective by itself.

It is worth noting that environmental or organizational factors can have an independent effect on failure (see dotted lines in Figure 2). These direct effects, we believe, are valid only in extreme situations, such as major environmental disaster or economic crisis, or extreme cases of management misbehaviour, as in the cases of Enron and World.com, where the moderation power of remaining factors is very small.

Interactions between the internal environment and facets of the environment are represented by R1 and R2 in Figure 2. At the firm level, the framework shows that typically management actions alone do not yield an organizational failure. To increase the predictability of management actions, the latter should be examined within the framework of the dynamics of the industry and the wider context in which a firm operates. The framework proposes that there will be significant differences in the outcomes of the same internal factors across firms in different business environments. According to the proposed framework, factors emphasized by IO/OE scholars, such as density, ILC, firm's size and age, and environment jolts, may mediate the effects of internal factors on organizational failure (R1). How, and the extent to which, external factors magnify or suppress the effects of internal factors is an empirical question. Studies, for example, could compare and contrast the impact of internal political crisis, management successions or maladaptive management behaviour during growth and decline stages, stable and unstable environments, periods of technological stability and discontinuity, etc. It is highly plausible, for example, that the consequences of management successions are not only likely to vary as a function of the nature of the succession, i.e. hostile or friendly, internal or external, but they also depend on the external context within which such successions take place, and the ecological characteristic of the population such as density, ILC stage, and size and age of the organization. One would assume that during the growth period, succession battles or management mistakes might not lead to failure, because the environment is favourable and the organizational could recover from the effects of a bad management decision. However, during a decline stage, survival might be fragile, and the impact of internal factors could have detrimental effects on the organization. Equally, favourable external environmental factors may offset the disruptive effects of internal factors that could cause failure. Organization size and age are also expected to influence the outcome of management successions. Larger and older organizations are likely to possess more experience in dealing with successions, which may enable them to undertake successions without suffering negative consequences. This may be particularly true of organizations with established succession policies and procedures. Younger and smaller organizations, in contrast, may not be able to withstand the potential disruption associated with management successions.

Thus, we suggest that future research on organizational failure should address the following questions: First, what organizational features cause failure in the face of changing circumstances, and under what specific circumstances? Secondly, under which environmental circumstances and ecological factors, do organizational factors increase the risk of failure? Taken together, these questions, we hope, provide insight into the challenging task of identifying and explaining the causes of organizational failure.

Methodological Issues

Although the two broad perspectives are defined in terms of theory rather than method, the perspectives lend themselves to differing sets of research methods. As noted earlier, each school of thought adheres to its own method, level of analysis and underlying assumptions.

The lack of consensus about research methods for understanding organizational failure has meant the two groups of scholars have developed and mastered habits of inquiry different enough to resist blending. For instance, according to OE scholars, only longitudinal analyses at a population level using sophisticated and often standard equations can be applied to explain, measure and predict organizational failure[7] (Singh and Lumsden 1990; Ulrich 1987). Methods in IO research are more likely to involve econometrics models or large survey questionnaires. In contrast, OS and OP researchers are traditionally associated with qualitative research methods using a single organization or a small number of organizations to explain the dynamics of organizational failure.

Given the differences between the two approaches to failure, it is not surprising that researchers taking each perspective have questioned the utility of adopting insights from the other tradition. A common tendency is to dismiss insights from the other perspective based on perceived methodological weaknesses. On one side, OS accounts based on ethnographic observation are often discounted on the basis of inconsistency across studies. Another potential drawback of OS/OP studies is the reliability of data gathered from managers on the causes of failure. Research shows that people tend to

IJMR
March 2004

overestimate their own influence on successes and to overestimate external or situational influences on failures (Huff and Schwenk 1990; Wagner and Gooding 1997). In addition, the case study method used in the OS/OP approach often results in comparability and validity problems stemming from idiosyncratic definitions in single or multiple firm(s) case studies. In brief, although the case-study research on organizational failure has clearly informed the current state of knowledge, without the analytical leverage provided by ecological and environmental approaches to large organizational populations it would not be possible to draw conclusions regarding the broad environmental dynamics that set the context within which managers in individual organizations operate.

On the other side, IO accounts based on survey data are often dismissed because researchers remained at a distance from respondents, potentially insensitive to how respondents were affected by their questions. Organization studies/organizational psychology scholars charge that, because several of the issues causing failure tend to be highly sensitive to the organizational and individual context within which they reside, it is improbable that a simple line of causation will explain the causes of organizational failure.

In order to bridge the gap between the IO/OP and OS/OP bodies of literature, both managerial and external frames of reference need to be reflected in researchers' choice of data sources and data collection methodologies. One could use a combined survey questionnaires, archival data and interviews to provide an accurate measures of managerial cognitions and actions and the external context within which they took place. Furthermore, we suggest that sources of perceptual data, for reasons explained above, should not be limited to managers but could include industry experts and academics leaders in the field of organizational failure.

Conclusion

In this paper, we have reviewed contributions to the organizational failure literature from different perspectives. We hope we have made a widely scattered empirical literature much more available and tractable to scholars. This is made possible by clearly identifying the domain of the phenomenon of organizational failure and the major theoretical links contained within it. We have also addressed the key methodological issues contributing to the divide between the two main schools of thought. Further, we have provided researchers with an integrative theoretical framework and specific research questions that directly identify a research agenda for the future. We argue that any attempt to explain organizational failure will not be complete unless the interplay between contextual forces and organizational dynamics is taken into account. The framework proposes that there will be significant differences in the outcomes of the same internal factors across firms in different business environments and vice versa. The researchers who take the next steps in understanding organizational failure should now have a better understanding of the ways in which they can advance the knowledge in this field. We hope that these contributions will be reflected in future research, in which theoretical richness and methodological rigour are combined.

Notes

1 For instance Geroski (2001) notes that, while organizational ecologists focus on organizational forms, IO scholars believe that what organizations do matters more than their forms.
2 It is worth pointing out that a small body of research argues that older organizations may fail because of their inability to respond to external pressures, in part because they are attentive to the expectations of established stakeholders. This is referred to as a 'rigidity of aging' (cf. Singh and Lumsden 1990). In contrast, the 'fluidity of aging' thesis posits that, as organizations age, they are in fact more likely to experiment with change, since investment in organizational maintenance calls for an ability to adapt to changing environmental circumstance.
3 For a broad review of the evolution of the theory

of groupthink and its body of empirical evidence, see Turner and Pratkanis (1998).

4 Research shows that people tend to overestimate their own influence on successes while they blame failure on external uncontrollable factors (cf. Huff and Schwenk, 1990; Wagner and Gooding 1997). For a review of management misperceptions, see Starbuck and Mezias (1996).

5 A fragmentation trap emerges when too many new middle range theories are proposed at too fast a pace in order for the scientific community to be able to evaluate each contribution properly and to integrate them into a reasonable coherent knowledge structure.

6 Van de Ven (1989) argues that the tensions, inconsistencies and contradictions between theories offer substantial opportunities to improve our understanding of organizational phenomena and to enhance theory development.

7 OE scholars rely on long time series and follow, year after year, every single event at every single firm in the population from its initial phase.

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Stakeholder Influences in Organizational Survival*

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ABSTRACT Although much has been written on declines and turnarounds, virtually no research has examined stakeholders' influence in an existence threatening crisis of an organization. This paper provides a theory and a historical case study that show how the most influential stakeholders can be identified and managed during an organizational survival. The proposed model demonstrates how stakeholders' influence in organizational survival consists of both direct resource dependence- and structure-based forms of power. The case analysis then describes an examination of actual stakeholder influences and changes in them during the decline and turnaround process. Finally, based on the findings of the case analysis and the influence identification, propositions are developed. They relate specific types of behaviours of influential stakeholders to the probability of organizational survival, showing how stakeholder management can be operationalized in an organizational turnaround.

INTRODUCTION

The continued existence of business organizations is dependent on their relationships to other organizations and actors (Oliver, 1990; Pfeffer and Salancik, 1978), that is, stakeholders. This dependency is likely to culminate in a crisis situation; when an organization has to implement a turnaround or otherwise face descent into failure (Barker and Duhaime, 1997; Filatotchev and Toms, 2003; Hambrick and Schecter, 1983; Nutt, 2004; Pearce and Robbins, 1993). Thus, for an organization in crisis, it becomes essential to understand: (1) What kinds of stakeholders are the most influential in the organizational survival? (2) How we should handle these stakeholders? Although it is explicitly acknowledged in the decline and turnaround literatures that stakeholders may have an important role in organizational survival (Arogyaswamy et al., 1995; D'Aveni and MacMillan, 1990; Rosenblatt et al., 1993), basically no research has openly focused on these issues. This paper, therefore, aims to contribute to the literature by addressing these two research questions.

The first of the research questions focuses on the identification of stakeholders. While the stakeholder literature has grown in recent years, only fairly generic schemes for

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identification have been presented. Clarkson (1995, p. 106), for example, stated that 'a primary stakeholder group is one without whose continuing participation the corporation cannot survive as a going concern', whereas secondary stakeholders are those who influence or are influenced by the firm, but who are not essential to its survival. Mitchell et al. (1997), then, presented a model in which the classes of stakeholders are identified by their possession of power, legitimacy, and urgency. Their argument is that stakeholders' salience will be positively related to the cumulative number of these attributes. Despite its contribution, the model ignores the different levels of the attributes. It is also difficult to separate power and legitimacy in practice, though they are different concepts.

Most recently, Friedman and Miles (2002) addressed some of the limits of earlier models by distinguishing stakeholders into four configurations depending on whether the material interests or the set of ideas of a firm and stakeholders are compatible or incompatible and whether the relationship between a firm and a stakeholder is necessary or contingent in terms of its contractual form. This provides a useful heuristic in considering why, for example, environmental groups in general behave as they do. However, neither the identification of a stakeholder group having compatible interests and a contractual relationship with the firm, nor of some other group with a different configuration, provides much information on the stakeholder's actual or potential level of influence regarding organizational survival.

Since the previous models remain at a generic level of analysis, their operationalization in the complex, context-related situation of organizational survival is difficult. In essence, when an organization faces a crisis, it is of secondary importance to define the broad group to which a stakeholder belongs. The primary concern is to define the stakeholders that have an influence on the organization's survival. Thus, in order to answer the first main question of this study, a more specific model for stakeholder influence identification is needed.

The second research question, and an even more fundamental area of concern, involves the management of stakeholders. In stakeholder research, the only more focused proposition is that of Jawahar and McLaughlin (2001), who considered how the generic strategies toward social responsiveness are used during a decline/transition stage of the organizational life cycle. They concluded that a strategy of defence or reaction is used to deal with stakeholders that are not critical, and strategies of proaction or accommodation are used to deal with stakeholders that are critical to survival. However, their proposition is underdeveloped regarding what the accommodation or proaction strategies actually include and how they could be operationalized in the context of organizational survival.

In earlier turnaround research, Arogyaswamy et al. (1995) drew attention to stakeholders by suggesting that an organization in crisis must ensure the support of critical stakeholders. This may entail actions such as management replacements (Barker et al., 2001) and continual communication with powerful stakeholders in order to influence their perceptions (D'Aveni and MacMillan, 1990). Rosenblatt et al. (1993) analysed a declining organization prior to its potential crisis situation and proposed that enhanced participation of different actors, 'unobtrusive' leadership, anticipation, adequate information sharing and an open dialogue about organizational goals may avert a crisis. Some of these principles may also be useful when dealing with the stakeholders of a crisis company – when continued existence is explicitly threatened. However, such thoughts need further examination.

To consider the first of the research questions, this paper provides a model for identifying stakeholders' influence. The model combines resource dependence (Emerson, 1962; Jacobs, 1974; Pfeffer and Salancik, 1978) and network centrality analyses (Brass and Burkhardt, 1993; Cook et al., 1983; Freeman, 1979) showing how stakeholders' influence in organizational survival consists of both attribute and structure based forms of power. The model is then applied in the historical case analysis of a decline and turnaround process of a Finnish pulp and paper firm, Kymi Corporation. The analysis concentrates on stakeholder influences and behaviours during the decline and during the explicit turnaround. Finally, the findings provided by the analyses of these two contrasting periods constitute the basis for propositions that address the second main question, the management of stakeholders.

A MODEL FOR STAKEHOLDER INFLUENCE IDENTIFICATION

The survival of organizations is seen as depending on their ability to acquire and maintain resources (Pfeffer and Salancik, 1978). Organizations, as open systems (Katz and Kahn, 1966) are always embedded in their environment, which consist of a network of different stakeholders (Granovetter, 1985). Therefore, acquiring and maintaining resources means that organizations must constantly interact with the members of that network (Oliver, 1991). Stakeholders having the needed resources and able to control the interaction and resource flows in the network most likely have a strong influence on an organization's survival. The identification of such stakeholders thus becomes an essential function for an organization in crisis. Next, a model for this purpose is constructed.

Basic Elements: Resource Dependencies and Network Positions

Resource dependency theory examines relationships by describing how power is organized around crucial and needed resources. The power of one organization over another is not possible without an existing asymmetry in the exchange relationship (Cook, 1977; Emerson, 1962; Jacobs, 1974; Pfeffer and Salancik, 1978). Thus, a stakeholder has power over the focal organization if the focal organization is more dependent on the stakeholder than stakeholder is on the focal organization. Stakeholders may control the use of resources critical to the operation and survival of the organization, possess means by which to influence organizational behaviour, control access to and allocation of critical resources, or regulate the possession of resources (Frooman, 1999; Oliver, 1991; Sheppard, 1995). Power can be seen as consisting of both the potential to affect outcomes and actual use of that power (Brass and Burkhardt, 1993; Mintzberg, 1983). Sometimes the mere existence of power exerts an effect without need for any concrete actions (e.g. nuclear weapons).

Since the resource dependence analysis only focuses on the nature of the resource relationship, the network perspective is needed to define stakeholders' structure based influence (e.g. Brass, 1984; Burt, 1992; Emirbayer and Goodwin, 1994; Mizruchi and Galaskiewicz, 1993; Nohria, 1992). This can be done by exploiting the concept of structural network centrality. Freeman's (1979) identification of major conceptions of graph-theoretic point centrality – in-degree, closeness, and betweenness – provide three options for this. Although each of these components explains the structural power of a stakeholder, each component measures a different property of the stakeholder's network position and may produce different rankings of centrality. Betweenness centrality – that takes the perspective of an intermediary stakeholder positioned between other stakeholders – is found to be the most appropriate for measuring the ability to control information and resource flows across networks (Freeman, 1979; Rowley, 1997). Therefore, betweenness centrality is seen as a relevant factor indicating the structure-based influence of a stakeholder over the focal firm in organizational turnarounds.

Analysis of structural centrality, however, does not explain the dynamics pertaining to inter-stakeholder relationships. A more profound understanding of stakeholders' network-based influence may require defining the quality, or relational embeddedness (Uzzi, 1996), of the linkages between stakeholders. Previous research has examined arm's-length and embedded ties (Granovetter, 1985; Uzzi, 1997). However, this categorization does not explain the power structure of the relationship. Resource dependence theory makes it possible to examine the dominating directions of relationships between stakeholders and to accommodate both arm's-length and embedded ties in the examination. Therefore, a stakeholder's influence based on network position is defined through its betweenness centrality and its inter-stakeholder resource dependencies.

Combination of the Elements

The process of influence identification involves three phases. In the first phase, since the resource space of a firm may be almost unlimited, the firm's dependency on its primary stakeholder relationships is evaluated using resource dependence analysis. The second phase consists of two parts. First, the central and peripheral stakeholders are defined by examining stakeholders' betweenness centrality. Then, the qualities of the inter-stakeholder ties are defined using resource dependency theory. As in direct resource dependence analysis, all network positions of stakeholders can be evaluated using the snowball technique (Wasserman and Faust, 1994). In this study, stakeholders' network centrality is considered from the focal organization's perspective, however, without supposing that the firm needs to be structurally in the centre of that network.

The final phase combines both the stakeholders' network position and resource dependence based powers on the same scale using a three-stage matrix, as shown in Figure 1. The model makes possible the assessment of the different levels of powers. The 'low' level indicates that the particular element of influence alone has no noteworthy effect on a firm's survival. The 'moderate' level indicates that noteworthy implications are possible, and, finally, the 'high' level suggests that the element probably has considerable implications for organizational survival.

The matrix categorizes stakeholders in nine different classes (named a, b, c, d, e, f, g, h, i). It is noteworthy that the low/moderate/high scales of direct resource dependency and network position do not need to represent equal forms of influence. The classes are not the results of multiplication or addition but specific combinations of stakeholders' influence based on both structural and individual attributes. This combinatorial logic is

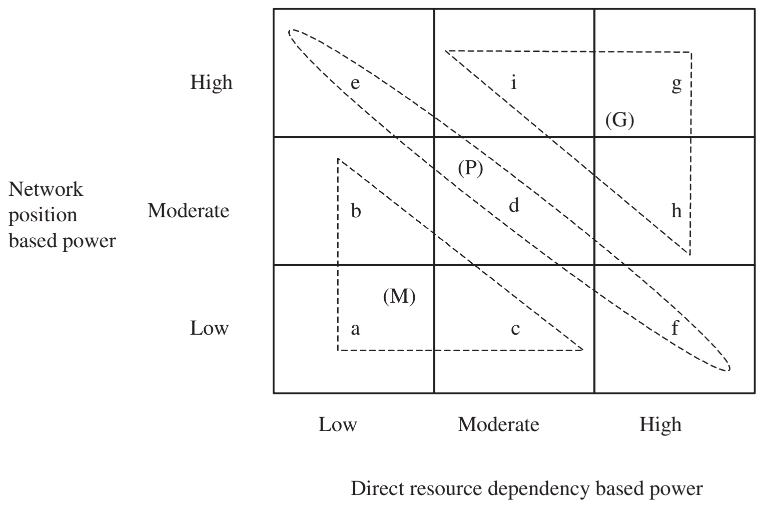

Figure 1. Stakeholder influence identification matrix
The areas outlined by the dashed lines and named respectively M, P, and G indicate when a stakeholder is minor, potential, or governing.

superior to a simple rating exercise because it simultaneously handles two essential forms of power that always constitute an interwoven whole.

The classes of combinatorial influence form three main groups. Stakeholders (a, b, c) that belong to the group of minor stakeholders (M) have no influence on an organization's survival. The potential stakeholders (P) (d, e, f) may have a potential influence on survival. Finally, those (g, h, i) that belong to the group of governing stakeholders (G) have a direct influence on an organization's survival. Thus, the model makes it possible for a stakeholder who possesses important resources but is peripherally located, or vice versa, to be a potential stakeholder. This supports the finding of Stevenson and Greenberg (2000) that peripheral actors may in certain situations have an influence on decision-making.

METHOD AND DATA

In order to apply the influence identification model and elaborate propositions for the management of stakeholders in the organizational survival, a decline and turnaround process of a Finnish pulp and paper industry firm, Kymi Corporation, was examined. The methodological approach of the study was an interpretive historical case analysis (Miles and Huberman, 1994), a research strategy particularly suitable for the examination of relatively long processes such as organizational declines and turnarounds. This study can also be seen as a part of the research tradition of new archivalism (see Ventresca and Mohr, 2002) and motivated by the fact that historical analysis may offer opportunities to examine social dynamics and prevailing organizational structures in ways that cross-sectional research cannot (Hergadon and Douglas, 2001; Kieser, 1994).

Kymi Corporation provided a well suited research setting for the examination of the stakeholder influences in the organizational survival for two basic reasons. First, the organization underwent an evident organizational decline and turnaround involving a broad group of various stakeholders. Thus, the research setting was relevant regarding the research objective of the study. Second, the decline and turnaround process of Kymi Corporation provides the kind of control and variation required by the research questions. That is, the contrasting periods of decline and turnaround make possible to examine what changed in the stakeholder relationships during the whole process.

In the actual research process, deductive and inductive logic worked together (see Ragin, 1987). The study was deductive in the sense that theoretical perspectives serve as guidelines for data collection and analysis and it was inductive because the understanding of the phenomena was advanced on the basis of empirical findings. Without explicit concepts, it would have been impossible to make sense of the complex nature of the phenomena and the infinite amount of information that can be collected from a single case.

Data Collection and Analysis

The prerequisite of historical analysis is the availability of research data. Sometimes, there is no data or the data may be inadequate. Another common problem is that access to archives is limited. Fortunately, these problems did not hamper this study. I had full access to all primary data sources, including the details of the firm and managers' documentation. The data were mainly collected from the archives of the company and the personal archives of the CEO. Although the material is a hundred years old, it is relatively well preserved.

The company archives of Kymi Corporation provided four main sources of research data. The first was the minutes of the board of directors' meetings, which also includes appendices concerning the issues discussed. While it is probable that the records do not provide information on all the issues and events occurring in the organization, or may not record all the opinions voiced in the meetings, they provide detailed information on the decisions and reasons for making decisions or suggestions. What is more, the minutes always record the person who made the suggestion or presented the information. In addition, the appendices provide further clarification on the issues discussed in the minutes.

The second main source of research data in the company archives was the minutes of the creditors' and owners' meetings. The minutes offer another perspective on the issues discussed in the board as well as novel information on the principal stakeholders. This material also includes appendices with, among other things, cost estimates, letters, reports and other internal documents. Since the material was meant for internal use only, there is no predetermined reason to suppose that the facts described are not correct. Of course, each piece of evidence must be judged on its own merits.

The third main source of evidence was the company and managerial correspondence. The company correspondence as research data is somewhat asymmetric in respect of the amount and information conveyed by the material. As a whole the correspondence consists of thousands of letters (both incoming and outgoing). Most of them are only short documents regarding business transactions with little detailed information. Accordingly, the amount of correspondence with a stakeholder cannot be seen as a direct indicator of the nature of the relationship; rather, inferences have to be based on the content of the correspondence. Managerial correspondence was more detailed in respect of the major issues in and around the organization. Moreover, the managerial correspondence offers opportunities to compare information relayed between different individuals facilitating source criticism.

The fourth broader class of the research data consists of annual reports as well as financial and production accounts. In all, the annual reports provided the 'official' description of the organization's performance, which meant that the facts presented need to be particularly critically evaluated by the researcher.

In addition to the company archives, the primary research data were also collected from other archives. While the correspondence material in the company archives was useful, even more intimate information was provided by the personal correspondence of Gösta Serlachius. In these letters the managers openly discuss and share information on various issues. Thus, the correspondence, besides providing unique information, supplements the evidence obtained from more formal sources. I also consulted the archives of the main creditors of the organization, Nordbanken and the Bank of Finland. Alas, the archives of Nordbanken were, in practice, destroyed. In turn, the minutes of the meetings of the Parliamentary Trustees of the Bank of Finland provided information of how the bank was disposed towards the firm.

The literature on Kymi Corporation (Ahvenainen, 1972; Hoving, 1947; Karonen, 2004; Norrmén, 1928; Talvi, 1972, 1987; Tuuri, 1999) was used to reflect the evidence provided by the archives. However, the literature did not offer new evidence. This is understandable, since the histories of the firm can only provide relatively short descriptions of the crisis. I also consulted histories of the banks, other organizations, and bibliographical information on each actor related to decline and turnaround if any was available.

This data was analytically examined by exploiting the framework. First, all documents related to different stakeholders were identified and categorized according to their information on resource dependencies and the network structure. The categorized information was then further analysed using data triangulation and, finally, the case analysis was documented. More generally, data triangulation involves using independent pieces of information to obtain a better grasp of something that is only partially known or understood (Denzin, 1978). The wide range of primary and secondary sources made it possible to analyse the qualities and structures of relationships from different perspectives by increasing the reliability and validity of the analysis (McCullagh, 2000).

DECLINE AND TURNAROUND PROCESS OF KYMI CORPORATION

Kymi Corporation was founded in 1904 as a result of the merger of three pulp and paper companies – Kuusankoski, Kymi, and Voikkaa – all located in the same area on the banks of the Kymi River. It was so far the biggest merger in Finnish history and resulted in the biggest corporation in Finland. The reasons for the merger are clear. The zones of the wood supply, the main market areas, and the potential customers were the same for all the companies. The new Kymi Corporation was one of the strongest players on the pulp and paper market of Northern and Eastern Europe. However, only a few years later, the survival of the firm was seriously threatened. I start the analysis from the situation after the merger and finish with the state of affairs of the company in 1912. During these eight years the company went through an organizational decline which was followed by an evident turnaround.

Decline

After the merger, Rudolf Elving, the former owner and manager of Voikkaa, became the chairman of the board of directors and the biggest owner of the firm. In practice, Elving had full control over all decisions in the corporation. One of the main purposes for the merger had been to achieve economies of scale in production. Elving immediately continued this expansive ideology and started a major investment programme including three new paper machines for Kymi as well as several calenders, cutting machines, beaters, and other extensions to all mills. This meant that Kymi paper mill was totally rebuilt. These investments were mainly financed by bank loans, but also personally by the main owners, the Dahlström brothers (the previous owners of the Kymi mills) and Elving himself.

The autocratic decision-making and investment policy of Elving did not please everyone. After the merger, the former CEO of Kuusankoski was appointed for nominal CEO of the Kymi Corporation. However, he already had to resign in the fall of 1904 due to major disagreements with Elving. Moreover, during this conflict, Elving dismissed the factory manager and all the clerical employees of the Kuusankoski factories.

These problems were rather trivial when compared to what happened on 1 July 1906, when a fire at Voikkaa destroyed the mill. Despite the extensive damage, Elving decided that the burned factory had to be repaired without delay. The insurance compensated some of the damage, but the firm had to borrow considerable sums of money and arrange a privileged subscription of shares. By the late spring of 1907, the whole factory was restored. However, at the time the firm was already facing new problems in the form of a dispute about working hours. An agreement on an eight-hour working day (previously twelve hours) with the same daily wages as before solved the issue. At the time of the agreement, the demand for paper in Russia was keen, but during the fall the situation changed. There had been a poor harvest in Russia causing difficulties throughout the country. This led the Russian government to strengthen its policy of censorship and to close down several newspapers.

Regardless of the deteriorating situation, the firm did not instantly reduce its manufacturing volume and paper stocks in Russia increased day after day. This may not have caused problems if the business cycle had soon changed, but no quick recovery came about. Only in December 1907 was the decision made to discontinue paper production in the Kymi factory and to reduce pulp production. Elving was again forced to apply for a new loan from the banks and to float new priority shares. The firm was granted a loan from the banks, but this was used up as early as in the beginning of 1908. Negotiations for new a loan lead to no solution. As the crisis deepened, the biggest banks were no longer willing to keep the firm afloat with extra finance – it had simply become too great a risk. In January 1908 a question arose if the firm should go out of business.

At the beginning of February 1908, Albert Snellman as a representative of the creditors asked if Gösta Serlachius would be willing to be included in the investigation of the Kymi Corporation situation together with Snellman and Gösta Björkenheim. Serlachius's response was positive. As a result, in February the group of three experts made a thorough investigation of the firm's present condition and future prospects. The results showed that Kymi was in serious difficulties, but also that it had chances for profitable production. Therefore, on March 1908, the creditors at an additional meeting of creditors, owners, and managers decided to take charge of the firm and officially declared that all its payment transactions should be discontinued. The official announcement sparked a public debate. The critics wondered how megalomaniac the previous management had actually been and how different the real situation was from that officially stated.

Turnaround

The creditors' intervention included an extensive rescheduling programme for the old loans and payments as well as a new credit programme to keep the business going. The consortium of three banks, Nordbanken (the biggest one), Privatbank (second), and Åbo Aktiebank (third), pledged to give a loan of FIM3,000,000 (€9,891,014 def. 2002). Similarly, the Bank of Finland made over FIM3,000,000 in three instalments including the necessary cash credit. While the representatives of the Bank of Finland were not totally satisfied with the arrangement, they accepted the agreement without further negotiation or clarification because, as they stated, such events 'might endanger the existence of the organization . . . and lead to severe social and economic conflicts'.

On the decision of the creditors and shareholders, Gösta Björkenheim, Gösta Serlachius, and Gustaf Langenskiöld were appointed to manage the firm. Björkenheim became chairman of the board of directors and Serlachius vice-chairman. The board of directors also included Ernst Dahlström (a major shareholder), Julian Serlachius as a representative of all the creditors, and Albert Goldbeck-Löwe and Ivar Lindfors chosen by the non-preferred shareholders. Only Dahlström and Julian Serlachius had been members of the retiring board. Before the appointment of the new managers the former chairman of the board, Rudolf Elving, resigned. However, he still was one of the main owners.

The new management team or 'the administrators' as they were entitled, were given full executive power to manage the firm. The only advance instructions in their assignments were that they would not be allowed to construct new mills and they should be most frugal in their activities. In practice, Langenskiöld concentrated on legal maters while Björkenheim and Serlachius were responsible for other matters. None of the new managers, however, lived near the mills and all of them also had other commitments. Accordingly, it soon became clear that the firm needed a CEO who would bear the responsibility for the management of all the mills and reside in Kuusankoski. This assignment was offered to Gösta Serlachius in the spring of 1908, but he was not willing to take it because of his other responsibilities.

The financial arrangements with the banks were the main issue during March 1908, but already in April the members of the management team were able to fully concentrate their efforts on other concrete questions. The investigation had already shown that the accounting system of the firm suffered from serious deficiencies. They had to reorganize the entire system. The new system was introduced in August 1908, but already at the beginning of April all factories were instructed to present daily reports of the selling prices and manufacturing costs for every quality of paper they had produced. This improved the managers' ability to evaluate what the most economical qualities of paper were for different machines. It was soon realized that some of the machines manufactured unsuitable papers that would have been produced more efficiently and with better quality on other machines.

The agreement on the eight-hour working day complicated the implementation of the labour cost cuts. By and large, the managers stated that their intention was to reduce the number of factory workers to a minimum. The job cuts were substantial in 1908 and 1909, when almost a thousand workers were laid off. The managers were not totally inhuman as the redundant workers were allowed to continue living in company housing. Moreover, since 1909, the firm began to systematically improve the services and living conditions of the workers. In November 1909, with the expiry of the agreement on an eight-hour working day, the organization reverted to the twelve-hour working day. Despite risk of a strike, the change turned out to be peaceful.

A third series of events also started in April 1908 with the aim of renegotiating the contracts with sales agents both in Finland and abroad as well as reorganizing the sales districts in order to make the sales system more manageable. During the negotiations with the agents in the summer of 1908, the managers emphasized that they could not afford to take excessive risks and that the agents should work as carefully as possible. Björkenheim also clarified the basic lines of their future sales policy, which included reductions of the stockpiled paper, increasing of the sales volume, accurate and fast payments and a gradual increase in prices. This last is interesting, since they did not try to beat down the prices. This did not mean that they would not sell the paper from the stocks at a reduced price.

The fourth broad issue that the new management started to consider in April 1908 was possible cooperation or the formation of a common price agreement with other Finnish paper mills selling paper to Russia. Earlier, in 1906, Kymi Corporation had made a two-year contract with other newsprint producers concerning the sales quotas on the Finnish markets. The renewal of this agreement came into effect in October 1908. The agreement regarding the Russian markets was more complicated and did not lead to such a straightforward solution as on the domestic market. In any case, this was a start for forthcoming negotiations.

In addition, technical improvements were started in the mills during the summer of 1908. The biggest open issue was what they should to do with the closed Kymi mill. A restart would necessitate an increase in order volume. According to Björkenheim, they should monitor the development of the paper markets in Russia very closely and gradually restart the machines. Most importantly, they could no longer produce papers to be held in stock. The agents were likewise ordered to accept only direct orders so that the managers could control the manufacturing processes more carefully. After the negotiations with the agents and the creditors, the first of Kymi's paper machines was restarted in September.

The issue regarding a competent chief executive officer to bear the responsibility for the management of all the mills and live in Kuusankoski was resolved in November 1908, when Serlachius started as CEO. Serlachius negotiated an agreement that allowed him to continue in his other positions in the paper mills of Mänttä, Kangas, and Leppäkoski. This entailed no conflict of interest because Serlachius asserted that the firms were not competitors of Kymi despite the obvious fact that some of them actually produced similar grades of paper. A direct effect of the appointment was that the turnaround process became more production oriented. Serlachius, for example, found that coal heating was 17 per cent cheaper than wood and would thus produce obvious and needed savings.

The managers did not only focus on the production processes but also on sales and marketing. In February 1909, Serlachius made a personal visit to St Petersburg, Moscow, and Rostow to meet the important customers and inspect the paper stocks of the agents. In his report, Serlachius describes the customers' wishes and complaints in detail. The development and future prospects of the Russian economy and the political situation influencing the prevailing state of affairs on the paper markets was also addressed. As a concrete result, a decision was made to extend exports by initiate trading in sulphate pulp to Russia via the agent Lindeberg.

Russia continued to be the main market area for paper, but Serlachius had a clear aim to extend the firm's clientele to more stable areas, namely Britain. The idea was to find new customers for newsprint. The quality standards in England were higher than in Russia. Thus, several experiments were made with the aim of developing an appropriate quality of newsprint. In 1910 exports to Britain already accounted for 5.8 per cent of the paper produced and by 1911 the amount had increased to 12.4 per cent. The price of newsprint in Britain was lower than in Russia, but focusing on a restricted sales area is risky for a bulk products manufacturer. Therefore, the extension can be seen as a farsighted strategic decision.

The demand for paper began to increase early in 1909. The cigarette paper machine of the Kymi factory was started up. The summer continued favourably and in July a decision was taken to restart the third machine. An interesting point is also that the managers tried to make the firm more coherent so that Kymi, Voikkaa and Kuusankoski would be in equal positions. In January 1910, for example, they founded a common engineering office that would serve the needs of all mills. Significant changes in production processes were also introduced.

In spite of the gradual improvement in the financial situation, the firm was still in need of external support. In September 1909, the banks granted a new loan. Moreover, Ernst Dahlström personally financed the firm. The year 1910 also saw some production changes. Concrete results were achieved by installing fibre recovery units in the paper machines. According to Serlachius's calculations, a single unit created savings of around FIM55,000–105,000 annually (€180,000–350,000 def. 2002). In the summer of 1909, an idea was evinced for a collective logging company to be founded together with the other four forest industry firms operating in the Kymi River area. The main purposes of the logging company were to acquire the timber needed for its members, reduce the cost of acquisitions, and at the same time avoid internecine competition.

The firm's financial situation and order volume improved during the spring of 1910 and finally in April a reimbursement plan was introduced. According to the plan, the firm would start gradual repayments of its loans. In his letter to Goldbeck-Löve, Björkenheim wrote that if the creditors accepted the plan the firm could be considered saved. Of course, there were many risks. Radical changes in the Russian customs or unfavourable decisions by the banks could change the situation. However, the creditors were satisfied with the plan and it was approved in May 1910. Additional funding for the loan payments was generated by selling land. Moreover, a redirection in the production was implemented in August 1910, when the management decided to discontinue the manufacture of cigarette paper.

The year 1911 followed the same lines: improvements were made in all areas and statistics. A collusive contract with the other Finnish newsprint producers for Russian markets was also finally concluded. At the same time, management decided to continue the reorganization of the agencies in Russia. Altogether, the state of Kymi, both financially and productionally, were already secure in 1912. The organization had managed to go through a turnaround, though the formal decision to end the creditors' administration was not made until June 1914, just before the outbreak of the First World War.

STAKEHOLDER INFLUENCE IDENTIFICATION

Applying the influence identification model, I next report the results of how the influence of Kymi's stakeholders developed during the process of decline (1904–07) and turnaround (1908–12).

Resource Dependence Based Influence

Owners and creditors. According to the resource dependencies, the owners and creditors were in a decisive position throughout the whole process. During the first years of the new organization one of the main owners and the head of the firm, Rudolf Elving, had significant influence over all decisions. Elving, besides possessing the best knowledge of the whole firm, holding its shares, and partly financing its operations, was able to control the allocation of resources inside the organization. Therefore, from 1904 to 1907, Elving most evidently possessed a high degree of resource dependence based power.

Other owners and creditors also had noteworthy resources already from 1904 to 1907, but compared to Elving their resource dependence based power was clearly less. The brothers Ernst and Magnus Dahlström were the second biggest owner group, holding together 24.6 per cent of the firm's stock after the merger (Elving's share was 25.9 per cent in 1904). However, like Elving, the Dahlströms were not only owners but also financed and guaranteed the loans. In addition, they had formal membership positions on the board of directors. Accordingly, the Dahlströms had highly important resources to influence the organizations' operations during the period 1904–07. The shares of the other owners were so small that, *de facto*, they did not possess noteworthy resources to exert influence over the organization.

The resource dependence based influence of the external creditors was low or moderate until 1907. Nevertheless, the power of the banks, as a result of their growing financing of the investments, increased year by year. As described, new investments in machinery, forest acquisitions, and the reconstruction of the Voikkaa paper mill were largely financed by external credit. Thus, in 1906 and 1907, the organization became much more dependent on the Bank of Finland and the group of commercial banks: Nordbanken, Privatbanken, and Åbo Aktiebank. Altogether, the resources of these three banks and the Bank of Finland were at least moderately important for Kymi from 1904 to 1907.

Regarding the resource dependence based power of the owners and the creditors, the situation obviously changed in 1907 and 1908. The firm became heavily dependent on the external creditors when Elving tried to ensure the continuation of normal operations of the organization. Finally, in 1908, a coalition of the creditors, led by the Bank of Finland, Nordbanken, Privatbanken, and Åbo Aktiebank, took the firm under administration and at the same time provided a considerable sum of new credit. The organization became highly dependent on the resources of these creditors. Åbo Aktiebank's share of the credits was clearly smaller. Therefore, its resources were more likely to be only moderately important.

Elving lost his position as an autocratic owner-manager but still remained a major owner. In all, the importance of Elving's resources was no more than moderate. The Dahlströms also remained major owners throughout the whole period. The organization was no longer dependent on them as guarantors, but they still personally financed the firm providing the needed flexibility for the business transactions. Accordingly, the organization's dependence on their resources diminished but can be considered as moderate.

Managers. From 1904 to 1907 the management of the firm was in the hands of Elving. After the creditors' intervention the structure of the organization's management changed and the new managers, Serlachius, Björkenheim, and Langenskiöld, became important stakeholders. The managerial power was delegated to the vice-chairman, Serlachius, and the chairman, Björkenheim. These two also turned out to be the most important individuals in the turnaround. Björkenheim was also the CEO of Kaukas, a stockholder of Kangas Paper Mill, a member and then chairman of Nordbanken's administrative board, and one of the creditors' representatives in the administration of Kangas Paper Mill (Nordbanken was the main creditor of Kangas and Kaukas). Thus, Nordbanken was behind the appointment of Björkenheim, but the bank also supported Serlachius's nomination since he had been leading the successful turnaround of Kangas in 1904–08.

The role of Björkenheim as chairman was the most prominent at the beginning, but after Serlachius had moved to Kuusankoski the roles changed, or at least became clearer. Björkenheim dealt mainly with issues relating to sales and finance. Serlachius was responsible for the management of the mills. However, both of them were familiar with the organization's operations and the questions and problems were often considered together. Both Björkenheim and Serlachius were purely salaried managers. The role of Langenskiöld was to manage legal matters and the relationship with the government. However, his role in the management was minor if compared to that of Björkenheim and Serlachius.

Except for orders to be economical the creditors and owners gave managers free hands to act as they saw fit. As a result, Björkenheim and Serlachius had power over both operational and strategic decisions, possessing a high degree of critical resources needed for organizational survival. The resources of Langenskiöld were only moderately important. As is reflected in the correspondence and records of the creditors' meetings, the owners and the creditors were always satisfied with the suggestions presented by management. The resources of the other board members – J. Serlachius, Goldbeck-Löwe, and Lindfors – were clearly low during the era of Elving. However, the importance of their resources increased somewhat in 1907 and can be considered moderately important vis-à-vis organizational survival. However, the correspondence between Björkenheim and Goldbeck-Löwe shows that the latter was often only informed of what the managers had already decided.

Other stakeholders. Although Kymi was most dependent on the resources of the main creditors, the managers, and the owners, other stakeholders also possessed important resources. The most important market area of Kymi was Russia and trade was arranged through the sales agents. Therefore, the agents in Russia, at least theoretically, possessed important resources such as connections with a variety of existing and potential customers as well as a good knowledge of the Russian markets and the political and business environments. Kymi was not fundamentally dependent on a single agent, but in the short run an incompetent agent was able to create considerable difficulties for the firm. The agency of Carl Neander in St Petersburg was the most critical. Therefore, his resources were at least moderately important throughout the whole decline and turnaround process.

The production of the mills was, of course, dependent on raw materials. Kymi was self-sufficient both in chemical and mechanical pulp production. Moreover, approximately one third of the pulpwood needed was obtained from the firm's own forests. The remainder had to be bought from outside the organization, but in these acquisitions Kymi was not dependent on any particular supplier. For that reason, the resources of particular suppliers were low.

Employees are often an important stakeholder group. However, in this case they did not possess particularly critical resources. There was the threat that the workers might go on strike, but the laying off workers, particularly in 1908, indicates that the factory workers' resource dependence based influence was no more than moderate. The government, if separated from the Bank of Finland, had none of the needed resources, though it did have a potential ability to raise customs tariffs, which would have had a direct effect on export earnings. Similarly, although Kymi was interested in the advantages that collusive trade could bring, the organization's direct dependence on the industry associations was fairly low.

Network Position Based Influence

Figure 2 illustrates the network of inter-stakeholder relationships surrounding Kymi before 1908 (i.e. during the accelerating organizational decline) and Figure 3 depicts the situation 1908–12. Each of the outlined stakeholders had a direct relationship with the focal organization. From 1904 to 1908, the betweenness centrality of Elving was clearly high. Elving as an autocratic owner-manager communicated and transmitted most of the

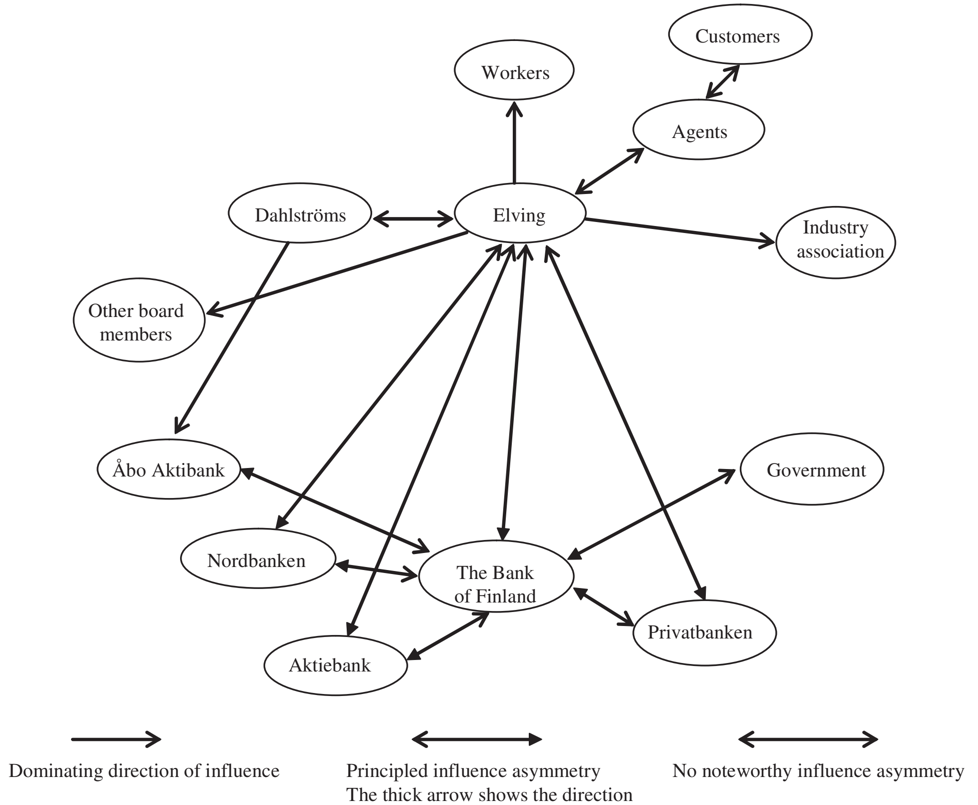

Figure 2. Network of inter-stakeholder relationships of Kymi before 1908

information between the organization and its stakeholders. The position of Elving changed as a result of the creditors' intervention. As Figure 3 shows, he was dismissed from his intermediate position and thereafter remained on the periphery of the stakeholder network.

Although Elving dominated the stakeholder network until the end of 1907, other stakeholders also had noteworthy positions. The Dahlströms, besides being the biggest owner group and members of the board, had an important intermediate position vis-à-vis a significant creditor, Åbo Aktiebank. Specifically, Ernst Dahlström was one of the bank's founders and the chairman of the board. Dahlström's structural position remained fairly constant throughout the decline and turnaround. However, after 1908, he was no longer able to use Åbo Aktiebank for his own purposes. The task of Dahlström was thus more pronouncedly to be a personal guarantor and controller of the bank in the administration of Kymi. Accordingly, the Dahlströms evidently had a moderately important network position until 1908, but thereafter their position, at the most, was moderately important, whereas the network position of Åbo Aktiebank, at least technically, became moderately important.

The positions of the sales agents were interesting. On the one hand, they were out-lying if we use degree point centrality. On the other hand, in such an arrangement

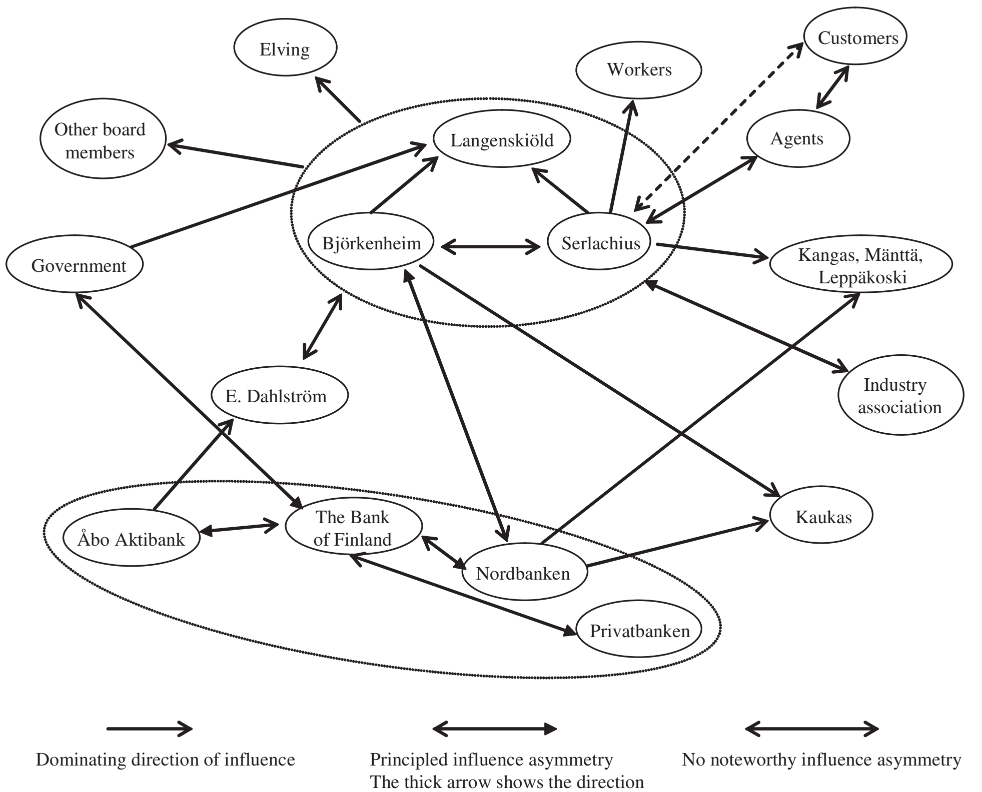

Figure 3. Network of inter-stakeholder relationships of Kymi 1908–12

other primary stakeholders had no power over them. Most importantly, the relatively independent agents were the intermediaries between Kymi and its customers, although the essential interests of the agents and Kymi were more or less the same. As a result, the agents can be considered as having at least moderately important network positions throughout the whole process.

The network positions of the main creditors and the new managers also merit a detailed discussion. Until 1908, the group of commercial banks held fairly neutral positions. In fact, the betweenness centrality of Privatbanken, and even Nordbanken, can be considered to be low. The position of Åbo Aktiebank was no longer crucial since the Dahlströms had the upper hand in the relationship until 1908. The network position of the Bank of Finland was more important, but it was based on the official relationships with different banks and the government. Nevertheless, these official linkages provided the power that made its network position moderately influential.

The situation regarding the network positions of the creditors and the management changed between 1907 and 1908. First of all, the new managers replaced Elving as an intermediary of information between the firm and its other stakeholders. Serlachius as a representative of the organization communicated particularly with the employees, the agents, and the customers. In addition, Serlachius had relationships with the potential competitors of Kymi, that is, the paper mills of Kangas, Mänttä and Leppäkoski.

Björkenheim had direct linkages with Kaukas and Nordbanken. Both Serlachius and Björkenheim communicated with the trade association, Elving, and other board members. All the managers exchanged information with the creditors.

The network position of Nordbanken clearly became more important than it had been before. Nordbanken's relationship with Björkenheim was reciprocal: each was dependent on the other. Nordbanken was a creditor of Kaukas, whereas Björkenheim was the chairman of Nordbanken's administrative board. Basically, Björkenheim was appointed on the assumption that he would further the bank's interests and if that did not happen, Nordbanken had the resources to influence Björkenheim's positions in three different organizations. In that respect the bank obviously possessed some power over Björkenheim. All in all, both Nordbanken and Björkenheim possessed highly influential network positions. While the position of Nordbanken evidently changed, the positions of other creditors, excluding Åbo Aktiebank, remained similar to what they were before 1908.

The position of Serlachius was as important as that of Björkenheim. However, the responsibilities of Serlachius in Kangas, Mänttä and Leppäkoski – the firms that were also financed by Nordbanken – restricted his autonomy in respect of the main creditor. Altogether, his position as an intermediary was still very important. Langenskiöld also took part in the intermediation of the information and resources. However, his position was not more than moderately important. Because the role of the board members was basically to be informed by the managers, their position vis-à-vis the different stakeholders was low in influence.

The government had a theoretical opportunity to exert influence by way of the Bank of Finland, but it remained in a position low in influence. Similarly, the position of the factory workers was low in importance. They negotiated with the managers but did not have any other relationships with the main stakeholders. The suppliers had an important position in the production chain but their ability to influence the other stakeholders was low. The position of the industry association was more complicated since it also formed an informal arena of information sharing between different organizations. The importance of collusive trade was strengthening in the pulp and paper industry. Therefore, with certain reservations, the network position of the industry association can be described as moderately important.

Stakeholders' Influence on Organizational Survival

By using the stakeholders' influence identification model, the stakeholders of Kymi can now be divided into governing (G), potential (P), and minor (M). Figure 4 illustrates the situation before 1908 and Figure 5 the situation from 1908 to 1912. The most striking changes occurred in the influence of Elving (El) and Nordbanken (NB). Elving was clearly a governing stakeholder until 1907, but from 1908 onwards, he was only a minor stakeholder, even if he had moderately influential resources. Nordbanken made an opposite move from a minor stakeholder to a governing stakeholder.

The Bank of Finland (BF) was already a potential stakeholder in 1907, but when its resources turned out to be highly critical it became a governing stakeholder. In contrast, the influence of the Dahlströms (Da), who were a governing stakeholder group until 1907, turned into that of a potential stakeholder during the process. At the same time the

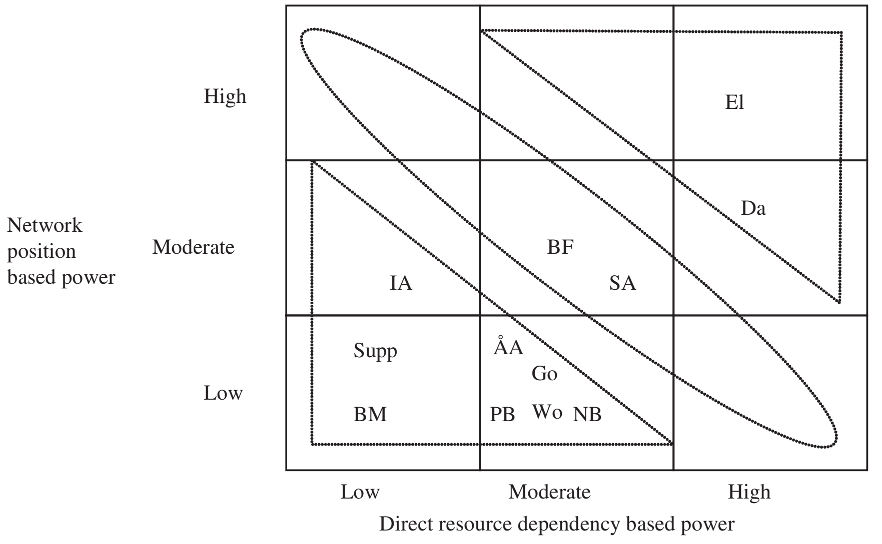

Figure 4. Influence of Kymi's stakeholders before 1908

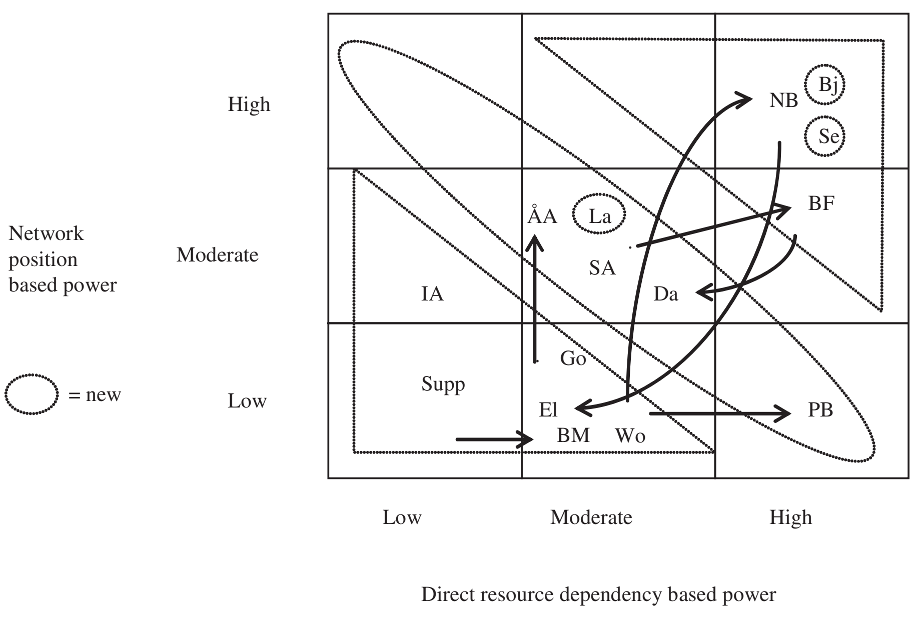

Figure 5. Influence of Kymi's stakeholders 1908–12

influence of Åbo Aktiebank (ÅA) increased. The sixth change during the whole decline and turnaround was that of Privatbanken (PB) which, as a creditor, developed from a minor stakeholder into a potential stakeholder. In addition to the above changes new and highly influential stakeholders also become associated with the organization during the process. The new managers, Björkenheim (Bj) and Serlachius (Se) were, undoubtedly, governing stakeholders. However, the third member of the new managerial team, Langenskiöld (La), can only be seen as a potential stakeholder.

The resources of the workers (Wo) and the government (Go) remained moderate, and their network positions low throughout the process. This made them minor stakeholders. Likewise, the group of other board members (BM) (Julian Serlachius, Goldbeck-Löwe, and Lindfors) remained a minor stakeholder. The industry association (IA) had a moderately influential network position throughout the process. In terms of resource dependence, however, its influence was low. Therefore, it can be only considered as a minor stakeholder. The suppliers (Supp) were minor stakeholders in all respects. Finally, the main sales agents (SA), as a group, had both moderately influential resources and network positions throughout the decline and turnaround, making them obvious potential stakeholders in respect of the organizational survival.

MANAGEMENT OF STAKEHOLDERS IN ORGANIZATIONAL SURVIVAL

Identification of stakeholders' influence can be considered as a preliminary part of stakeholder management during turnarounds. How, then, should these influential stakeholders be handled after identification? The case analysis and the results of the influence identification provide an interesting basis for comparing how the stakeholders were actually managed during the decline on the one hand and during the turnaround on the other hand.

Basic Function of Stakeholder Management in Organizational Survival

The main argument in earlier research that the support of influential stakeholders has to be ensured (Arogyaswamy et al., 1995; Jawahar and McLaughlin, 2001; Rosenblatt et al., 1993) was also corroborated in this study. In the case of Kymi, the minor stakeholders were neither critical to organizational survival nor the first stakeholders the firm paid attention to during the turnaround; conversely, organizational survival was evidently dependent on the support provided by the governing stakeholders. However, during the decline, minor stakeholders, such as the workers, received considerable attention while the creditors and the sales agents were often ignored. Thus, the following proposition summarizes the basic function of stakeholder management in organizational survival.

> *Proposition 1*: The more secure the continuing support of governing stakeholders in an existence-threatening crisis, the more probable is organizational survival.

This proposition does not indicate that minor stakeholders should be undervalued. An important lesson in stakeholder influence identification is that neither the resources nor the network positions of stakeholders are static. Moreover, although the influence of a minor stakeholder is insignificant in organizational survival, the combined influence of several minor stakeholders, even if uncoordinated, may cause substantial negative consequences for the organization. Therefore, the management of minor stakeholders should not be forgotten.

In addition, the value of Proposition 1 for stakeholder management remains vague without more specific suggestions regarding its operationalization. We need to know what 'proaction' and 'accommodation' mean in practice. Thus, the crucial questions are: what changed in the management's actual behaviour toward influential stakeholders and what changed in the management's position among other stakeholders?

Management's Behaviour Toward Stakeholders

Comparing the periods, the first noteworthy difference relates to communication. In general, the communication between the management and other stakeholders was much more frequent and close during the turnaround than during the era of Rudolf Elving. In fact, the creditors and the sales agencies did not receive any specific information on the state of affairs in the company in 1907.

After 1908, the managers, in addition to communicating openly among themselves, kept the banks and the main sales agencies informed of the investment decisions and requested the banks' opinion in advance on every major decision. These findings suggest that open and active communication with governing and potential stakeholders has a positive effect on their support for organizational survival. This also concurs with the view that continual communication with powerful stakeholders is important during an organizational decline and turnaround (Arogyaswamy et al., 1995; D'Aveni and MacMillan, 1990; Rosenblatt et al., 1993).

Specifically, the analysis indicates that reciprocal communication with stakeholders enables a stakeholder to realize the benefits ensuing if it gives the organization its continuing support. This is corroborated by the social dilemma and cooperation literature (e.g. Kerr and Kaufman-Gilliland, 1994; Valley et al., 1998). In particular, extensive face-to-face communication has been found to increase mutual understanding and thereby cooperation (Brown and Eisenhardt, 1997; Dawes et al., 1977). Moreover, during the turnaround the managers communicated more openly and more often face-to-face with the governing stakeholders than with other stakeholders. Although the historical data comprises only written communication, the correspondence between these influential stakeholders often begins by referring to a previous telephone or face-to-face discussions and often ends by suggesting themes to be discussed face-to-face. These considerations lead to the following proposition.

> *Proposition 2*: In an existence-threatening crisis, frequent and open communication between managers and governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organizational survival.

In Kymi, the management's communication with the governing and potential stakeholders during the turnaround was strengthened by the use of personal and informal relationships, even if a relationship had a formal, contractual basis. Elving, of course, also knew stakeholders personally, but the new managers had noticeably closer relationships, for example, with Nordbanken and the Bank of Finland. Moreover, the managers tried to establish personal connections with the customers and the sales agents. Without the informal social networks of managers negotiating crucial loans with the banks and arranging special sales contracts with the sales agents would have been much more difficult. Together with open communication, the personal relationships promoted trust between the management and other influential stakeholders, thereby securing their support.

These findings are consistent with the results indicating that fair relationships with key stakeholders may have a substantial positive impact on the performance of a firm (Jones, 1995; Wicks et al., 1999) and show that relationships are especially important in a crisis situation. Trust decreases the need to monitor others' behaviour and provides flexibility in decision-making and transactions (Ireland et al., 2002). During the decline Elving lost the stakeholders' trust and could not regain it by means of formal relationships. Thus, the construction of informal, trust-creating relationships with influential stakeholders seems to be a noteworthy factor in promoting organizational survival in an existence-threatening crisis. Therefore, the following is proposed.

Proposition 3: In an existence-threatening crisis, personal relationships between managers and governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organizational survival.

Management's Position among Stakeholders

The promotion of open communication and the cultivation of personal connections with the most influential stakeholders are among the practical functions of managers in a crisis organization. However, the comparison of the decline and turnaround periods of Kymi also raises the issue of management's role and position from the perspective of other stakeholders as the managers were clearly governing stakeholders. First of all, due to the management change, the new managers replaced the brokerage position of Elving. Thus, management had a similar structural position during the decline and turnaround. However, during the turnaround the managers were facilitators of communication between different stakeholders while Elving acted quite differently. In fact, he created a barrier between stakeholders.

The restricting behaviour of Elving impeded influential stakeholders from obtaining knowledge of the situation and the positions of other stakeholders. This made it difficult to create an understanding that an individual stakeholder was not alone in supporting the firm. A thorough investigation and an additional meeting of creditors, owners and managers were needed in order to create such an understanding. Thus, how the brokerage function of management is used by managers and perceived by stakeholders seems to be an important factor in an existence-threatening crisis. These findings lead to the following proposition.

Proposition 4: In an existence-threatening crisis, management's unlocked brokerage position between governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organizational survival.

Communication with stakeholders seems to have an important role in organizational survival, but it can also be used for opposite purposes. Therefore, in addition to active information sharing, a crucial element in the case of Kymi that particularly ensured the support of the governing stakeholders, the banks, was that the communication was based on the same long-term goal: to improve the firm's performance so that in the near future the firm would show a profit and be able to settle its debts. A short-term goal of the banks would have been to drive the organization into bankruptcy and then call in its assets.

The understanding of the common goal was received during the creditors' investigation and in the additional meeting of the owners, creditors and new managers. It is unlikely that the turnaround would have been started without agreement on a consensual goal. During the decline, the goals clearly differed, or they were vague. Elving emphasized and implemented megalomaniac investments, whereas other managers and owners would have been satisfied with more modest development. The importance of shared long-term goals is also noted in the literature. Axelrod (1984, p. 12) showed how the future can 'cast a shadow back upon the present and thereby affect the current strategic situation'. Insko et al. (1998), in turn, found that intergroup competitiveness can be reduced by inducing a concern with long-term outcomes. Altogether, the value of consensual long-term goals seems to culminate in a crisis organization. Thus, the following is proposed.

> *Proposition 5*: In an existence-threatening crisis, consensus on long-term goals among governing stakeholders will tend to enhance (rather than undermine) the continuing support of those stakeholders and increase (rather than decrease) the probability of organizational survival.

Regarding the stakeholders' perceptions of the managers, the findings of this study do not directly support the proposition of Rosenblatt et al. (1993) that 'unobtrusive' leadership may prevent a crisis. Although it was apparent that Elving was an obtrusive leader, the new managers also had very prominent positions. However, there was a clear difference in how the positions of these high profile managers were interpreted by other stakeholders.

During the decline, the negative signals were personified in Elving. This damaged his authority and ability to manage the firm's transactions and operations. In such a situation a turnaround with the same leader was seen as unthinkable. The new managers received a position with demanding but uncertain stakeholder expectations. As a result of the first positive results, the affirmative perceptions of the governing stakeholders started to cumulate and the turnaround came to be associated with the good management team. Thus, it seems that during a crisis, the firm performance (both positive and negative) and the stakeholders' expectations of the firm's future prospects are directly associated with management's behaviour. This implies that the leading managers in a crisis company may not be unobtrusive.

While these findings do not corroborate the positive effect of unobtrusive leadership, they lead us to consider the importance of how stakeholders in a crisis company associate the firm's performance with its managers. In Kymi, as the decline exacerbated, the banks could no longer provide support for the firm because that would have required them to support Elving, which was associated with unsuccessful performance. Conversely, the new managers' latitude increased and the support of the banks and owners for the organization strengthened as they associated the management with successful performance. An important point was also that during the decline it was also the personality of the manager that disturbed the stakeholders. However, during the turnaround there were three different personalities managing the firm. Dissatisfaction with one of them may not have been as serious as it was in the case of Elving. Altogether, these considerations lead to the last proposition.

Proposition 6: In an existence-threatening crisis, governing stakeholders' association of management with good firm performance is positively (rather than negatively) related to the continuing support of those stakeholders and will tend to increase (rather than decrease) the probability of organizational survival.

DISCUSSION AND CONCLUSION

Stakeholder management may become critical to the organization's survival in an existence-threatening crisis. This study has addressed this issue by considering two research questions: (1) What kinds of stakeholders are the most influential in organizational survival? (2) How we should handle these stakeholders in an existence threatening crisis? To answer these questions, I constructed a model for stakeholder influence identification and through a historical case analysis proposed a set of factors with important function in the management of stakeholders during an organizational crisis.

This study makes three specific contributions to the turnaround literature. First, it identifies two constitutive elements of stakeholder influence in organizational survival, direct resource dependence based power and network position based power, that always form an interwoven whole. The explication of these dimensions through the stakeholder influence identification model elucidates an important and missing aspect in turnaround research: it provides a specific and theoretically robust way to define the stakeholders that are the most influential regarding organizational survival. Thus, this study complements those that have noted the importance of continuing support from governing and potential stakeholders by showing why those stakeholders are influential and how such stakeholders can be systematically identified. The model also explicitly responds to the suggestions of recent stakeholder research (Rowley, 1997) by integrating network analysis with resource dependence theory, thereby adding to the ongoing debate on stakeholder theory development and identification of stakeholders (e.g. Donaldson and Preston, 1995; Friedman and Miles, 2002; Jones and Wicks, 1999; Mitchell et al., 1997; Stoney and Winstanley, 2001). In particular, it brings the research of stakeholders closer to the actual dilemmas of stakeholder management.

Second, the findings of the longitudinal analysis show how the influence of stakeholders may change during the process of decline and turnaround and also that it is crucial to recognize those changes. Indeed, the study provides ample evidence that considerable changes in the influence of specific stakeholders are possible. This is an important contribution to earlier research as it emphasis the dynamic nature of the decline and turnaround process. While it seems that the awareness of the processual nature of declines and turnarounds exists in the literature, the research is largely dominated by cross-sectional studies (Barker and Duhaime, 1997; Barker and Mone, 1994; Robbins and Pearce, 1992). This distortion is critical, since a decline and turnaround is always a matter of process and, therefore, also needs to be studied from the processual perspective (Pajunen, 2005).

Third, this study explicates six important factors in the management of governing stakeholders during an existence-threatening crisis in an organization. For each factor, I have formulated a proposition that relates a specific type of behaviour of a governing stakeholder to the probability of organizational survival. The proposed behaviours may intuitively give the impression that they are also relevant for stakeholder management in other situations. However, this detracts nothing from their importance in the context of organizational survival. In contrast, the propositions identify factors that seem to become particularly critical in a crisis organization despite the fact that they may also be important in other situations.

Two of these propositions fairly straightforwardly corroborate the views presented in earlier literature showing that in an existence-threatening crisis as in a more modest decline the support of influential stakeholders has to be ensured and that continual communication with influential stakeholders is important. However, the other propositions go clearly beyond previous research by identifying how personal relationships, brokerage position of management, long-term goals, and stakeholders' association of management with firm performance form a set of important factors that affect the changes of organizational survival. Each of the propositions is also testable. Thus, the paper can be seen as carrying on the development of descriptive stakeholder research (Jawahar and McLaughlin, 2001) by examining how stakeholder management is actually implemented.

The study is subject to the limitations generally connected with historical and archival research. One consideration is that the analysis concerns a single organization in the context of the Finnish pulp and paper industry. Conclusions based on a single case are obviously not generalizable empirically. However, as Eisenhardt (1989) suggests, a rich case analysis is appropriate for supporting the development of theories in new topic areas and for providing new insights into already researched topics. Thus, at this stage of theory development, and as regards the processual perspective, the approach of this study was eminently appropriate (Langley, 1999; Pentland, 1999; Weick, 1995).

By concentrating on an in-depth analysis of one organization, I had access to sources with intimate information on the inter-organizational communication throughout decline and turnaround process. An important benefit was that a considerable part of the communication between the focal firm and the primary stakeholders was carried out through written correspondence. Although I analysed all primary materials, including several hundreds of letters and documents, it is possible that some important information was communicated only verbally without any written documentation. It is, however, unlikely that this has distorted the overall picture of the relationships described in this study. In addition, at the beginning of the 20th century, the number and variety of different stakeholders was slightly more limited than nowadays, but all the primary stakeholders and most of the secondary stakeholders that firms have today were represented. Due to the limited number of stakeholder relationships, it was possible to gain an accurate understanding of the whole structural situation.

Another data-related issue was that I analysed the inter-organizational relationships mainly from the perspective of Kymi. This was the most reasonable basis because the interest of the study was the stakeholder relationships of Kymi. Data triangulation and the use of secondary sources made it possible to consider closely the basic qualities of inter-stakeholder relationships from several perspectives, thereby limiting the risk of biased information.

The findings of this study also have other implications and provide directions for future research. The study found that the boundaries of different stakeholder groups are often rather indistinct or overlap. For example, owners may also be customers or creditors of the same firm. One of these roles is often in a predominant position, though in the context of an individual case it is misleading to examine stakeholders solely on the basis of terms defined in advance. The possession of multiple stakeholder roles may also be a relevant indicator of stakeholders' importance during an organizational crisis. This finding suggests that there is a need for further consideration of other implications of multiple stakeholder roles both in turnaround research as well as in stakeholder theory development. Future research could also apply the model to multiple cases or contexts other than turnarounds. In addition, the propositions need further empirical testing.

On a broader scale, this study has other important implications. First, it can be considered an example of how stakeholder research can be used to make sense of concrete organizational phenomena and, second, how we may need to connect scholarly literatures in order to understand how inter-organizational relationships influence firm performance in a specific situation. This is also consistent with the finding of Rowley et al. (2000) that the roles of relational and structural embeddedness can only be understood with reference to each other and supports the broader view suggested by Cook (1977) that it is possible and valuable to integrate separate theories into more comprehensive perspectives that enable us to better explain organizational interaction. Third, regarding the future development of the turnaround literature, the stakeholder perspective seems not to be the only stream of research that can add to our understanding of organizational crises. The findings of the present study suggest that the social dilemma, cooperation, and conflict management literatures may provide views that further explain stakeholders' behaviours in organizational declines and turnarounds.

The exploitation of historical analyses is also suggested to be a promising area for future research. Specifically, both stakeholder and turnaround literatures need research that focuses on the dynamic and contextual aspects of organizational processes. Historical analyses and the extensive use of archival materials can contribute substantially to the research in this area. Archival material is especially useful when constructing theories that explain structural relations and causal mechanisms.

The implications of this study for managers seem obvious. The stakeholder influence identification model is easily adaptable for the use of both stakeholder and turnaround managers. Systematic, integrative analysis of resource dependencies and stakeholders' network positions contributes to decision-making in both crisis and stable situations.

Interaction with minor, potential and governing stakeholders based on explicit evaluation usually has a positive impact on financial performance in all contexts. Moreover, each of the propositions evinces direct implications for how the continuing support of stakeholders can be secured in organizational survival.

NOTE

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Corporate Turnarounds: The Duality of Retrenchment and Recovery

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ABSTRACT Corporate turnaround research has described retrenchment and recovery as contradictory forces that should be addressed separately. While a few scholars have argued that retrenchment and recovery are interrelated and may have to be integrated, others have contended that such arguments are flawed since they downplay the contradictions between the two activities. In this paper, we clarify the nature of the retrenchment–recovery interrelations, as well as their importance for turnaround performance. Drawing on the paradox literature, we argue that retrenchment and recovery form a duality: they are both contradictory and complementary. Integrating the two activities allows turnaround firms to create benefits that exceed the costs of their integration, which affects turnaround performance positively. We test our arguments through an empirical study of 107 Central European turnaround initiatives and find evidence for the assumed duality between retrenchment and recovery. Our main contribution is integrating the hitherto disparate theory perspectives of corporate turnaround into an overarching framework.

Keywords: corporate turnaround, organizational decline, organizational paradox, recovery, retrenchment

INTRODUCTION

After two fundamental economic crises in recent years, corporate turnaround has become a common phenomenon in managerial practice. It refers to the recovery of a firm's performance after an existence-threatening decline situation (Hofer, 1980; Lohrke et al., 2012). Scholars explore two essential categories of turnaround activities: retrenchment and recovery (Robbins and Pearce, 1992; Sudarsanam and Lai, 2001). While retrenchment focuses on increasing efficiency through cost and asset reductions, recovery concentrates on improving a firm's market position through strategic change (Lamberg and Pajunen, 2005). Since prior research describes retrenchment and recovery as contradictory forces (Pearce and Robbins, 2008), scholars generally advise turnaround

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firms to opt for one or the other (e.g. Hofer, 1980; Schendel et al., 1976), or to address them sequentially (e.g. Bruton et al., 2003; Robbins and Pearce, 1992).

Given the focus on separating the two activities, prior turnaround research has paid little attention to the interrelations between retrenchment and recovery (Lohrke et al., 2012). However, some scholars suggest that retrenchment and recovery may be mutually reinforcing and their integration beneficial. For example, Arogyaswamy et al. (1995) argue that it may be difficult to retrench effectively without an understanding of which resources should be retained for recovery activities. Without a better grasp of these complementarities, we have, at the very best, a partial understanding of how retrenchment and recovery contribute to turnaround success (Pajunen, 2005). At the same time, others warn that integrating retrenchment and recovery can create additional costs that impact turnaround performance negatively (Pearce and Robbins, 2008; Sheppard and Chowdhury, 2005). The purpose of this study is thus to clarify the nature of the retrenchment–recovery interrelations, as well as their importance for turnaround performance.

We draw on the paradox literature (Cameron, 1986; Lewis, 2000; Smith and Lewis, 2011) to build new theory on the interrelations between retrenchment and recovery. We argue that retrenchment and recovery are a duality (Farjoun, 2010): they are contradictory, but also mutually enabling. The interaction of retrenchment and recovery allows turnaround firms to create benefits that exceed the cost of their integration, which contributes positively to turnaround performance. We test our theoretical arguments through an empirical study of 107 Central European turnaround initiatives. The results confirm that the two activities' interaction enhances turnaround performance through their mutually enabling relationship.

Our arguments and findings allow us to make several theoretical contributions. We contribute to the corporate turnaround literature by developing a richer conceptualization of the retrenchment–recovery interrelations. This conceptualization considers the complementarities and tensions, not just one or the other. In addition, it provides the foundation for the integration of the hitherto disparate threat-rigidity theory (e.g. Barker and Mone, 1998) and prospect theory (e.g. Hambrick and D'Aveni, 1988) perspectives of corporate turnarounds into an overarching framework. Further, we contribute to the debate on turnaround stage models (e.g. Bruton et al., 2003; Robbins and Pearce, 1992) by providing a more integrative perspective. We show that retrenchment and recovery are beneficial at all stages of the turnaround process and present multiple strategies for managing the tensions that arise from their integration. Finally, we contribute to the paradox literature by conceptualizing and quantifying a novel duality in the empirical context of corporate turnarounds.

CORPORATE TURNAROUNDS: RETRENCHMENT AND RECOVERY

Corporate turnarounds are dynamic processes comprising an activity sequence that leads firms from a decline situation to a period of sustained success or failure (Boyne and Meier, 2009). While the literature does not provide a generally accepted conceptualization of the turnaround process, the different models share a common idea: firms engage in retrenchment and recovery activities during the turnaround process (Lohrke et al., 2012; Robbins and Pearce, 1992).

Similar to the downsizing literature (e.g. DeWitt, 1998), turnaround studies argue that retrenchment activities' purpose is to reduce assets and/or improve operational efficiency to increase firm profitability and strengthen the firm's industry position (Robbins and Pearce, 1992). While it can involve similar resource-reduction techniques, retrenchment's objectives are distinct from those of other size-decreasing moves such as downscaling (which aims at reducing the firm's output) and downscoping (which aims at restructuring the firm's activity portfolio) (DeWitt, 1998). Some turnaround scholars (e.g. Morrow et al., 2004) distinguish between asset retrenchment (i.e. reducing assets through plant closings or divestures) and cost retrenchment (i.e. reducing operational costs through layoffs or process improvements). Despite equivocal empirical evidence (Barker and Mone, 1994; Boyne and Meier, 2009; Castrogiovanni and Bruton, 2000), the most recent studies agree that successful turnarounds depend on effective retrenchment activities (Lohrke et al., 2012; Morrow et al., 2004; Pearce and Robbins, 2008).

Recovery activities refer to strategic changes that transform and reposition the firm for sustained growth and profitability (Barker and Duhaime, 1997). These activities include market penetration, product launch, market entry, acquisitions, and structural change (Bibeault, 1982; Robbins and Pearce, 1992). Despite theory suggesting that recovery is essential for turnaround success, there is little empirical evidence for this contention. Notable exceptions are the studies by Barker and Duhaime (1997), Sudarsanam and Lai (2001), and Ndofor et al. (2013), which provide some illustrative support for recovery's role in turnarounds.

Most corporate turnaround studies describe retrenchment and recovery as contradictory forces and warn against pursuing them concurrently (Pearce and Robbins, 2008). According to early research (Hofer, 1980; Schendel et al., 1976), turnaround firms opt for either retrenchment or recovery, depending on the cause of decline: retrenchment when they experience internal inefficiencies that threaten their survival, and recovery when their strategies and the environment are misaligned. Conversely, later turnaround stage models suggest that turnarounds always involve both retrenchment and recovery. Since the two activities are contradictory, scholars argue that they should be addressed sequentially (Lohrke et al., 2012).

As initially described by Robbins and Pearce (1992), the sequential perspective has two, clearly separate, subsequent stages: 'The retrenchment phase was considered to extend from the onset of the turnaround situation until asset and cost reduction ceased . . . [whereas] the recovery phase was considered to extend from the cessation of asset and cost reductions until the firm achieved or failed to achieve turnaround' (p. 296). Robbins and Pearce advise against initial recovery activities: the focus should be solely on retrenchment to provide 'a stable base from which an array of recovery strategies could be successfully undertaken' (p. 304). After the initial stage's completion, retrenchment activities cease and turnaround firms shift to recovery (Filatotchev and Toms, 2006).

While the sequential perspective has many followers (e.g. Bruton et al., 2003; Lohrke et al., 2012; Sheppard and Chowdhury, 2005), it also faces criticism. Scholars argue that engaging in retrenchment without a clear understanding of the recovery strategy may enhance short-term performance, but that retrenched resources might later be required for sustainable adaptation to the market (Martin and Kimberly, 2008; Morrow et al., 2004). DeWitt (1998) and Lim et al. (2013) warn that retrenchment activities need to consider the firm's long-term strategic orientation. Moreover, an initial focus on retrenchment may reduce firms' innovation capacity and delay or hinder effective recovery activities (Morrow et al., 2004). Consequently, some argue in favour of a more interdependent perspective that considers retrenchment and recovery as complementary actions (Pajunen, 2005). For instance, Arogyaswamy et al. (1995) present a turnaround model in which the stages 'are interdependent rather than sequential . . . [which] suggests that both activities can occur simultaneously' (p. 513).

While some scholars (e.g. Barker and Duhaime, 1997; Boyne, 2006; Pajunen, 2005) applaud the more interdependent view of the corporate turnaround stages, this perspective has also been criticized. Scholars argue that a simultaneous focus on both turnaround activities is problematic due to a lack of organizational resources (Lohrke et al., 2012) and the increased level of managerial complexity (Sheppard and Chowdhury, 2005). Owing to resource constraints, declining organizations may have considerable difficulties focusing on retrenchment and recovery simultaneously.

In summary, scholars have argued that the existing perspectives fail to capture the full complexity of the turnaround process (Castrogiovanni and Bruton, 2000; Sheppard and Chowdhury, 2005). While most studies highlight the contradictions between retrenchment and recovery, others point to the two activities' complementarities. Drawing on the paradox literature (Lewis, 2000; Smith and Lewis, 2011), we now consider both the contradictions and the complementarities between retrenchment and recovery. Following the dominant view in extant turnaround research, we first build a theory on the contradictions between retrenchment and recovery (the dualism perspective). Subsequently, we expand the theory to include the complementarities that can result from their integration (the duality perspective).

THE DOMINANT VIEW: RETRENCHMENT AND RECOVERY AS A DUALISM

Similar to prior studies (Lewis, 2000; Smith and Lewis, 2011), we define paradoxes as contradictory, yet interrelated, elements that exist simultaneously and persist over time. Early paradox scholars tended to accentuate the contradictions between the opposing elements, suggesting that organizations take measures to separate them (Cameron, 1986). Consequently, this 'dualism perspective' of organizational paradoxes (Farjoun, 2010) is focused on clarifying the nature of paradoxical tensions (Smith and Lewis, 2011).

Accordingly, corporate turnaround research has generally focused on the contradictions between retrenchment and recovery. However, it has frequently been criticized for its failure to provide an overarching theory framework (e.g. Lohrke et al., 2012). Some turnaround scholars draw on threat-rigidity theory (Staw et al., 1981) to describe decline processes as inhibitors of risk taking, change, and adaptation (e.g. Barker and Mone, 1998; Sutton and D'Aunno, 1989). Other scholars refer to prospect theory (Kahneman and Tversky, 1979) to argue that decline processes stimulate innovation and risk-seeking responses (e.g. Bolton, 1993; Hambrick and D'Aveni, 1988). We rely on the paradox literature to theoretically integrate these arguments. Drawing on Luscher and Lewis's

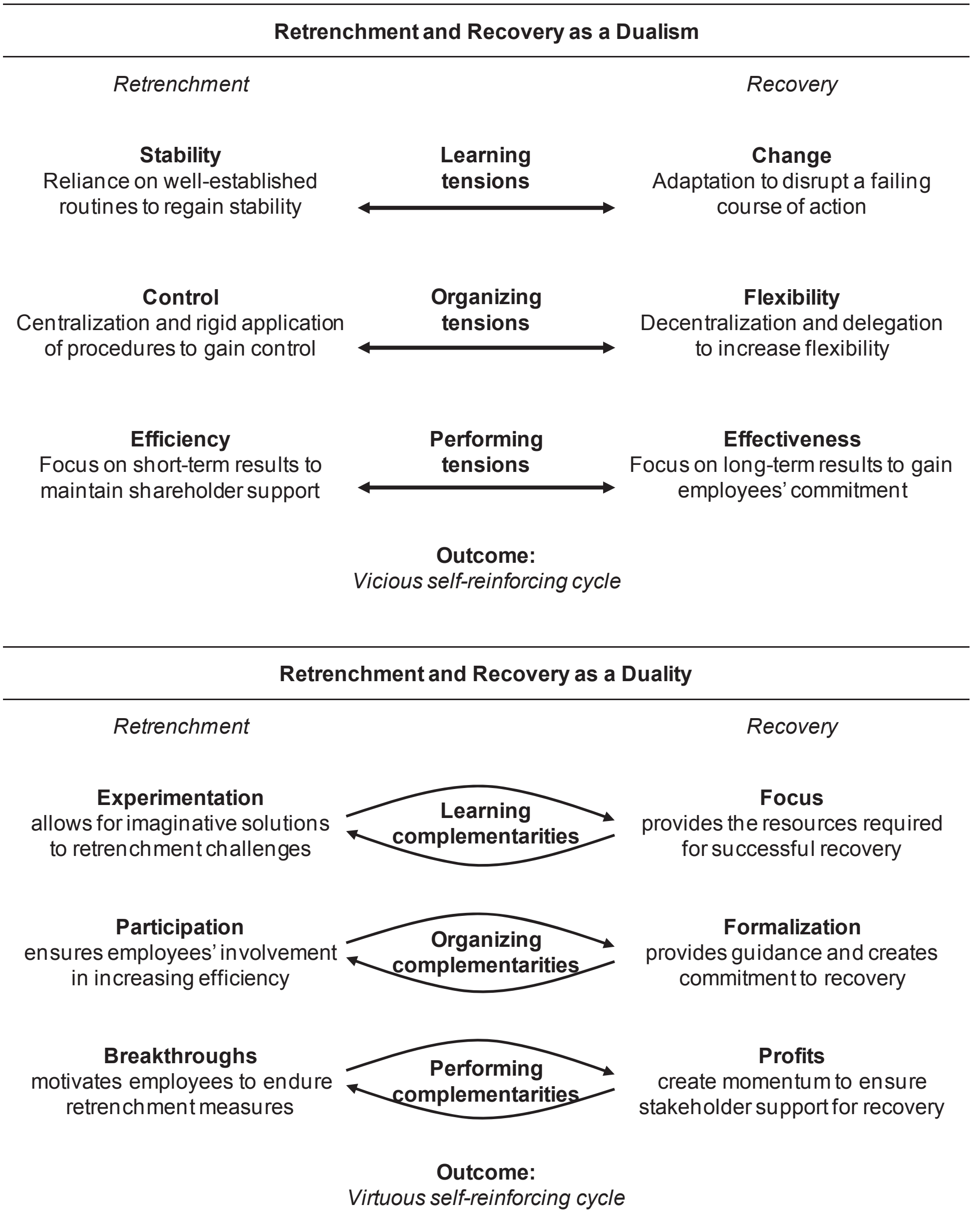

Figure 1. Corporate turnarounds: dualism vs. duality perspectives

(2008) empirically validated paradox framework, we distinguish three types of paradoxical tensions (learning, organizing, performing) between retrenchment and recovery during corporate turnarounds (see Figure 1).

Learning tensions surface as dynamic systems change, renew, and innovate (O'Reilly and Tushman, 2008). They include stability-change and efficiency-innovation tensions (Smith and Lewis, 2011). During corporate turnarounds, learning tensions become visible through the retrenchment and recovery activities' distinct purposes. Retrenchment is defensive, focused on fixing the existing to regain stability. The reliance on well-established routines hinders innovation (Barker and Mone, 1998; Carmeli and Sheaffer, 2009), but allows turnaround firms to regain stability by improving their efficiency (Bruton et al., 2003; Lohrke et al., 2012). Conversely, recovery is proactive, focused on change towards something new. Recovery activities disrupt the firm's failing course of action and seek adaptation (Barker and Duhaime, 1997). The drive for change can undermine stability, but allows the innovation and reorientation required to overcome the firm's difficulties (Barker and Duhaime, 1997; Hoffman, 1989). Learning tensions thus emerge in corporate turnarounds through competing learning efforts focused on either stability/efficiency or change/innovation.

Organizing tensions surface when complex systems create competing structures and processes to achieve desired outcomes (Denison et al., 1995). They include control-flexibility and centralization–decentralization tensions (Lewis, 2000). During corporate turnarounds, such tensions arise from retrenchment and recovery's contradictory organizational requirements. Turnaround scholars describe retrenchment as going hand-in-hand with a 'mechanistic shift' that is characterized by an increase in managerial involvement in decision processes, restricted internal communication, and tighter resource control (Barker and Mone, 1998; Musteen et al., 2011). While such an organizational context may be conducive to retrenchment, it is harmful to recovery. Mechanistic firms have difficulties changing their strategic orientation, because top managers restrict their information channels (Barker and Mone, 1998; Cameron et al., 1987). Recovery requires organic structures that allow the decentralization, employee involvement, and organizational flexibility needed for innovation and change (Arogyaswamy et al., 1995). Organizing tensions thus arise in turnarounds from competing organizing efforts focused on either control/centralization or flexibility/decentralization.

Performing tensions stem from the plurality of stakeholders and their conflicting demands (Donaldson and Preston, 1995). They include competing objectives such as efficiency vs. effectiveness and short-term vs. long-term performance (Smith and Lewis, 2011). During corporate turnarounds, such tensions arise from retrenchment and recovery objectives' varying attractiveness for internal and external stakeholders. In the face of decline, external stakeholders – such as shareholders and banks – seek short-term improvements to protect their investments (Khandwalla, 1983). Since favourable relationships with external stakeholders are critical for survival (Chen and Hambrick, 2012), turnaround firms have a strong motive to rely on retrenchment, which provides more immediate performance results (Bibeault, 1982). Conversely, internal stakeholders – such as employees – consider retrenchment a short-term solution that fails to address the real causes of decline, leading to reduced employee commitment (Schmitt et al., 2012) and the loss of talented employees (Trevor and Nyberg, 2008). Employees prefer a recovery plan that details the strategic changes required to ensure the firm's long-term survival (Arogyaswamy et al., 1995). Performing tensions thus emerge in turnarounds through competing objectives focused on either efficiency/short-term or effectiveness/long-term performance.

Managing turnaround tensions. Since managers normally demonstrate a strong preference for consistency in their attitudes and beliefs (Cialdini et al., 1995), they tend to react to contradicting tensions by choosing one agenda over the other (Lewis, 2000). Such commitments are reinforced by organizational dynamics that embed inertia in structures, routines, processes, and capabilities (Gilbert, 2005; Smith and Lewis, 2011). Accordingly, the sequential perspective of corporate turnarounds suggests that firms resolve retrenchment–recovery tensions by addressing only one of these activities at a time (e.g. Bruton et al., 2003; Robbins and Pearce, 1992). However, these studies may underestimate the self-reinforcing nature of turnaround firms' initial choices. As Walrave et al. (2011) illustrate, turnaround managers may become increasingly aware of their one-sided strategies' limitations, but they are still unable to shift their attention to alternative demands. The initial failure to consider opposing requirements makes the tensions more salient, which induces even greater stress and anxiety. Such a context not only impairs managerial decision making, but also makes it more difficult to search for alternative courses of action (Barker and Mone, 1994). In such situations, turnaround firms may be caught in downward spirals (Hambrick and D'Aveni, 1988).

AN ALTERNATIVE VIEW: RETRENCHMENT AND RECOVERY AS A DUALITY

In recent years, paradox research has shifted its attention to an alternative perspective that no longer sees contrasting elements as separate, but as fundamentally interdependent and potentially compatible (Smith and Lewis, 2011). In this 'duality' perspective (Farjoun, 2010), the integration of contradictory elements is more important than segregated efforts targeted at one or the other. Managers accept the interrelations between the opposites and adopt creative strategies to benefit from their mutually enabling qualities (Smith and Lewis, 2011).

While most turnaround scholars focus on retrenchment–recovery tensions, some have argued that integrating the two activities can also create benefits (e.g. Pajunen, 2005). Whereas the turnaround literature did not explore these interrelations further, the discussion of the exploitation–exploration duality in the paradox literature (e.g. Andriopoulos and Lewis, 2009; Farjoun, 2010; Smith and Lewis, 2011) has brought rich insights into the interrelations between opposing poles. Turnaround scholars have started to relate the exploitation–exploration duality to retrenchment and recovery (Lohrke et al., 2012; Walrave et al., 2011). We thus draw on insights into the exploitation–exploration duality to explore how retrenchment and recovery activities are interrelated and how their interaction relates to turnaround performance.

Our model of retrenchment and recovery as a duality describes the two activities as simultaneously contradictory and mutually reinforcing (Farjoun, 2010). Given the contradictions, the benefits from integrating retrenchment and recovery cannot be realized without incurring additional costs. We thus take a marginalist perspective (Jones and Hill, 1989) when considering the benefits and costs of integrating retrenchment and recovery. In its basic version (see Figure 2), our model shows two curves for the marginal turnaround benefits (MTB) and the marginal turnaround costs (MTC). At I_1, the MTB are higher than the MTC, which implies that turnaround firms could benefit from further integration between retrenchment and recovery. At I_3, the MTB are lower than the MTC, which implies that the costs already exceed the benefits of integrating the two

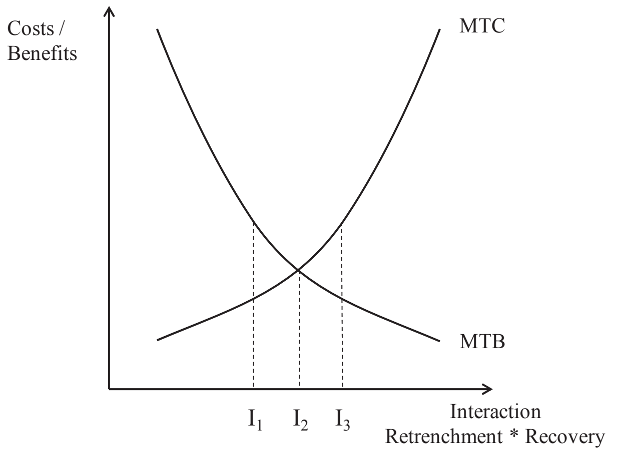

Figure 2. Static view of marginal turnaround benefits and costs

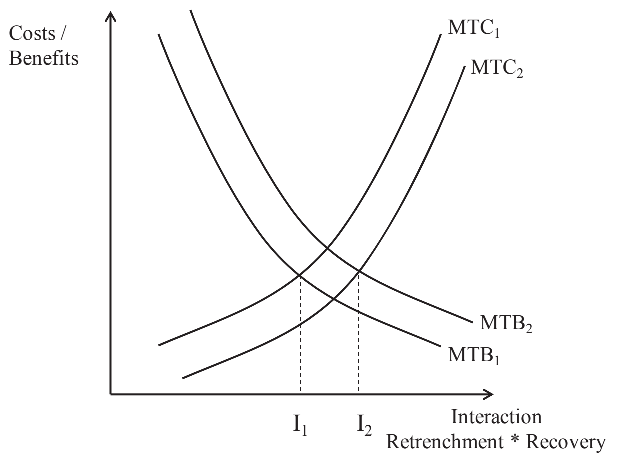

Figure 3. Dynamic view of marginal turnaround benefits and costs

turnaround strategies. The optimum interaction level between retrenchment and recovery is therefore achieved at I_2 where the MTB are equal to the MTC.

So far, our model only assumes that there are movements along the benefit and cost curves. This static picture does not yet reflect the dynamic nature of real-life activities (Jones and Hill, 1989). During turnarounds, managerial activities can shift the benefit (MTB) and cost (MTC) curves, which creates a new optimum level of interaction between retrenchment and recovery (see Figure 3). Turnaround managers can use paradoxical thinking to employ creative strategies that increase the benefits (from MTB_1 to MTB_2) and reduce the costs (from MTC_1 to MTC_2) of integrating retrenchment and recovery. Paradoxical thinking recognizes and accepts existing tensions between opposing strategies (Luscher and Lewis, 2008), leading to counterfactual thinking and double-loop learning (Farjoun, 2010). These acceptance and resolution strategies (Smith and

Lewis, 2011) contribute to a shift in the optimum level of interaction between retrenchment and recovery (from I_1 to I_2). We now explore the learning, organizing, and performing strategies that enable turnaround managers to strengthen the complementarities between retrenchment and recovery while reducing their underlying tensions.

Learning complementarities stem from focus and experimentation strategies. While focus is a variance-reducing practice that supports exploitation, it can also enable exploration by freeing up scarce resources, setting clear priorities, and ensuring coherence between varied efforts (Andriopoulos and Lewis, 2009). During turnarounds, focused retrenchment allows firms to free up redundant resources (Castrogiovanni and Bruton, 2000), while ensuring that they retain those resources that are critical to generate and absorb new knowledge during recovery (Morrow et al., 2004). Conversely, experimentation is a variance-increasing practice through which firms explore, but it can also help them regain stability (Farjoun, 2010). In turnarounds, experimentation has been related to recovery (Barker and Barr, 2002), but it can also contribute to retrenchment as it allows firms to learn how to do the same work with fewer resources. Lohrke et al. (2012) argue that retrenchment requires trial-and-error learning. Studies show that turnaround managers hold periodic staff meetings to find imaginative solutions to retrenchment challenges (Martin and Kimberly, 2008; Pajunen, 2006). Overall, focus and experimentation may enable turnaround firms to increase the benefits (from MTB_1 to MTB_2) and reduce the costs (from MTC_1 to MTC_2) of integrating retrenchment and recovery.

Organizing complementarities arise from formalization and participation strategies. Formalization is not only associated with exploitation (March, 1991), but is also conducive to exploration (Farjoun, 2010) because it stimulates knowledge sharing (Baum and Wally, 2003) and provides guidance for non-routine activities (Dougherty, 2006). In a turnaround context, formalization fosters retrenchment by ensuring tighter resource control (Hoffman, 1989), but it can also help define expectations and ensure organizational commitment to recovery objectives (Lamberg and Pajunen, 2005; Simons, 1994). Conversely, participative settings not only enable exploration (Kang and Snell, 2009), but ensure employees' cooperation and mutual trust in exploitation activities (Adler et al., 2009). During turnarounds, participatory management has particularly strong effects since the norms of respectful interaction provide employees with the resilience required in a decline situation (Barker and Mone, 1998). This applies to involving employees in recovery activities (Arogyaswamy et al., 1995), but also to motivating them to become more rigorous when utilizing resources during retrenchment (Beeri, 2012; Boyne, 2006). Overall, formalization and participation may thus enable turnaround firms to increase the benefits and reduce the costs of integrating retrenchment and recovery.

Performing complementarities surface when managers combine profit and breakthrough strategies: while an orientation towards short-term profits is linked to exploitation, it can also build the 'trust to employ the firm for more radical innovation' (Andriopoulos and Lewis, 2009, p. 703). During turnarounds, retrenchment's short-term performance outcomes can create the momentum and confidence required for recovery activities. Khandwalla (1983) suggests that a declining company's stakeholders need to see continuous profit improvements to continue supporting the turnaround firm's recovery activities (Pajunen, 2006). Conversely, long-term breakthroughs are linked to exploration, but they can also help build the motivation and morale to ensure stakeholders' commitment to short-term profit goals (Andriopoulos and Lewis, 2009). For instance, turnaround firms are more likely to gain stakeholders' support for retrenchment if they perceive these activities as leading to long-term recovery (Arogyaswamy et al., 1995). Presenting a detailed recovery plan can thus convince stakeholders of the firm's long-term potential for breakthroughs, which will help ensure their support for short-term retrenchment measures (Morrow et al., 2007). Overall, profit and breakthroughs may thus enable turnaround firms to increase the benefits and reduce the costs of integrating retrenchment and recovery.

Managing turnaround complementarities. Our discussion shows that turnaround managers can refer to learning, organizing, and performing strategies to shift the benefit and cost curves of integrating retrenchment and recovery during corporate turnarounds. As Walrave et al. (2011) argue, such integrative measures can only be successful if they are constantly maintained throughout all stages of the turnaround process. Consequently, the initial optimum for the retrenchment–recovery interaction (I_1) is only a short-run equilibrium. In reality, the optimal level of interaction is dynamic and characterized by adjustment processes that lead from one short-run equilibrium to another (Jones and Hill, 1989). During corporate turnarounds, firms find themselves in a continual state of flux under which the above-mentioned benefit and cost drivers change for better or worse. Turnaround managers who are aware of the retrenchment–recovery interrelations can rely on the above-described strategies to increase the benefits and reduce the costs of integrating the two activities. Such an approach is likely to reduce the well-documented problems of impaired decision-making and the resulting stress and anxiety during corporate turnarounds (Hambrick and D'Aveni, 1988). We thus argue that an integrative approach to corporate turnarounds is positively associated with turnaround performance.

Hypothesis: Throughout the corporate turnaround process, the interaction of retrenchment and recovery is positively related to turnaround performance.

METHOD

Research Setting

We selected a research setting that addresses prior corporate turnaround studies' limitations and considers some of the recommended alternatives. First, we collected primary data on turnaround initiatives to avoid previous turnaround studies' reliance on archival data. Several authors (e.g. Robbins and Pearce, 1992) recommend using firm self-appraisal measures to obtain more fine-grained data and increase data reliability. Second, we collected field data on both public and private companies. Given that many companies experiencing turnarounds are private (Bibeault, 1982) and that these firms face different challenges than public firms do (Boyne and Meier, 2009), representative samples of turnaround cases have to include both private and public turnarounds. Finally, we used turnaround consultants as informants to address prior studies' problems with respondent subjectivity, a lack of response, and a small sample size (Chowdhury, 2002). While a similar approach based on consultants was recently used in acquisition studies (Zollo and Meier, 2008), this approach is novel in corporate turnaround research.

Turnaround consultants are particularly resourceful informants for a number of reasons. First, since they contribute their rich expertise to analyse problems, recommend solutions, and support their implementation, they are particularly insightful informants (Bergh and Gibbons, 2011) who have strong social relations with management (McKenna, 2006). Second, consultants gain experience in different companies, industries, and countries, and can therefore benchmark their assessments more accurately than the average manager can. Third, consultants' responses are likely to be less biased regarding socially desirable elements (i.e. performance), since they are not directly responsible for an initiative's success (Zollo and Meier, 2008). Fourth, consultants may be a better source of information than turnaround managers, as there are frequent leadership changes during corporate turnarounds (Bibeault, 1982). Finally, consultants are generally more objective and open than turnaround managers, who face the risk of civil and criminal liabilities. While the use of consultants may have its limitations, such as their tendency to favour the client and their reduced responsibility regarding implementing their advice (Delany, 1995; Zollo and Meier, 2008), we believe that the arguments above sufficiently justify our contention that using them has considerable advantages.

Sample Construction

Owing to a need for market similarities with regard to language, culture, and legal regulations, our study focused on Central Europe (Austria, Germany, and Switzerland). In this German-speaking region, companies in distress are restructured in one of two ways, namely out-of-court turnarounds and in-court bankruptcy proceedings (Davydenko and Franks, 2008; Fruhan, 2009). Out-of-court turnarounds are undertaken if firms have a chance of long-term viability and do not face immediate insolvency. The troubled firm's main bank usually accepts responsibility for the turnaround and assures objectivity regarding the firm's turnaround viability. During turnarounds, it is common practice to use external turnaround consultants' analytical reports to limit the bank's legal responsibilities in case of insolvency.

According to the European Federation of Management Consultancies (FEACO), the Central European region employs 26.2 per cent of Europe's consulting professionals and represents 31.2 per cent of the European consulting markets' revenues. Given that there is no listing of all the consulting firms in this region, we screened the most relevant databases. We relied on databases provided by the Austrian Federal Economic Chamber, the Association of German Consultants (BDU), and the Association of Swiss Consultants (ASCO) and searched for consulting firms by using the search criteria 'turnaround'. We then studied the consulting firms' websites and annual reports to ensure that they were engaged in substantial turnaround consulting services. Finally, we discussed the resulting list with industry experts. This procedure led to a total population of 136 Central European turnaround consulting firms (38 Austrian, 75 German, and 23 Swiss).

We then approached each consulting firm's main contact person for turnaround services. A total of 27 emails were returned as undeliverable or were blocked by spam filters. This reduced the sample from 136 to 109 firms, of which 33 (or 30.3 per cent) agreed to participate in the study. We found no systematic pattern regarding consulting firms declining to participate. The top three reasons for non-participation were: (1) corporate policies against participating in research projects; (2) a lack of time and resources to participate; and (3) a lack of interest in the study topic. To test for non-response bias, we compared the responding and non-responding consulting firms. Given that size or scale is an important criterion for differentiation in the consulting industry (Bergh and Gibbons, 2011), we compared observable firm size characteristics from archival sources. T-tests showed no significant differences between the participating and non-participating firms. Our sample of consulting firms reflects the European consulting industry's structure with its mix of large (27.3 per cent), medium-sized (21.2 per cent), and small (51.5 per cent) firms. Overall, our sample included 12 Austrian, 14 German, and 7 Swiss consulting firms.

In phone interviews with the participating firms' main contact persons, we explained the study's interest in analysing out-of-court turnaround initiatives. We also explained that we sought to study initiatives initiated between 2003 and 2004, that it was important that the consulting firm had been engaged throughout the project, and that the turnaround had had to be completed at the time of inquiry. While this approach excluded firms whose turnaround initiatives failed in the process, it matches our main research interests of exploring interrelated turnaround activities throughout the entire turnaround process and analysing how these activities relate to relative differences in turnaround performance.

We ensured that the initiatives were comparable by collecting financial data on the turnaround situation. Prior research suggests that turnaround initiatives should be selected by following a four-year period comprising two years of positive return on investment (ROI) and two years of an average pre-tax ROI below 10 per cent (Barker and Mone, 1994). While these selection criteria were reflected in our sample, we also ensured that the firms had experienced negative return on assets (ROA), as well as an absolute and a relative-to-industry decline over two years. Our main contact persons identified 121 turnaround initiatives that fulfilled our selection criteria.

Data Collection

We asked our main contact persons to nominate one supervised consultant from each of the 121 turnaround initiatives. Since consultants often work in multidisciplinary teams under a defined hierarchical structure (Delany, 1995), in which they serve different roles and can create different kinds of value (Bergh and Gibbons, 2011), we focused exclusively on experienced project managers with at least two years' experience of executing, managing, and planning turnaround projects prior to this initiative. Our 33 main contact persons sent our questionnaire to 121 supervised consultants, who had agreed to provide information on their respective turnaround initiatives. While 75 consultants responded immediately, we used follow-up phone calls to obtain the other 46 questionnaires. Of the 121 questionnaires, we excluded 14 due to incompleteness or insufficient informant competency. We used the 107 remaining questionnaires for the data analysis. Turnaround studies traditionally have relatively small samples due to difficulties with data acquisition (Barker and Mone, 1998). The most cited studies have sample sizes of 54 (Schendel et al., 1976), 32 (Barker and Mone, 1994; Robbins and Pearce, 1992), and 38 (Barker and Duhaime, 1997). Our study's sample size of 107 is strong since it is two to three times larger than those of many other empirical studies in the field.

Our final sample included 27 Austrian (25.2 per cent), 64 German (59.8 per cent), and 16 Swiss (15.0 per cent) turnaround initiatives. Of these turnaround initiatives, 28 occurred in public (26.2 per cent) and 79 in private companies (73.8 per cent). There were 72 turnaround initiatives in manufacturing firms (67.3 per cent) and 35 in service firms (32.7 per cent). On average, the firms employed 1210 people. Sixteen turnaround initiatives (15.0 per cent) had been conducted in growing industry environments, 79 in mature industry environments (73.8 per cent), and 12 in declining industry environments (11.2 per cent).

We applied Huber and Power's (1985) guidelines to control for potential informant biases. First, we assured and controlled the key informants' suitability to answer our questionnaire. The 107 consultants of our sample had an average consulting experience of 8.8 years and an average tenure of 5.9 years at their consulting firm. Second, we ensured that the informants had a certain level of emotional involvement with the turnaround projects by asking them to describe a project in which they had actively participated. Third, we attempted to motivate the informants to participate by outlining the benefits of our study, promising confidentiality, specifying the time required to complete the questionnaire, and offering to share the study's results. We pre-tested our questionnaire to ensure that our questions were well structured and understandable.

Further, to minimize concerns about retrospective data collection (Golden, 1992), we tested and found no significant difference between the responses of those who had returned our questionnaire immediately and late. We also ensured that our respondents relate their responses to a concrete turnaround project in which they had been involved as a project manager, which ensured that they were familiar with all aspects of the turnaround approach. Given that consulting firms constantly document their turnaround efforts to limit their legal responsibility, we believe that retrospective bias has been minimized. To minimize concerns about self-selection bias, we searched the Bloomberg® database and identified 36 firms in distress and compared them to our sample companies. The comparison group's firm-specific characteristics showed no significant differences with our participating firms in terms of their total assets ($p = 0.31$), employees ($p = 0.51$), sales ($p = 0.33$), and ROA ($p = 0.23$).

To reduce concerns about common method bias, we asked the consultants to provide data for the dependent variables, while supervisors provided data for the independent variables. Even though our study's complex data relationships (i.e. interaction effects) reduce the likelihood of common method bias (Slater and Atuahene-Gima, 2004), we conducted a Harman single-factor test to mitigate the threat of same-source bias in our data (Podsakoff et al., 2003). We entered all the variables into an exploratory factor analysis to determine the number of factors that are necessary to account for the variance in the variables. The unrotated principal component analysis revealed the presence of five factors with eigenvalues greater than 1, with the largest factor accounting for just 28.1 per cent of the variance. Furthermore, the Kolmogorov–Smirnov goodness-of-fit test indicated no significant differences ($p < 0.10$) from a normal distribution. All variables were then loaded on one factor to examine the fit of the confirmatory factor analysis model (CFA) (Korsgaard and Roberson, 1995). The one-factor CFA model indicated a poor overall fit ($\chi^2(324) = 1196.5$, $p < 0.001$; CFI = 0.46, SRMR = 0.16, and RMSEA = 0.16). Thus, none of the three tests provided any indication of common method bias in our data.

Measurements

Researchers (e.g. Pearce and Robbins, 1993) suggest the identification of distinct stages – by including an intermediate observation point – when measuring turnaround activities. Hence, we pre-defined two turnaround stages. We defined the initial stage as lasting from the beginning of the turnaround project until the year of the sharpest absolute decline in the ROI (Robbins and Pearce, 1992) and the advanced stage as lasting from this transition point to the end of the turnaround project.

Dependent variable. We used subjective measures to evaluate the turnaround performance. Self-reported formats are appropriate when there are difficulties with obtaining access to objective measures (Dess and Robinson, 1984). Since we included privately held firms in our sample, we did not have access to objective performance data. As in previous studies (Morrow et al., 2004; Robbins and Pearce, 1992), the respondents indicated the net change in performance from the start of the turnaround process to its completion. To account for industry effects (Barker and Mone, 1994; Pearce and Robbins, 1993), the respondents were asked to evaluate the performance in relation to the industry averages. We relied on four previously used accounting measures: (1) sales, (2) market share, (3) ROI, and (4) ROA (e.g. Meeks and Meeks, 1981). We further asked the respondents to provide (5) their general opinion of the turnaround firm's overall performance improvement (Datta, 1991).

Independent variables. We applied Michael and Robbins' (1998) established measures for *retrenchment* activities. We measured retrenchment by means of: (1) the reduction in the finished goods and inventory, (2) employee layoffs, (3) the reduction in maintenance costs, (4) the reduction in property, plants, and equipment, (5) the reduction in marketing costs, and (6) the reduction in R&D expenditures. These items were assessed on a Likert-type response scale (ranging from 1: 'given low priority' to 7: 'given high priority') and measured in respect of each turnaround stage ('initial stage'/'advanced stage': $\alpha = 0.86/0.86$). Similarly, the *recovery* activities were measured by a total of five items ('initial stage'/'advanced stage': $\alpha = 0.85/0.86$) adapted from Robbins and Pearce (1992). The respondents specified the recovery activities regarding (1) new markets, (2) new product or service offerings, (3) new production or service processes, (4) new competitive advantages, and (5) new organizational structures.

Factor analysis (Table I) was used to transform the overall 16-factor items of our dependent and independent variables into three variables with acceptable Cronbach alphas: retrenchment, recovery, and turnaround performance. Confirmatory factor analysis of all the items yielded a good fit ('initial stage': $\chi^2(101) = 102.2$, $p < 0.001$,

Table I. Factor analysis for retrenchment, recovery, and turnaround performance

Factor items	*Initial stage*			*Advanced stage*		
	Retrenchment	*Recovery*	*Performance*	*Retrenchment*	*Recovery*	*Performance*
Cronbach alpha	0.86	0.85	0.94	0.86	0.86	0.94
Reduction in finished goods and inventory	0.804	−0.042	0.187	0.795	0.094	0.140
Layoffs	0.767	−0.061	0.148	0.732	−0.009	0.211
Reduction in maintenance costs	0.786	0.034	0.177	0.704	−0.124	0.164
Reduction in property, plant, and equipment	0.708	−0.074	0.240	0.741	−0.042	0.106
Reduction in marketing costs	0.739	0.140	0.182	0.800	0.055	0.041
Reduction in R&D expenditures	0.777	0.023	0.101	0.778	0.076	0.122
New markets	−0.143	0.772	0.064	−0.117	0.738	0.308
New product or service offerings	0.052	0.784	0.241	0.135	0.776	0.132
New production or service processes	0.103	0.793	0.098	−0.024	0.751	0.220
New competitive advantage	0.082	0.786	0.174	−0.035	0.777	0.225
New organizational structure	−0.080	0.807	0.082	0.046	0.835	0.081
Sales	0.189	0.148	0.876	0.194	0.186	0.868
Market share	0.287	0.196	0.825	0.138	0.233	0.856
ROI	0.251	0.167	0.854	0.231	0.212	0.850
ROA	0.196	0.150	0.860	0.173	0.277	0.822
Individual opinion	0.175	0.119	0.896	0.147	0.172	0.889

Notes:
Extraction method: Principal component analysis. Rotation method: Varimax with Kaiser normalization.
Explained variance: 67% (initial stage) and 69% (advanced stage).

CFI = 0.99, SRMR = 0.05, RMSEA = 0.02; 'advanced stage': $\chi^2(101) = 159.7$, $p < 0.001$, CFI = 0.96, SRMR = 0.07, RMSEA = 0.04).

Control variables. We included several control variables to mitigate potential misinterpretations of turnaround activities and performance. First, turnaround research (e.g. Schendel et al., 1976) has postulated that the severity of a decline may affect the choice of different turnaround activities and how they relate to turnaround performance. In line with prior turnaround research (Chen and Hambrick, 2012; McClelland et al., 2010), we measured the *severity of decline* with a short-term liquidity ratio (the quick ratio = [current assets-inventory]/current liabilities) and a long-term leverage ratio ([total debt/total assets] × 100).

Second, scholars (e.g. Barker and Duhaime, 1997; Hofer, 1980) have argued that firms' turnaround strategies and their performance effects are contingent on the reasons for the firm's decline. These causes of decline have been commonly dichotomized into internal and external factors (Filatotchev and Toms, 2006; Pajunen, 2005). We thus controlled for the *cause of decline* and applied Robbins and Pearce's (1992) seven-point scale (1: 'completely insignificant' to 7: 'greatest significance') to measure the relative impact of four external causes (economic problems, competitive change, technological change, social change) and four internal causes (lack of operating controls, overexpansion, excessive leverage, top management).

Third, scholars have found that firm size can influence turnaround firms' ability to implement different turnaround strategies (Boyne and Meier, 2009) and, ultimately, affect their turnaround performance (e.g. Bruton et al., 2003; McClelland et al., 2010). We measured *firm size* by means of the natural logarithm of the firm's total number of employees to correct skewed distributions (McClelland et al., 2010).

Fourth, turnaround research (Morrow et al., 2004; Ndofor et al., 2013) argues that a firm's specific industry environment may determine the turnaround strategies' effectiveness. We therefore controlled for the firm's *industry environment* by using its main industries' average market growth rate over the six years prior to the turnaround (Morrow et al., 2004). This control variable was coded '0' to indicate growth industries (>10 per cent average market growth rate), '1' to indicate mature industries (0–10 per cent), and '2' to indicate declining industries (<0 per cent).

Finally, we included a dummy variable *consulting firm* that controlled for specific consulting firm characteristics that may have affected the turnaround response.

ANALYSIS AND RESULTS

We used hierarchical (step-wise) regression analysis to test our hypotheses. Our study aims at analysing the retrenchment–recovery interaction throughout all stages of the turnaround process. Consequently, we added a dummy variable for the turnaround stage (1 = advanced stage; 0 = initial stage) to our regressions as an interaction term. Further, we examined the *interaction effects* between retrenchment and recovery by means of the multiplication of the retrenchment and recovery scores. Prior to the creation of the interaction term, we mean-centred the variables (Aiken and West, 1991). Similar procedures have been applied in the related discussion on the exploration–exploitation duality (e.g. He and Wong, 2004; Jansen et al., 2012).

Table II presents the descriptive statistics and correlations of the study's variables. Table III presents the regression results of turnaround performance. While the baseline model shows the control variables, model 2 introduces the retrenchment construct, and model 3 the recovery construct. The interaction effect between retrenchment and recovery is added in model 4. The variance inflation factors (VIF) remain below the generally accepted cut-off levels, indicating no problems of multicollinearity (Neter et al., 1985).

Model 1 indicates that the control variables liquidity ($b = 0.93$, $p < 0.01$) and firm size ($b = 0.30$, $p < 0.01$) have a significant and positive effect on turnaround performance, whereas cause of decline ($b = -0.33$, $p < 0.05$) has a significant and negative effect. In model 2, the control variables liquidity ($b = 0.85$, $p < 0.01$) and firm size ($b = 0.24$, $p < 0.05$) remain significant and have a positive effect on turnaround performance. Retrenchment has a significant and positive effect on performance ($b = 0.50$, $p < 0.001$). The inter-stage difference regarding retrenchment's effect on turnaround performance remains insignificant ($b = -0.08$, $p > 0.05$).

Model 3 also indicates the significant and positive effect that liquidity ($b = 0.92$, $p < 0.01$) and firm size ($b = 0.28$, $p < 0.01$) have on turnaround performance.

Table II. Means, standard deviations, and correlations[a]

	Mean	*SD*	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*
Initial stage											
(1) Retrenchment	4.51	1.25	(0.86)								
(2) Recovery	3.05	1.15	0.05	(0.85)							
(3) Turnaround performance	4.91	1.59	0.45***	0.33***	(0.94)						
(4) Liquidity ratio	0.96	0.66	0.07	−0.01	0.23*	/					
(5) Leverage ratio	59.10	36.01	−0.05	−0.02	−0.08	−0.74***	/				
(6) Cause of decline	1.19	0.67	−0.09	−0.07	−0.12	−0.03	−0.04	/			
(7) Firm size[b]	6.08	1.53	0.11	−0.12	0.24*	−0.11	0.08	0.10	/		
(8) Industry environment	0.96	0.51	−0.01	0.26**	0.01	−0.07	0.07	−0.02	0.06	/	
(9) Consulting firm	18.15	8.46	−0.05	0.05	0.09	−0.03	0.03	−0.22*	0.24*	0.13	/
Advanced stage											
(1) Retrenchment	3.57	1.17	(0.86)								
(2) Recovery	4.03	1.32	0.06	(0.86)							
(3) Turnaround performance	4.91	1.59	0.35***	0.46***	(0.94)						
(4) Liquidity ratio	1.01	0.77	0.08	0.12	0.15	/					
(5) Leverage ratio	47.47	29.74	−0.05	−0.13	−0.18*	−0.60***	/				
(6) Cause of decline	1.19	0.67	0.01	−0.08	−0.12	−0.05	0.05	/			
(7) Firm size[b]	5.86	1.57	0.17	−0.10	0.21*	−0.15	0.07	0.11	/		
(8) Industry environment	0.96	0.51	−0.10	−0.05	0.01	−0.04	−0.02	−0.02	0.08	/	
(9) Consulting firm	18.15	8.46	0.05	−0.12	0.09	0.11	−0.22*	−0.23*	0.22*	0.13	/

Notes:
[a] n = 107. Numbers in parentheses on the diagonal are Cronbach's alphas of the composite scales.
[b] Logarithm of the number of employees.
* $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$.

Table III. Effects of retrenchment and recovery on turnaround performance[a]

Turnaround performance	*Model 1*		*Model 2*		*Model 3*		*Model 4*	
Control variables								
Turnaround stage	1.813	(1.183)	1.849†	(1.113)	1.931†	(1.003)	1.915*	(0.886)
Liquidity	0.930**	(0.334)	0.852**	(0.312)	0.916**	(0.281)	1.053***	(0.249)
Leverage ratio	0.008	(0.061)	0.008	(0.006)	0.009†	(0.005)	–0.010*	(0.005)
Cause of decline	–0.329*	(0.161)	–0.264†	(0.151)	–0.195	(0.136)	–0.156	(0.121)
Firm size	0.297**	(0.099)	0.238*	(0.093)	0.277**	(0.084)	0.200**	(0.075)
Industry environment	0.001	(0.205)	0.060	(0.192)	–0.072	(0.175)	–0.136	(0.157)
Consulting firm	–0.002	(0.013)	0.002	(0.012)	0.006	(0.011)	–0.006	(0.010)
Main effects								
Retrenchment			0.497***	(0.111)	0.473***	(0.100)	0.246**	(0.096)
Recovery					0.479***	(0.110)	0.635***	(0.103)
Retrenchment^2							–0.239***	(0.051)
Recovery^2							–0.211***	(0.046)
Interaction effects								
Retrenchment × Recovery							0.203**	(0.072)
Inter-stage differences[b]								
Liquidity	–0.738†	(0.412)	–0.738†	(0.385)	–0.841*	(0.346)	–0.902**	(0.306)
Leverage ratio	–0.016†	(0.009)	–0.016†	(0.008)	–0.015*	(0.007)	–0.015*	(0.006)
Firm size	–0.036	(0.134)	–0.044	(0.127)	–0.046	(0.115)	–0.028	(0.102)
Retrenchment			–0.075	(0.163)	–0.095	(0.147)	0.107	(0.137)
Recovery					–0.052	(0.145)	–0.084	(0.134)
Retrenchment × Recovery							–0.073	(0.100)
R^2	0.135		0.256		0.407		0.547	
Adjusted R^2	0.093		0.211		0.365		0.505	
ΔR^2			0.121***		0.151***		0.140***	
Mean VIF	8.01		7.09		6.48		5.53	

Notes:

[a] n = 214. Values are unstandardized regression coefficients (standard errors in parentheses).

[b] Interactions with turnaround stage.

† $p < 0.10$; * $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$.

Retrenchment ($b = 0.47$, $p < 0.001$) and recovery ($b = 0.48$, $p < 0.001$) have significant and positive effects on turnaround performance. The inter-stage difference regarding retrenchment's ($b = –0.10$, $p > 0.05$) and recovery's ($b = –0.05$, $p > 0.05$) effect on turnaround performance remains insignificant.

Model 4 indicates that liquidity ($b = 1.05$, $p < 0.001$) and firm size ($b = 0.20$, $p < 0.01$) have a significant and positive effect on turnaround performance, whereas leverage ratio ($b = –0.01$, $p < 0.05$) has a significant and negative effect. The interaction between retrenchment and recovery has the proposed positive effect on turnaround performance ($b = 0.20$, $p < 0.01$), thus supporting our Hypothesis. The inter-stage difference regarding the retrenchment–recovery interaction's effect on turnaround performance remains insignificant ($b = –0.07$, $p > 0.05$).

We conducted several analyses to challenge the robustness of our empirical findings. In line with Edwards (2008), we assessed whether the hypothesized relationship between our variables in model 4 is a linear or non-linear relationship. Including curvilinearity tests allows researchers to make a more fine-grained distinction regarding whether 'the relationship between X and Y is linear . . . [or] make the more modest claim that higher values of X are associated with higher values of Y' (Edwards, 2008, p. 153). The squared effects of retrenchment ($b = -0.24$, $p < 0.001$) and recovery ($b = -0.21$, $p < 0.001$) indicate a curvilinear relationship of retrenchment and recovery with turnaround performance and confirm the retrenchment–recovery interaction's positive and non-linear relationship with turnaround performance (Ganzach, 1997).

Moreover, we examined whether our results hold across different turnaround situations. Prior studies (e.g. Barker and Duhaime, 1997; Morrow et al., 2004) proposed a contingency perspective of corporate turnarounds in which the choice of retrenchment and recovery activities depends on the severity and the cause of the decline. Similarly, our initial analyses had indicated that these control variables might have a significant effect. We therefore tested our results for distinct severity (high vs. low severity; median cut-off) and cause of decline situations (firms primarily facing internal problems vs. those primarily facing external causes).

As indicated in Table IV, the interaction effect of retrenchment and recovery holds for alternative causes of decline (external: $b = 0.43$, $p < 0.01$; internal: $b = 0.24$, $p < 0.01$). Our results indicate that retrenchment plays a non-significant role in turnarounds characterized by external decline situations ($b = -0.39$, $p > 0.10$). Further, we found that the severity of decline affects our findings significantly. For turnaround firms facing high severity decline situations, retrenchment ($b = 0.32$, $p < 0.05$) and recovery ($b = 0.54$, $p < 0.01$) are both positively associated with turnaround performance, but the interaction term is insignificant. Conversely, the interaction effect is significant under conditions of low severity ($b = 0.36$, $p < 0.01$) and retrenchment plays a less significant role in these turnaround situations ($b = 0.25$, $p < 0.10$).

Finally, we controlled for distinct types of retrenchment (Morrow et al., 2004) by separately calculating the net reductions in total costs (Barker and Mone, 1994) and total assets (Robbins and Pearce, 1992). Further, we included dummy variables for manufacturing and service companies (O'Neill, 1981), as well as for the three countries in our sample (Bruton et al., 2003). None of these additional control variables had a significant effect.

DISCUSSION

Prior corporate turnaround models have generally described retrenchment and recovery as contradictory forces that should be addressed separately (e.g. Bruton et al., 2003; Robbins and Pearce, 1992). While a few scholars have suggested that retrenchment and recovery are interrelated and their integration is beneficial (Arogyaswamy et al., 1995; Pajunen, 2005), we are the first to develop and empirically validate theory on the retrenchment–recovery interaction and its relevance for turnaround performance. Drawing on the paradox literature (Lewis, 2000; Smith and Lewis, 2011), we established a duality perspective of corporate turnarounds that has important theoretical implications and provides new research directions for different streams of the corporate turnaround literature, as well as for the paradox literature.

Table IV. Effects of retrenchment and recovery on turnaround performance: the role of severity and cause of decline[a]

Turnaround performance	*Severity of decline*								*Cause of decline*							
	Low severity				*High severity*				*External causes*				*Internal causes*			
	Model 1		*Model 2*		*Model 3*		*Model 4*		*Model 5*		*Model 6*		*Model 7*		*Model 8*	
Control variables																
Turnaround stage	2.74	(1.898)	1.742	(1.568)	0.635	(1.546)	0.688	(1.214)	2.090	(2.133)	1.387	(2.371)	1.169	(1.420)	0.692	(1.030)
Liquidity	1.313*	(0.538)	0.947*	(0.397)	0.754	(0.532)	1.382**	(0.043)	0.244	(0.612)	0.749	(0.637)	1.077**	(0.391)	0.956***	(0.268)
Leverage ratio	−0.002	(0.011)	−0.006	(0.008)	0.005	(0.007)	0.014*	(0.006)	0.006	(0.112)	0.001	(0.012)	0.010	(0.007)	0.008	(0.005)
Cause of decline	−0.508*	(0.235)	−0.275	(0.173)	−0.147	(0.220)	−0.0101	(0.167)	−0.625	(0.683)	−0.214	(0.729)	−0.269	(0.191)	−0.155	(0.131)
Firm size	0.221	(0.180)	0.136	(0.136)	0.332**	(0.115)	0.181*	(0.092)	0.199	(0.168)	0.011	(0.174)	0.308*	(0.120)	0.189*	(0.086)
Industry environment	0.419	(0.295)	0.052	(0.228)	−0.406	(0.304)	−0.154	(0.241)	−0.288	(0.321)	0.383	(0.325)	−0.19	(0.256)	−0.292†	(0.181)
Consulting firm	−0.026	(0.021)	−0.027†	(0.152)	0.006	(0.019)	−0.004	(0.014)	−0.056*	(0.023)	−0.032	(0.027)	−0.016	(0.016)	−0.001	(0.011)
Main effects																
Retrenchment			0.247†	(0.152)			0.321*	(0.163)			−0.390	(0.299)			0.339**	(0.112)
Recovery			0.636***	(0.167)			0.541**	(0.157)			0.456*	(0.214)			0.609***	(0.119)
Retrenchment^2			−0.339***	(0.094)			−0.356**	(0.112)			−0.462*	(0.218)			−0.347***	(0.073)
Recovery^2			0.127	(0.119)			−0.210†	(0.125)			0.036	(0.160)			0.116	(0.098)
Interaction effects																
Retrenchment × Recovery			0.362**	(0.167)			0.125	(0.103)			0.430**	(0.145)			0.236**	(0.085)
Inter-stage differences[b]																
Liquidity	−1.102†	(0.616)	−0.792†	(0.458)	−0.060	(0.105)	−0.905†	(0.519)	−0.558	(0.719)	−1.000	(0.759)	−0.551	(0.493)	−0.557†	(0.337)
Leverage ratio	−0.022		−0.014		−0.001		−0.006		−0.021		−0.017		−0.013		−0.010	

Notes:
[a] Values are unstandardized regression coefficients, with standard errors in parentheses. Models 1–4 show the result of firms facing high and low severity (median cut-off). Models 5–8 show the results of the subset of 86 companies with mainly internal causes and 21 companies with mainly external causes.
[b] Interactions with turnaround stage.
† $p < 0.10$; * $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$.

A Duality Perspective of Corporate Turnarounds

Two competing theory perspectives have dominated the extant corporate turnaround literature: the threat-rigidity perspective (e.g. Barker and Mone, 1998; Sutton and D'Aunno, 1989) and the prospect theory perspective (e.g. Bolton, 1993; Hambrick and D'Aveni, 1988). Despite their unquestionable contributions, the two perspectives fail to provide an overarching theory framework (Lohrke et al., 2012), while defending their contradictory viewpoints on the 'if', the 'when', and the 'how' to implement retrenchment and recovery during turnarounds (Barker and Mone, 1994; Robbins and Pearce, 1992). This paper extends the two theoretical perspectives and integrates them in an overarching duality framework. The recognition of this duality (Farjoun, 2010) is an important departure from prior studies since it shifts the field's analytical focus from exploring retrenchment and recovery's distinct causes and effects to clarifying their interrelations. While we acknowledge the tensions between retrenchment and recovery (e.g. Robbins and Pearce, 1992), our perspective highlights their mutually enabling qualities. In this perspective, turnaround success is a function of the firm's ability to integrate contradictory, yet interrelated, retrenchment and recovery activities in corporate turnarounds.

The duality perspective opens up interesting avenues for future research. Most importantly, future research could examine the boundary conditions under which our theoretical framework applies. While our post-hoc analyses show that our assumptions hold for different causes of decline, the interaction effect between retrenchment and recovery vanished under conditions of a particularly severe decline. These findings indicate that firms struggle with the simultaneous management of retrenchment and recovery in situations of particularly severe resource scarcity (Barker and Duhaime, 1997), which cause high levels of managerial stress and anxiety (Barker and Mone, 1994). Future research should investigate whether firms experiencing particularly severe decline are better off by initially opting for a one-sided attention to retrenchment (Robbins and Pearce, 1992) to 'stop the bleeding' (Bibeault, 1982). These studies should prioritize objective measures of the causes and severity of decline (Robbins and Pearce, 1992), which will allow the turnaround firm's key performance indicators (e.g. labour efficiency, ROA, R&D investment) to be compared with the industry mean values (Deephouse, 1996). Further, we relied on a sample of Central European firms that mostly operated in mature industry contexts. Prior studies have shown that industry conditions, regulatory contexts, and cultural environments can shape turnaround activities and influence their performance implications (e.g. Bruton et al., 2003; Morrow et al., 2004). We thus welcome comparative studies that empirically test elements of our theory across different institutional and cultural settings.

Moreover, prior turnaround studies have provided illustrative evidence that focusing on either retrenchment or recovery can exacerbate organizational decline in turnaround situations (Barker and Mone, 1998; Cameron et al., 1987) due to impaired decision making (Walrave et al., 2011). While our duality perspective suggests that turnaround firms can prevent such vicious cycles, our methodological choices did not allow for a detailed examination of the underlying processes. Since we gathered field data from knowledgeable respondents, we were limited by our cross-sectional approach and retrospective biases (Golden, 1992). Future research should thus investigate whether the integration of retrenchment and recovery leads to virtuous cycles (Smith and Lewis, 2011) and how they unfold over time. Case study research combining in-depth field data with archival data (Hambrick and D'Aveni, 1988) could enable researchers to examine the decision-making processes at multiple points during corporate turnarounds.

The Interrelations between Retrenchment and Recovery

While prior turnaround research has developed multiple stage models (e.g. Chowdhury, 2002; Lohrke et al., 2012; Robbins and Pearce, 1992), we provide a more integrative conceptualization of corporate turnarounds. Previous stage models suggest that firms address retrenchment in the initial turnaround stage, while shifting their full attention to recovery in the advanced turnaround stage (Filatotchev and Toms, 2006). Conversely, we provide theoretical arguments and empirical evidence that retrenchment and recovery are positively associated with turnaround performance during both turnaround stages. Retrenchment acts as a resource provider in the initial turnaround stage (Pearce and Robbins, 2008), but it is also essential to regain stability in the face of strategic change in the advanced turnaround stage. While recovery drives strategic change in the advanced turnaround stage (Barker and Mone, 1994), it is also an important means to direct retrenchment in the initial turnaround stage. Our results thus suggest that retrenchment and recovery play a far more complex and dynamic role in corporate turnarounds than previously assumed. Rather than simply stating the simultaneous need for retrenchment and recovery, we further reveal the two turnaround activities' complementarities.

An important question for future research concerns the optimum level of interaction between retrenchment and recovery. Previous research has stressed the tensions between retrenchment and recovery and the costs of their integration (Pearce and Robbins, 2008; Sheppard and Chowdhury, 2005). While our results show an overall positive association of the retrenchment–recovery interaction with turnaround performance, the negative squared effect of each turnaround strategy's individual impact on performance indicates a curvilinear relationship. This indicates a certain threshold above which the performance will not be further improved. Given that integrating contradictory tensions requires constant managerial attention and their acceptance that the tensions may never be fully resolved (Smith and Lewis, 2011), future studies may explore the optimum balance between retrenchment and recovery. For instance, future research could explore how turnaround firms assess, maintain, and shift their levels of integration between retrenchment and recovery and how these activities relate to turnaround performance. In particular, it may be interesting to explore how turnaround managers combine integrative solutions (to benefit retrenchment and recovery's mutually enabling qualities) with temporal separation (to avoid some of the two activities' inherent tensions).

Moreover, researchers have started to explore the 'how' of turnaround firms' retrenchment and recovery activities (e.g. Arogyaswamy et al., 1995; Barker and Duhaime, 1997). In particular, scholars argue that there is not only one kind of retrenchment and that the different types' usefulness may vary with organizational and environmental conditions (Ndofor et al., 2013; Pearce and Robbins, 1993). For example, Morrow et al. (2004) show that asset retrenchment and cost retrenchment are either more or less beneficial for turnaround firms depending on their industry context. While our analyses indicate that our findings hold for both types of retrenchment, future research should explore the conditions under which different types of retrenchment activities are either more or less suitable for integration with recovery activities. Further, researchers could draw on insights from related, theoretically more advanced, literature debates. For example, DeWitt (1998) provides empirical evidence that different downsizing approaches are a function of specific firm, industry, and strategy determinants. Moreover, Bergh et al. (2008) emphasize that different corporate restructuring activities' influence on firm performance depends partly on how they are implemented. Lim et al. (2013) provide objective measures for asset and cost retrenchment and show that each type's performance effects are contingent on a firm's rent creation mechanism. We believe that expanding the turnaround literature's theoretical bases to insights from these related literatures could further enrich the discussion and refine the current approaches' perspectives.

Managing the Retrenchment–Recovery Interrelations

Corporate turnarounds are managerial responses to decline (Arogyaswamy et al., 1995) under conditions of high uncertainty and ambiguity (Rosenblatt et al., 1993). In this study, we provide the first theoretical arguments regarding how turnaround managers can approach the retrenchment–recovery duality through specific learning, organizing, and performing strategies. These strategies should help reduce the managerial stress (Ford and Baucus, 1987) and the related information processing problems (Staw et al., 1981) encountered in turnaround situations. Further, the strategies could contribute to greater strategic flexibility and the 'dynamic managerial ability' (Walrave et al., 2011) required to manage turnarounds.

Future research should explore in greater depth how managers leverage learning, organizing, and performing complementarities to integrate retrenchment and recovery activities during corporate turnarounds. More specifically, scholars could investigate the interrelations between organizing, learning, and performing strategies. For example, learning strategies – such as focus and experimentation – may challenge managers to engage in (or disengage from) organizing strategies of formalization and participation (Smith and Lewis, 2011). Similarly, profit and breakthrough strategies may have to be aligned with learning strategies to yield the expected results. Given that prior turnaround research has described the necessity to balance conflicting goals across dimensions (Arogyaswamy et al., 1995), future research may explore how coping with one tension enables firms to manage another. Our large-scale, cross-sectional approach did not allow for empirically exploring the different managerial strategies and their interrelations. Future research may use inductive and longitudinal process studies (Langley, 1999) to better capture these dynamic processes. Moreover, future research could formally test the individual strategies' interaction and effects based on established measures for focus and experimentation (e.g. Jansen et al., 2006), formalization and participation (e.g. Gibson and Birkinshaw, 2004), and profit and breakthrough strategies (e.g. He and Wong, 2004).

Future studies should also explore the organizational contexts that enable turnaround managers to effectively integrate retrenchment and recovery. Prior turnaround research points to the crucial role of top management team processes (e.g. Barker et al., 2001), governance mechanisms (e.g. Filatotchev and Toms, 2006), human resource systems and processes (e.g. Boyne and Meier, 2009), and stakeholder relations (e.g. Pajunen, 2006). We need to know more about how these activities enable turnaround managers not only to engage in retrenchment and recovery, but also to simultaneously approach and integrate the two activities.

From a practitioner perspective, an important question relates to the particular qualities and capabilities that turnaround managers need to successfully manage the retrenchment–recovery tensions. Are these similar to those required for managing sequential turnaround processes or do we need a new breed of turnaround managers? If turnaround success depends on integrating retrenchment and recovery, turnaround managers have to support these contradictory activities simultaneously. This requires awareness of tensions, as well as paradoxical thinking to view 'tensions as an invitation for creativity and opportunity' (Smith and Lewis, 2011, p. 391). Paradox studies show that the ability to attend to competing demands simultaneously requires managers with cognitive complexity (Smith and Tushman, 2005), behavioural complexity (Denison et al., 1995), and emotional equanimity (Lewis, 2000). While beyond the scope of this study, future turnaround studies could draw on these foundations to investigate the leadership characteristics and processes that enable managers to integrate retrenchment and recovery.

Contributions to the Paradox Literature

Our study also contributes to the paradox literature, especially to the emerging debate on dualities. To date, this debate has focused primarily on the exploitation–exploration duality (e.g. Farjoun, 2010; Smith and Lewis, 2011). Exploring a related duality in a corporate turnaround context is particularly interesting for paradox research, since turnaround firms are characterized by resource scarcity (Arogyaswamy et al., 1995). Prior paradox studies assumed that resource scarcity reinforces the oppositional and relational nature of dualities, which causes latent tensions to become salient (Smith and Tushman, 2005). Since the integration of contradictory activities implies the risk of falling short of both objectives, prior studies suggested that resource-scarce organizations may be better off by opting for either a focused orientation or by temporarily separating the contradictory tasks (Raisch and Birkinshaw, 2008).

Conversely, our findings indicate that even resource-scarce organizations can benefit from integrating opposing activities. While this may not fully apply to organizations experiencing exceptionally severe decline, turnaround firms in general benefit from integrating rather than from separating contradictory activities. We describe several strategies (e.g. focus and experimentation) that enable resource-scarce firms to 'make do' with the little resources they have at their disposal. Since the acceptance and resolution strategies simultaneously work on increasing the benefits and reducing the costs of integrating opposing elements, even resource-scarce organizations can benefit from integrative solutions to manage dualities.

Finally, we contribute to paradox research by clarifying the nature of the interrelations between opposing elements in dualistic relationships. While recent paradox studies stress the need to consider both contradictions and complementarities in paradoxical relationships (e.g. Smith and Lewis, 2011), this study offers one of the first integrated efforts to conceptualize, operationalize, and quantify such a relationship. Our empirical test of the retrenchment–recovery duality and its association with performance provides additional insights. While the duality's interaction effect is positive, our empirical analysis indicates that the two opposing elements – retrenchment and recovery – have a curvilinear relationship with turnaround performance. This provides first empirical evidence supporting prior theoretical arguments (Cao et al., 2009) that dualities, due to their inherent contradictions, may force organizations to opt for moderate levels of the two opposing elements. Future paradox research could thus explore whether the relative attention that managers assign to one or the other end of the duality (e.g. retrenchment and recovery) shifts with changing internal and external requirements. For example, it may be that turnaround organizations, while integrating retrenchment and recovery at all times, engage in higher degrees of retrenchment in the early stages of the turnaround (when the severity of the decline is particularly high), but gradually shift to higher degrees of recovery in the later stages of turnaround (when the worst losses are over). Such a 'shifting balance' may enable organizations to focus the limited resources at their disposal to resolve the most pressing challenges at a given point in time, without entirely neglecting the opposing elements.

Conclusion

Prior turnaround models have provided limited insight into different turnaround activities' interrelations during corporate turnarounds. In our study, we developed a duality perspective of corporate turnarounds. Based on an empirical study of 107 Central European turnaround initiatives, we showed that successful turnaround firms drive the complementarities between efficiency-oriented and innovation-stimulating activities. In times of increasing environmental turbulence and extended periods of global recession, these insights are of the utmost importance for firms' long-term prosperity. It is our hope that this study will generate renewed interest in the complex interrelations between changing environmental conditions, corporate turnaround activities, and firm development.

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Corporate Financial Distress and Turnaround Strategies: An Empirical Analysis

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Extant research on corporate turnaround from financial distress has prescribed a range of strategies to effect corporate recovery. However, no large sample study has examined the general applicability and effectiveness of these strategies. We set out to test the effectiveness of strategies and identify the underlying factors of effectiveness – the impact of timing, intensity and implementation of strategies on corporate recovery. We examine a sample of 166 potentially bankrupt UK firms drawn from 1985 to 1993 and track their turnaround strategies for a period of three years from distress. These strategies include operational, asset, managerial and financial restructuring. Our results show recovery and non-recovery firms adopt very similar sets of strategies, and managers of non-recovery firms restructure more intensively than recovery firms. Nevertheless, non-recovery firms seem far less effective in strategy implementation than their recovery counterparts. Whereas recovery firms adopt growth-oriented and external-market focused strategies, non-recovery firms engage in fire-fighting strategies.

Introduction

Corporate turnaround has received much attention in the strategy literature and, increasingly, in finance. These two streams have, however, differed in their focus, i.e. type of strategies, in their approach, i.e. whether descriptive or prescriptive and in the definition of performance decline. A range of strategies has been prescribed for their potency in corporate recovery. Corporate responses to performance decline cover a wide range of restructuring: managerial, asset or strategic, financial, operational and organizational.

Corporate downward spiral to failure, after the onset of performance decline, is attributed by past researchers (e.g. Barker and Mone, 1994; Hambrick and Schecter, 1983; Hofer, 1980; Hoffman, 1989; Schendel, Patton and Riggs, 1976; Weitzel and Jonsson, 1989) to managerial inaction, poor timing and lack of intensity and poor implementation of turnaround strategies. This suggests that success of managerial responses to performance decline is conditioned by their timing, intensity and effective implementation. Analysis of these factors requires a multi-period examination of the turnaround process. Again, empirical evidence on these factors contributing to effectiveness of turnaround strategies, based on large-scale analysis, is limited.

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We aim to fill the empirical gap by investigating the turnaround strategies of firms that suffer performance decline. The questions we ask are:

- Do firms that recover from financial distress adopt different turnaround strategies from those that continue to decline into severe distress?
- Do these two groups differ in the intensity and timing of the strategies they deploy?
- Which of these strategies contribute to corporate turnaround?

We define financial distress in terms of potential bankruptcy risk using an accounting-based index of such risk. For a sample of 166 UK firms which experience financial distress during the period 1983–93, we test the effectiveness of each restructuring strategy. We also test the overall effectiveness of all the identified corporate restructuring strategies in achieving turnaround with logit and linear regressions of recovery on restructuring intensity. Our results show recovery and non-recovery firms adopt very similar sets of strategies following financial distress but their strategic choices diverge over time, with recovery firms choosing investment and acquisition to lead them out of trouble whereas non-recovery firms are more internally focused on operational and financial restructuring.

The paper is organized as follows. The next section reviews the literature on corporate restructuring and turnaround. The third section describes the methodology and data, the fourth presents and interprets the results, and the final section provides a summary and the conclusions.

Corporate turnaround strategies

Fall of a firm from a superior performance position to an extremely poor position on any appropriate performance criterion normally points to fundamental problems with its management and strategies. However, given that the firm is poorly performing, how should management respond? Management may sit tight in hope of an upturn in its fortunes or restructure to recover rapidly from poor performance. However, 'masterly' inaction may lead to further deterioration in firm performance (Schendel, Patton and Riggs, 1976; Weitzel and Jonsson, 1989). Managers may also refrain from actions that may contribute to turnaround but hurt their own self-interest.

Firms which experience financial distress may choose a variety of methods of restructuring themselves back to financial health (e.g. John, Lang and Netter, 1992). Firms' choice of restructuring strategy is, however, contingent on a range of factors. Ofek (1993) examines the impact of capital structure on the choices made by such firms. Kang and Shivdasani (1997) examine the impact of bank relationship, block shareholders, managerial shareholding and the traditional keiretsu membership of a sample of Japanese firms experiencing performance decline on the restructuring actions they take, and report that the probability of actions such as downsizing is influenced by many of these factors. Kang and Shivdasani (1997) also examine the impact of managerial ownership, block shareholdings and leverage on the responses of a comparative sample of US firms to performance decline, and find no evidence for it. We first map out the range of turnaround strategies identified in the extant literature and then discuss their empirical effectiveness.

Managerial restructuring

Top management change is widely quoted as a precondition for successful turnarounds (Bibeault, 1982; Hofer, 1980; Schendel, Patton and Riggs, 1976; Slatter, 1984). Simply, when old ways of operating need to undergo drastic change, it is difficult for incumbent top management to change their habits and institute radical reforms. Often, banks and creditors will continue financial support only if they are confident that the management team can manage the crisis in hand. A change in top management is tangible evidence to bankers, investors and employees that something positive is being done to improve the firm's performance, even though the cause of poor performance may have been beyond management's control (Slatter, 1984). Grinyer, Mayes and McKiernan (1988, ch. 4) report that one of the most important differences between their sample of firms achieving recovery from poor performance and control firms is that the former make considerably more management changes.

There is empirical evidence of an inverse relation between the probability of management change and a firm's stock performance (Coughlan and Schmidt, 1985; Warner, Watts and Wruck, 1988). Gilson (1989, 1990) and Murphy and Zimmerman (1993) find significant top-management changes in distressed firms. However, the stock market's reaction to top-management changes in distressed firms is mixed. Announcements of change in senior management in distressed firms are greeted positively (Bonnier and Bruner, 1989), negatively (Khanna and Poulsen, 1995) or neutrally (Warner, Watts and Wruck, 1988; Weisbach, 1988) by the market.

From the above studies it is not clear that management change in financially distressed firms contributes to recovery. If we interpret the stock market reaction as a measure of the perceived effectiveness of that change then the evidence from the above studies is not clear cut. Thus effectiveness of managerial restructuring in turnaround is yet to be conclusively established.

Operational restructuring

The strategic management literature provides empirical support for an overlapping two-stage approach to corporate turnarounds: the efficiency/operating turnaround strategy stage and the entrepreneurial/strategic stage (e.g. Bibeault, 1982; Robbins and Pearce II, 1992; Slatter, 1984). The efficiency/operating turnaround stage aims to stabilize operations and restore profitability by pursuing strict cost and operating-asset reductions. The entrepreneurial/strategic stage aims to achieve profitable long-term growth through restructuring the firm's asset portfolio or product/market refocusing. Our research classifies efficiency/operating measures as operational restructuring and entrepreneurial/strategic measures as asset restructuring.

Operational restructuring comprises cost reduction, revenue generation and operating-asset reduction strategies to improve efficiency and margin by reducing direct costs and slimming overheads in line with volume (Slatter, 1984). Operational restructuring is, generally, the first turnaround strategy implemented by a financially distressed firm, as there is no point in assessing the strategic health if the firm goes bankrupt in the near term (Hofer, 1980). Efficiency measures are directed at both maximizing output (revenue) and minimizing input (resources such as inventory). Cost reduction may be sufficient where the firm is weak operationally. Kang and Shivdasani (1997) report that their sample of Japanese firms in performance decline carry out lay-offs and improve their operating income to assets significantly.

Next, revenue generating strategies may be pursued focusing on existing lines of products, initiating price-cuts (or raising prices where products are price insensitive) and increasing marketing expenditure to stimulate demand (Hofer, 1980).[1] When the firm is operating well below capacity, asset reduction to improve utilization and productivity of assets is imperative, and also augments the cash flow which is vital to firms in financial distress. Asset-reduction can be operational or strategic in nature. The latter type is discussed in the next subsection.

Operating-asset reduction refers to business-unit level sale, closures and integration of surplus fixed assets such as plant, equipment and offices, and reduction in short-term assets such as inventory and debtors. This is driven by the need to enhance the efficiency of the firm's current operations through improved asset utilization at the operating level (Bibeault, 1982; Hofer, 1980; Schendel, Patton and Riggs, 1976).

Operational restructuring is primarily designed to generate, in the short term, cash flow and profit improvement. It is of a fire-fighting nature and differs from restructuring aimed at the longer-term competitive positioning and performance of the firm. Grinyer, Mayes and McKiernan (1988, ch. 4), in their survey of firms which, after a decline relative to their competitors, achieve a dramatic and sustained improvement in performance (hence characterized as sharpbenders), observe that such firms do not restrict themselves to operational-cost reduction strategies but shift to long-term strategic changes through new product market focus, diversification, acquisition and so on. Thus operational strategies may be a

[1] Due to data availability problems, revenue-generating strategy is not explicitly studied in this research. Potentially, sales growth can be used to proxy for revenue growth but the effect of asset restructuring, such as acquisitions, obscures operational-revenue generating efforts. This limitation precludes analysis of some potentially significant recovery strategies focused on revenue generation from existing operations.

necessary but not a sufficient condition for recovery for many firms.

Operating efficiency strategies have been empirically associated with turnaround success (Finkin, 1985; Hambrick and Schecter, 1983; John, Lang and Netter, 1992; O'Neill, 1986; Pearce II and Robbins, 1993). However, whether operational restructuring leads to recovery from potential bankruptcy remains to be empirically tested.

Asset restructuring

Strategic/portfolio[2] restructuring covers reorganizing the firm into self-contained strategic business units; divestment of lines of businesses not fitting the core businesses; acquiring companies that relate to and strengthen the core; discontinuing unpromising products; and forming strategic alliances, joint ventures and licensing agreements.[3] In addition, distressed firms may merge with other firms, be taken over in a hostile bid or be bought-out by their own management (MBOs). The strategic stage resembles the asset restructuring found in the finance literature, as it refers to the major reconfiguration of the firm's assets. This covers asset divestment and investment.

Asset divestment. Where the firm is in severe distress and/or where strategic health is weak,[4] asset reduction is deemed imperative for turnaround (Hofer, 1980; Pearce II and Robbins, 1993). Asset reduction at the portfolio (corporate) level covers divestment of subsidiaries/divisions.[5] The objective at this level may be to divest non-profit generating assets (and halt cash drain), non-core assets or even profitable assets for the purpose of raising cash to alleviate financial distress and fund restructuring. Divestment of subsidiaries is perhaps the most common turnaround strategy by all but the smallest firms (Slatter, 1984). For a sample of Japanese firms in performance decline, Kang and Shivdasani (1997) find that asset contraction contributes to significant improvement in operating income/assets. In this study we examine whether asset sales such as divestments contribute to turnaround of financially distressed firms.

Asset investment. Asset investment covers business and corporate-level investments and comprises both internal capital expenditure and acquisitions. Capital expenditure is often designed to achieve efficiency/productivity improvement, e.g. building new plants and equipment (Hambrick and Schecter, 1983; Schendel, Patton and Riggs, 1976) or computerized processing and monitoring equipment which speeds up production and market response, improves productivity and reduces costs (Grinyer, Mayes and McKiernan, 1988, p. 88). Such expenditure complements, rather than conflicts with, efficiency-driven operational restructuring described earlier. It may also enhance the firm's competitive advantage, e.g. when the firm achieves economy of scale by expanding its output. Since it involves cash outflow, firms in decline can only undertake such capital expenditure as can ensure their survival and promote their recovery. Thus internal capital expenditure may be a critical component of a firm's turnaround strategy.

Firms may also seek to acquire businesses that fit their core competencies with long-term profit potential. This stage is crucial for turnaround by firms with inappropriate corporate strategy or mature or declining product/markets where a new strategic direction is imperative (Hofer, 1980; Pearce II and Robbins, 1993; Schendel, Patton and Riggs, 1976). Firms with poor financial performance but not yet in severe distress often resort to acquisitions to accelerate growth (Slatter, 1984, p. 96). Acquisitions may thus contribute to successful sharpbend and sustained good performance thereafter but need to be selected and managed carefully (Grinyer, Mayes and McKiernan, 1988, p. 98).

Financial restructuring

Cash generation strategies, e.g. asset divestment and equity issues, are commonly-used strategies

[2] Term used by Bowman and Singh (1993).
[3] Adapted from Business Intelligence Research Report: Corporate Restructuring and Turnaround, 1987.
[4] For example, where present capacity far exceeds long-term revenue potential or assets are in declining product/markets.
[5] This type of asset reduction is distinct from operating-asset reduction discussed earlier. We acknowledge that in practice it is sometimes difficult to differentiate between the two types of asset reduction very sharply.

to alleviate financial distress, pay down borrowings, reduce interest cost and improve cash flows (Slatter, 1984). Extant strategy-based research on corporate turnarounds has not identified financial restructuring as an integral component of corporate turnaround strategy, as opposed to the finance-based research (e.g. Brown, James and Mooradian, 1993; DeAngelo and DeAngelo, 1990; Franks and Tourous, 1994; Gilson, 1989; John, Lang and Netter, 1992). Grinyer, Mayes and McKiernan (1988, p. 98) note, however, that their sample of sharpbenders followed debt reduction less frequently than their control firms. Our study incorporates financial restructuring as a key element of the corporate restructuring framework and evaluates its importance.

Financial restructuring is the reworking of a firm's capital structure to relieve the strain of interest and debt repayments and is separated into two strategies: equity-based and debt-based strategies. Equity-based strategies cover dividend cuts or omissions and equity issues, i.e. rights issue, public offer or institutional placing. Firms in financial distress tend to reduce or omit dividends due to liquidity constraints, restrictions imposed by debt covenants, or strategic considerations such improving firm's bargaining position with trade unions (DeAngelo and DeAngelo, 1990). Empirically, DeAngelo and DeAngelo (1990) and John, Lang and Netter (1992) find large firms respond to financial distress with rapid and aggressive dividend reductions. Distressed companies may also raise equity funds via share issues more than non-distressed firms because of pressure from creditors concerned with the security of their lending.

Debt-based strategies refer to the extensive restructuring of firm debt. Firms restructure their debt either to avoid financial distress or to resolve an existing financial distress. Gilson (1989, 1990) defines debt restructuring as a transaction in which an existing debt is replaced by a new contract, with one or more of the following characteristics: (1) interest or principal reduced; (2) maturity extended; (3) debt-equity swap. Until recently, raising additional finance in the form of equity and new loans was more common than debt restructuring in the UK (Slatter, 1984). We investigate whether debt restructuring is an effective strategy for turnaround.

Selection and implementation of corporate turnaround strategies

Corporate turnaround often requires swift managerial actions to 'stop the bleeding'. Corporate failures, on the other hand, may be caused by managerial inaction or inappropriate actions (Hoffman, 1989; Makridakis, 1991; Schendel, Patton and Riggs, 1976; Slatter, 1984; Weitzel and Jonsson, 1989). Adoption of turnaround strategies itself is no guarantee of recovery. For a strategy to be effective, it may have to be carried out swiftly, intensively and competently. For example, swift and deep, rather than superficial, cost cutting may be instrumental to efficiency improvements and eventual turnaround. Poor implementation of turnaround strategies may exacerbate decline (Cameron, Sutton and Whetten, 1988; Freeman and Cameron, 1993). Barker III and Mone (1994), in their critique of Robbins and Pearce's (1992) study, contend that how managers retrench could be more important than whether managers retrench at all. Similarly, Hoffman (1989) suggests that the difference between successful and failed turnarounds lies more in the strategy implementation process than in its content.

Effectiveness of corporate turnaround strategies

Successful turnaround is return to the same performance level of the firm as before its distress. The chosen strategies may have contributed to such turnaround in different degrees. Some of the strategies are implemented simultaneously and some in sequence. Also, the overlapping and joint effects of complementary strategies may confound the impact of individual strategies. We estimate the joint impact of strategies on our measure of turnaround success over a period of three years from the distress year.

Methodology and data

Definition of financial distress and turnaround

In the turnaround literature in corporate strategy and finance, a range of definitions has been used to define distress, some based on change in either simple or industry-adjusted accounting ratios such as return on assets and some others based on stock returns. Altman (1968) popularized the Z score as a measure of a firm's bankruptcy likelihood. In the UK, a popular Z-score model used by banks and industrial firms is developed by Taffler (1983, 1984). Firms with a negative Z score are classified as potential failures, as their financial profiles resemble those of previously bankrupt firms.

The model, developed using linear discriminant analysis techniques, takes the following form:

$$Z = c_0 + c_1 X_1 + c_2 X_2 + c_3 X_3 + c_4 X_4$$

where $X_1 \ldots X_4$ denote the financial ratios, and $c_1 \ldots c_4$ the coefficients that are proprietary. There are two versions. The first is used to analyse listed manufacturing and construction companies and has component ratios (with Mosteller-Wallace percentage contribution measures in brackets): profit before tax/current liabilities (53%), current assets/total liabilities (13%), current liabilities/total assets (18%) and no-credit interval (16%).[6] The second variant is used to rate listed retail enterprises and has ratios: cash flow/total liabilities (34%), debt/quick assets (10%), current liabilities/total assets (44%) and no-credit interval (12%).

In this paper, we employ the Z scores developed by Taffler to define distress.[7] A firm is in distress if it has a minimum of one year of negative Z score after two consecutive years of positive Z scores.

Definition of restructuring strategies and control variables

The four generic restructuring strategies studied are operational, asset, managerial and financial strategies. These are defined in Table 1. Operational restructuring covers cost rationalization, lay-offs, closures and integration of business units. Asset sales include divestment of subsidiaries, management buy-outs, spin-offs, sale and lease-back, and other asset sales. Acquisitions include both full and partial acquisition of businesses. Management restructuring means removal of Chairman or Chief Executive Officer (CEO) or Managing Director (MD). Dividend cut or omission refers to omission or reduction of cash dividends per share from their pre-decline year level. Equity issue covers issue of equity for cash. Debt restructuring is defined as new debt issue and debt refinancing involving maturity extension, debt-equity swap or forgiving of debt and interest.

Intensity of restructuring

Intensity of restructuring is measured by change in accounting and cash-flow variables relative to a measure of their pre-distress size.[8] Operational restructuring is measured by the cost of restructuring as reported in the company accounts relative to pre-distress total assets. Asset sales, acquisition and capital expenditure are measured by the cash flows raised or expended relative to pre-distress total assets. Dividend change is the change in current year dividends from the pre-distress year's. Equity issue is measured by cash raised by equity issue as a proportion of pre-distress year total assets.[9]

Control variables

The empirical literature (e.g. Robbins and Pearce II, 1992, 1993) also suggests that suitability and effectiveness of turnaround strategies are dependent on certain internal and external factors. These additional variables are included in our regressions

[6] No credit interval is the ratio of excess of quick assets over current liabilities to the projected daily operating expenditure (see Taffler, 1983 for elaboration of this definition).

[7] Taffler (1995) tracks the performance of this model from its development. Overall, it has had better than 98% success rate in classifying subsequently bankrupt companies as potentially insolvent ($Z < 0$) based on their last accounts prior to failure, and exhibits true *ex ante* predictive ability in statistical terms.

[8] The choice of pre-distress value is based on the need to avoid contamination by severity of decline. For example, more-severely distressed firms by construct will have a more severe drop in assets. Thus, asset restructuring may appear artificially more intensive for such firms than for less-severely distressed firms of similar size prior to distress.

[9] Intensity of management or debt restructuring is not examined. It was not possible to track, during the sample period, the proportion of directors replaced, based on information in company annual reports and accounts, which only provided information on resignation and reelection of directors on rotation each year. Debt restructuring is not examined due to the difficulty in quantifying the value of the restructuring package.

Table 1. Definition of restructuring strategies and control variables

Panel A. Restructuring strategies

Strategy	Definition
Operational restructuring	Cost rationalization, lay-offs, closures and integration of business units
Asset restructuring	
Asset sales	Divestment of subsidiaries, management buy-outs, spin-offs, sale and leaseback and other asset sales
Acquisitions	Full and partial acquisitions of businesses
Internal capital expenditure	Capital expenditure on fixed assets such as plant and machinery
Managerial restructuring	Removal of Chairman or Chief Executive Officer/Managing Director (retirement under 65 years age treated as removal)
Financial restructuring	
Dividend cut/omission	Omission or reduction of dividends from previous year
Equity issue	Issue of equity for cash
Debt restructuring	Debt refinancing involving extending, converting or forgiving of debt or interest

Panel B. Control variables

Factor	Definition
Severity of decline	Stock-return ranking of sample firm in the year of decline
Internal problems	Reported internal problems such as project failure, bad acquisitions or poor financial control
Industry condition	Median Z score of firms in the same Financial Times Actuaries (FTA) sector to which the sample firm belongs
Economic condition	Growth rate in Gross Domestic Product (GDP) in post-decline, turnaround years
Size	Size of sample firm measured as market capitalization of its equity in the pre-decline year

Notes: Restructuring strategies selected by financially distressed firms are defined. Information on strategies is from press releases to the London Stock Exchange which are documented by Extel Financial News Summary from 1987 with the exception of capital expenditure. Capital expenditure is defined as significant expenditure in excess of 10% of prior year asset value. The 10% limit is intended to capture expenditure significantly above routine asset replacement which, proxied by sample firms' depreciation charge, amounts to an average of 7% of prior year asset value. Supplementary information is also collected from Hambro/Andersen Corporate Register and Company Guide, Datastream International and company reports and accounts. These alternative sources are also used for cross-checking information reported in the Extel Financial News Summary.

as control variables. Severity of decline dictates both the pace of restructuring and effectiveness of particular actions. For example, asset investment or acquisitions may be unsuitable for more-seriously distressed firms as they consume scarce cash resources.

Economic and industry conditions may also influence effectiveness of strategy. For example, where the industry as a whole is depressed, asset sales and divestments may not raise as much cash as otherwise (Schleifer and Vishny, 1992). During an economic downturn, operational cost-cutting actions could be effective but equity issues may not be appropriate, as the stock market would be depressed. Size of the firm is a proxy for both the flexibility and internal slack available to the declining firm. Certain strategies such as acquisition and divestment are more appropriate for large rather than small firms. A large firm may also be able to negotiate debt restructuring more effectively.

Where the firm's performance decline has been caused by internal, firm-specific factors such as bad acquisitions or poor financial control, any restructuring has to reverse the firm specific causes. Again the effectiveness of restructuring will be dictated by the existence of internal causes of decline. These control variables are defined in Panel B of Table 1.

Effectiveness of turnaround is measured by the return of the distressed firm to the positive Z-score territory over the two-year period following the distress year. Relative recovery is represented by the change in Z score two years post-distress relative to that in the pre-distress year.

Data

Sample firms are those which experience a sharp decline to a negative Z score after having had a positive Z score for at least two consecutive years.

This sampling criterion is called the + + – (plus, plus, minus) rule.[10] The sample covers the period 1983–93, with 1983–91 as the base (plus, plus) years and 1985–93 the distress (minus) years. Z scores are provided by Taffler.

An initial sample of 245 distressed firms satisfying our + + – rule is assembled from a total of 976 Financial Times All-Share Index (FTA) firms listed on the London Stock Exchange in the period 1983–93. The restriction to FTA firms is due to the fact that, at the time of the study, a complete database of Z scores dating back to 1983 was only available for FTA firms. Sampling excludes financials and utilities because of their being regulated.

Data on the sample firms' restructuring activities and on the explanatory variables are collected from Datastream International, company annual reports and Extel Annual News Summaries. Such data are not available for all companies defined as distressed, e.g. small firms with a market capitalization of less than £10m are excluded. The reduced sample consists of 201 financially distressed firms.

Table 2 shows financial characteristics of the sample firms in terms of a range of conventional accounting measures of performance. All the measures testify to a steep and significant decline in performance from the two pre-distress, healthy years to the distress year. Profit margin, return on equity and on assets, cash-flow return to capital employed and cash-flow cover for debt all show precipitous decline. In particular, the largest fall is in PBITD/TD, the cash-low cover for debt. This fall is an indication of the falling profitability of the sample firms reflected in the profit margin and return ratios, and also of the rapid rise in debt of the sample firms.

Table 3 shows the financial status of sample firms two years after decline.[11] Over a third of the distressed firms recover, whilst nearly half the sample firms do not revert to their pre-distress financial health two years post-distress. The remainder of the sample is either taken over (9%) or become insolvent (2.7%).[12] The rate of recovery fluctuates between a low of 32% and a high of 75%. It is clear that distress immediately prior to an economic downturn (i.e. distress years 1988 and 1989) have a much tougher turnaround job than do firms that decline in a boom period (distress years 1986 and 1987). The final sample comprises 166 recovery and non-recovery firms

Table 2. Financial characteristics of distressed firms in pre-distress and distress years

Financial characteristics	Two pre-distress years Mean (%)	Distress Mean (%)	Test of difference t statistic
PBIT/sales	9.54	4.64	6.25[a]
ROE	24.96	5.90	7.22[a]
ROA	18.38	8.88	7.06[a]
PBITD/CE	14.20	3.37	8.14[a]
PBITD/TD	74.39	6.36	12.72[a]

Notes: This table shows the financial characteristics of distressed firms in the base years and the distress year. PBIT = profit before interest and tax. PBITD = PBIT plus depreciation (a cash-flow proxy). Return on equity (ROE) = profit after tax for ordinary shareholders/ shareholders' funds. Return on assets (ROA) = PBIT/total assets. Capital employed (CE) = total assets less current liabilities. TD = total debt. Differences in means between the two groups are tested using the t statistic. [a] indicates significance at 1% level.

Results

Table 4 provides descriptive statistics on the distress year and post-distress financial performance of the sample firms divided into recovery and non-recovery firms. Recovery firms are those distressed firms which attain positive Z scores by the end of the second year from distress, whereas non-recovery firms still have negative Z scores. Recovery firms improve their operating performance quite substantially over the post-distress years contributing to their reversion

[10] The + + – (plus, plus, minus) rule means sampling a firm that has a positive Z score in two consecutive years followed by a negative Z score in the third year during the sampling period 1983–93, i.e. a firm that is financially healthy in two consecutive years and then lapses into financial distress in the third year

[11] In the distress year the sample size is 201 firms. Since data on restructuring for 13 firms which become distressed in 1993 are not available these are excluded from our analysis of turnaround firms.

[12] It may be argued that insolvency is the ultimate non-recovery and thus merits analysis as to recovery strategies employed by the receiver or liquidator. However, the tiny sample size of this subgroup precludes any meaningful statistical analysis. Once a firm is taken over and becomes a subsidiary of the acquirer or is merged, details of restructuring are generally not publicly available. For these reasons we exclude insolvent and acquired firms.

Table 3. Sample firms and their financial status two years after distress

Year	Taken over		Insolvent		Recovery		Non-recovery		Total	
	No	%	No	%	No	%	No	%	No	%
1985	3	20.0	–	–	9	60.0	3	20.0	15	8.0
1986	3	20.0	–	–	8	50.0	5	31.3	16	8.5
1987	–	–	–	–	9	75.0	3	25.0	12	6.4
1988	4	26.7	3	10.7	9	32.1	12	42.9	28	14.9
1989	5	33.3	–	–	11	37.9	13	44.8	29	15.4
1990	–	–	–	–	18	60.0	12	40.0	30	16.0
1991	2	13.3	1	3.0	17	51.5	13	39.4	33	17.6
1992	–	–	1	4.0	16	64.0	8	32.0	25	13.3
Total	17	9.0	5	2.7	97	51.6	69	36.7	188	100.0

Notes: This table shows the sample firms and their financial status two years post-distress. Two years after distress, firms may be taken over, become insolvent, recover or remain in distress. Recovery is defined as the reversal to a positive Z score two years after distress. Firms that remain in negative Z-score position are accordingly still in distress. Firms in distress two years after distress are called non-recovery firms.

Sources: Taffler, Extel Financial and Datastream International.

to positive Z scores. Whereas there is little difference in these accounting performance measures between the two groups in the distress year, the recovery group's performance is significantly superior to the non-recovery firms' in the post-distress years in terms of profit margin (PBIT/Sales), return on assets (ROA) and cash-flow cover for debt (PBITD/TD). The cash-flow return measure (PBITD/CE) also strongly suggests such superiority.

Frequency and timing of restructuring

We report, in Table 5, the frequencies of use of various turnaround strategies by the recoverers and non-recoverers. In the distress year, operational restructuring actions are taken by over 50% of firms in both groups. Heavy asset investment by way of capital expenditure and acquisition characterizes both groups in that year. Over a third of sample firms appear to start reducing their assets in the distress-year. The only weakly significant difference between recovery and non-recovery firms in terms of distress-year strategies lies in debt restructuring. Over 10% of non-recovery firms restructure their debt whereas only 3% of the recoverers do so.

In the first year after distress, restructuring intensifies, especially by non-recovery firms. Acquisition and capital expenditure though subside rapidly, presumably because of liquidity problems, with the exception of an increase in capital expenditure by recovery firms. However, these differences are not statistically significant.

A higher percentage of non-recovery firms than recovery ones carry out operational restructuring,

Table 4. Post-distress financial characteristics of recovery and non-recovery firms (means %)

Financial characteristic	Distress year			Average of two post-distress years		
	Recovery	Non-recovery	Test of difference t statistic	Recovery	Non-recovery	Test of difference t statistic
PBIT/Sales	4.09	4.48	0.24	6.58	0.40	3.73[a]
ROE	6.87	3.22	0.66	13.32	6.13	1.01
ROA	8.81	9.47	0.20	14.04	5.81	2.61[b]
PBITD/CE	2.63	4.81	0.64	7.07	0.49	1.98[c]
PBITD/TD	7.60	9.8	0.29	33.26	–1.06	3.77[a]

Notes: This table shows the financial characteristics of distressed firms in the distress year and two post-distress years partitioned by recovery or non-recovery. PBIT = profit before interest and tax. PBITD = PBIT plus depreciation (a cash-flow proxy). Return on equity (ROE) = profit after tax for ordinary shareholders/ shareholders' funds. Return on assets (ROA) = PBIT/total assets. Capital employed (CE) = total assets less current liabilities. TD = total debt. Differences in means between the two groups are tested using the t statistic . [a,b,c] indicate significance at 1%, 5% and 10% levels respectively. Sign of t statistic not shown.

Table 5. Frequency (%) and timing of restructuring strategies by recovery and non-recovery firms in response to financial distress

Restructuring strategy	Distress year			Distress year + 1			Distress year + 2		
	Recovery	Non-recovery	z statistic	Recovery	Non-recovery	z statistic	Recovery	Non-recovery	z statistic
Operational restructuring	57.7	52.2	0.7	35.1	49.3	1.8[c]	28.9	43.5	1.9[c]
Asset sales	38.1	34.8	0.4	40.2	43.5	0.4	41.2	42.0	0.1
Acquisition	46.4	53.6	0.9	34.0	30.4	0.5	32.0	27.5	0.6
Capital expenditure	49.5	56.5	0.9	54.6	43.5	1.4	47.4	36.2	1.4
Managerial restructuring	21.8	30.4	0.6	27.8	31.9	0.6	22.7	30.4	1.1
Dividend cut/omission	26.8	33.3	1.3	30.9	52.2	2.8[a]	28.9	63.8	4.5[a]
Equity issue	15.5	23.2	1.3	22.7	27.5	0.7	19.6	8.7	1.9[c]
Debt restructuring	3.1	10.1	1.9[c]	3.1	14.5	2.7[a]	2.1	13.0	2.8[a]

Notes: This table shows the frequency (%) of firms adopting specific restructuring strategies in response to financial distress. Operational restructuring covers costs of rationalization. Asset sales refer to divestment of subsidiaries, investments and other assets. Acquisitions include both full and partial acquisition of businesses. Internal capital expenditure refers to capital expenditure on fixed assets such as plant and machinery. Managerial restructuring refers to removal of Chairman or CEO or MD. Dividend cut or omission refers to omission or reduction of cash dividends per share from pre-distress year. Equity issue covers issue of equity for cash. Debt restructuring refers to debt refinancing involving extending, converting or forgiving of debt and interest. Differences in proportions between recovery and non-recovery firms are tested using the non-parametric Mann-Whitney Wilcoxon test. z is test statistic and its significance at 1%, 5% and 10% is denoted by [a,b,c] respectively.

Sources: Company Reports and Accounts, Datastream International, Extel Financial News Summary and Hambro Corporate Register and Company Guide.

dividend cut/omission and debt restructuring. The difference is strongly significant for the latter two but only strongly suggestive in the case of operational restructuring. This trend is repeated in year two after distress, with the difference in frequencies becoming more significant or larger. In contrast, investment strategies, acquisition and capital expenditure are employed more frequently by non-recovery firms in the distress year (about 54–7% against 46–50% by recoverers) and by fewer firms in distress year + 2 (28–36% against 32–47% by recoverers). The difference in frequencies between the two groups is not significant in either year. However, it appears that growth strategies like acquisition and capital investment may have become relatively less important to non-recoverers. For this group, the frequency of acquisition falls from 54% to 28% and the frequency of capital expenditure from 57% to 36%. For recoverers, the corresponding frequencies fall from 46% to 32% and from 50% to 47% respectively. Frequency of asset sales is not different between the two groups in any of the three years and there is a marginal increase in frequency (3.1% for recoverers and 7.2% for non-recoverers) between the distress year and distress year + 2.

Temporal shift in strategy preferences

Comparison of the frequencies of various turnaround strategies over the three-year period reveals some interesting shifts in priority between the two groups. For example, while the percentage of non-recovery firms resorting to dividend cut/omission increases from 33% to 64% between distress year and distress year + 2 it increases by only 2% among recovery firms. While the percentage of recovery firms doing operational restructuring decreases by 29%, among non-recovery firms the decline is only 9%. Acquisition frequency falls by 14% for recovery firms but by 26% for non-recoverers. Capital expenditure frequency declines by 2% and 20% respectively. Equity issue frequency rises 4% for recoverers, but falls 15% for non-recoverers.

To assess such large shifts in strategic preferences, we test for the significance of the change in frequencies between the distress year and distress year + 2. For the recoverers, the falls in frequency of operational restructuring and acquisition are both significant at 5% or better. For the other strategies the changes are insignificant. For the non-recoverers, the falls in frequency of acquisitions, capital expenditures

Table 6. Importance of turnaround strategies over time

Turnaround strategy	Recovery firms (97)			Non-recovery firms (69)		
	Distress year	Distress year + 1	Distress year + 2	Distress year	Distress year + 1	Distress year + 2
Operational restructuring	1	3	4	3	2	2
Capital expenditure	2	1	1	1	4	4
Acquisition	3	4	3	2	6	6
Asset sales	4	2	2	4	3	3
Dividend cut/omission	5	5	5	5	1	1
Management restructuring	6	6	6	6	5	5
Equity issue	7	7	7	7	7	8
Debt restructuring	8	8	8	8	8	7

Notes: In this table we rank eight turnaround strategies in the descending order of their importance to recovery firms in their distress year. The ranking is based on the frequency of their use shown in Table 5 for the distress and two post-distress years. The ordering is shown separately for recovery and non-recovery firms. Recovery firms are those which regain positive Z-score values by the end of two years from the distress year. Non-recovery firms are those whose Z scores by that time are still negative. Distress year + 1 = first year after distress year. Distress year + 2 = second year after distress year. Sample size in parentheses.

and equity issues are significant at 2% or better. The increase in frequency of dividend cut/ omission is also significant at 1%.[13] There is no significant change in frequency of other strategies.

To understand the shifting strategic priorities, in Table 6 we rank the strategies in terms of frequency of use in each of the three years for recovery and non-recovery firms separately. Both groups of firms start off with nearly the same order of importance of strategies with operational restructuring, capital expenditure and acquisition the most frequent. The non-recovery firms attach more importance to asset expansion and growth than recovery firms. There is no difference between the two groups as regards the ranking of the remaining strategies in the distress year. Over the following two years, however, the priorities shift. In distress year + 1, the most frequently adopted strategies in non-recovery firms are dividend cut/omission, operational restructuring and asset sales. While capital expenditure falls from the first to fourth place acquisition drops from second to sixth place.

On the other hand with recovery firms, capital expenditure moves up along with asset sales while operational restructuring drops from first to third place. In distress year + 2, operational restructuring recedes further down, whereas capital expenditure, asset sales and acquisition become the three most important strategies. For recovery firms, asset sales appear less of a fire-fighting exercise than part of a strategic refocusing of their asset and business portfolio. In stark contrast, non-recovery firms, still prefer dividend cut/ omission, operational restructuring and asset sales to other strategies. Management restructuring moves up to fifth place ahead of acquisition, and capital expenditure is relegated to fourth place. Debt restructuring has now moved ahead of equity issue. Thus non-recovery firms' strategies are still of a fire-fighting nature, with more focus on their internal organizational and managerial problems than on the growth opportunities.

This shifting pattern of the relative frequencies of different turnaround strategies suggests that recovery firms adopt more forward-looking, expansionary and external market focused strategies than non-recovery firms which seem still preoccupied with internal changes. This preoccupation may have resulted from the ineffectiveness of earlier attempts at similar strategies in non-recovery firms. One cannot argue that persistence with restructuring strategies by non-recovery firms *causes* their non-recovery. Non-recovery in the second or third year may compel firms to persist in or increase the intensity of certain strategies, such as dividend cut or debt restructuring. Non-recovery in such cases occurs not because, but inspite, of persistence with certain strategies. Our analysis shows the pattern of restructuring strategies over

[13] The test statistics are available from the first author, Sudi Sudarsanam.

time rather than the direction of causality from strategy to recovery.

The external focus of recovery firms is reflected in their considerably-improved profit margins from 4.09% to 6.58% in the post-distress period. By contrast, non-recovery firms experience further decline in profit margins from 4.48% to 0.40% over the same period (see Table 4 above). The shift by recovery firms from short-term operational to long-term strategic actions is consistent with the behaviour of sharpbenders observed by Grinyer, Mayes and McKiernan (1988, ch. 4).

Intensity of restructuring

Table 7 shows the intensity of restructuring by recovery and non-recovery firms in response to financial distress. Intensity is measured by relating the cash flows generated or drained by a strategy as a ratio of pre-distress year total assets, with the exception of dividend change where the change is related to pre-distress dividend per share. Non-recoverers appear to restructure their operations significantly more intensively than recoverers one year after distress. This trend is continued in the second post-distress year caused perhaps by lack of effectiveness in the previous year.

There is no significant difference in asset sales, acquisition and capital expenditure. The mean difference in dividend change ranges from 28% to 48% between recoverers and non-recoverers over the two years after distress. Dividend cut or omission is used intensively by non-recoverers to conserve scarce cash resources in distress year + 2. The lower levels of equity issues by non-recoverers, in distress year + 2, may be due not only to managers' lack of efforts but also due to lack of enthusiasm among investors to support a failing firm.[14]

Impact of non-recovery on subsequent restructuring

It may be argued that level of intensity of restructuring in later years may be influenced by the failure to recover in the initial years of distress. For example, as noted above, non-recovery firms may be less able to issue new equity in the second year than in the first. Similarly, non-recoverers may be forced to cut or omit dividends or restructure debt more intensively in the second year. Our data in Tables 5 and 7 are consistent with this interpretation. However, to the extent that such restructuring actions, whether triggered by their earlier ineffectiveness or not, are designed to achieve recovery it is of empirical and practical interest whether they are associated with recovery. For example, even though a deep dividend cut may be forced on the distressed firm by failure of earlier cuts to produce recovery, it may nevertheless be a decision calculated to effect subsequent recovery.[15]

Restructuring, control factors and corporate turnaround

It appears that non-recovery is not due to managerial inertia in non-recoverers. Yet they fail to recover. One possible reason is that these managers are not effectively implementing their chosen strategies. It appears that recoverer managers are not only doing the right things but also doing them right. Non-recovery, despite similarity between recoverer's and non-recoverer's restructuring strategies, may also be due to factors other than flawed implementation. Whether particular restructuring strategies are effective may depend on circumstances beyond the control of distressed-firm managers. Economic and industry conditions and firm-specific factors such as the cause of distress may impede or aid effectiveness of strategies. Benign economic and industry conditions may facilitate firm recovery. Very severe distress may diminish the chances of recovery. We look to the logit and linear regressions to assess how much the turnaround strategies contribute to recovery from financial distress after controlling for a number of these factors.

Table 8 shows the logit and linear regressions of recovery to positive Z score and the change in Z score two years post-distress from that in the

[14] Tests of difference in median intensities based on the Mann-Whitney Wilcoxon test yield similar conclusions to those based on the t-test except that the median equity issue in distress year + 2 by non-recovery firms is significantly lower than for recovery firms.

[15] However, a dividend cut or debt restructuring may merely contribute to survival. Thus it is a necessary, but not a sufficient, condition for subsequent recovery.

Table 7. Intensity of restructuring by recovery and non-recovery firms in response to financial distress

Restructuring strategy	Distress year			Distress year + 1			Distress year + 2			Distress years 1 + 2		
	Recovery	Non-recovery	t statistic	Recovery	Non-recovery	t statistic	Recovery	Non-recovery	t statistic	Recovery	Non-recovery	t statistic
Operational restructuring	2.85	2.41	0.81	1.53	2.80	2.07[b]	1.72	3.51	1.75[c]	3.48	6.95	2.55[b]
Asset sales	5.35	4.74	0.77	8.01	10.70	1.09	9.07	14.30	1.18	17.28	23.25	1.09
Acquisition	19.13	22.27	0.76	13.09	20.78	1.32	13.12	14.74	0.34	27.44	31.50	0.50
Capital expenditure	13.54	14.68	0.64	16.80	18.64	0.47	19.55	19.80	0.04	36.50	39.07	0.28
Dividend change	–3.05	–9.03	0.87	2.58	–16.35	1.66[c]	16.59	–31.71	3.61[a]	15.99	–40.99	2.51[b]
Equity issue	0.76	1.16	1.34	5.22	9.29	1.24	4.28	2.34	1.02	17.80	23.78	0.60

Notes: This table shows the intensity of restructuring by recovery and non-recovery firms. Operational restructuring is measured by the cash expended on restructuring as reported in the company's cash-flow statement/pre-distress year total assets. Asset reduction, acquisition and capital expenditure are measured by the cash flows received expended/pre-distress year total assets. Dividend change is the change in current year dividends per share/the pre-distress year dividend per share. Equity issue is measured by cash raised by equity issue/pre-distress year total assets. Differences in means between recovery and non-recovery firms are tested by t tests. Significance levels at 1%, 5% and 10% are indicated by [a,b,c]. Sign of t statistic not shown.

Sources: Datastream International and Company Reports and Accounts.

Table 8. Logit and multiple regressions of recovery and change in Z score two years after distress, on intensity of restructuring strategies and control variables

	Logit regression Model 1		Linear regression Model 2	
	Coeff.	p	Coeff.	p
Operational restructuring	–3.33	0.17	–11.90	0.03
Asset sales	–0.50	0.55	–1.88	0.31
Acquisitions	–0.43	0.40	–1.42	0.20
Capital expenditure	0.30	0.58	–0.08	0.94
Managerial restructuring	–0.03	0.93	–0.15	0.85
Dividend change	0.31	0.07	0.62	0.08
Equity issue	–0.17	0.68	0.29	0.75
Debt restructuring	–1.56	0.02	–6.08	0.00
Internal cause of distress	0.35	0.43	1.02	0.28
Severity of distress	0.16	0.13	0.47	0.03
Firm size	0.05	0.67	0.15	0.56
Economic condition	0.01	0.87	0.13	0.25
Industry condition – distress year + 1	–0.10	0.35	–0.11	0.63
Industry condition – distress + 2	0.11	0.25	–0.08	0.71
Constant	0.46	0.75	–1.69	0.59
McFadden's R-Square/ Adj R^2	16.9%		25.7%	
Chi-square/F statistic	30.6		5.05	
Regression p-value	0.00		0.00	

Notes: Model: Recovery/change in Z score = f (operational, asset, managerial and financial restructuring intensity and control variables). Logistic and multiple regression coefficients of restructuring strategies and control variables are shown. Debt and managerial restructurings are coded as dichotomous variables. Recovery is defined as return to positive Z score, two years after distress year or as change in Z score two years after distress from pre-distress year's Z score. Control variables are internal cause of distress, severity of distress, firm size and external environments during the restructuring period. Internal problem refers to reported internal problems such as project failures, bad acquisitions or poor financial management. Severity of distress refers to Z score in the distress year. Size is measured by the log of total assets. External environment during restructuring refers to economic and industry condition in the two years after distress. Economic condition is measured by the GDP growth rate in the two years after distress year. Industry condition is proxied by the Z score of the median firm in the sample firm's FTA industry sector, in the same period. Existence of an internal cause of distress is represented by dummy variable 1, 0 if otherwise. Coefficients are tested for significance using the Wald/t-test statistic.

pre-distress year on intensity of restructuring strategies and control variables.[16] As the outcome of restructuring is recovery or non-recovery, logit regression in Table 8 measures the impact of explanatory variables on the logarithm of the likelihood of a firm recovering or non-recovering. Linear regression complements the logit regression by capturing the magnitude of recovery as represented by the Z score change two years after distress.

The signs of coefficients in both logit and linear regressions are quite similar. The R^2 of both regressions is between 17% and 26%, proving that restructuring strategies explain a significant part of the recovery story but a substantial part remains unexplained. Higher intensity of operational restructuring appears to be associated with negative, rather than positive, Z scores. It is also negatively related to change in Z score. Dividend change is positively related to recovery but it is only weakly significant. In other words, dividend cut/omission is not an effective recovery strategy. Yet, as we have seen earlier in Table 7, non-recoverers resort to dividend cut/omission with increasing intensity over the turnaround period. Non-recoverers' resort to debt restructuring is again ineffective.

Asset sales appear to be adopted by both recoverers and non-recoverers with the difference between them not significant. Other restructuring strategies are not significantly different between the two groups. Surprisingly, none of the control variables except severity of distress contributes significantly to recovery. Nor do they make it more difficult. The less-severely distressed firm i.e. with a higher Z score in the distress year achieves a significantly higher level of recovery. As we control for several factors in our multiple regressions in Table 8 that may potentially impede or facilitate recovery, the lack of effectiveness of more intensive strategies raises questions about the quality of implementation especially in the early years of distress. These questions can only be answered by a close scrutiny of the organizational decision and implementation processes within the recovery and non-recovery firms.[17]

[16] Since recovery is measured by the return to pre-distress performance, i.e. positive Z score, the extent of recovery is the change in Z score two years post-distress from the pre-distress year's Z score.

[17] It may be argued that the factors associated with non-recovery in the models in Table 8 – operational restructuring, dividend change, debt restructuring – may have been triggered by severity of distress, thus potentially causing a collinearity problem. Lai (1997, ch. 9) investigates the impact of severity of distress on the choice of the three restructuring strategies one at a time using logit models and including a range of other

Summary and conclusions

How firms faced with potential bankruptcy avoid that fate and turn themselves around is of profound importance to those firms, their stakeholders and the economy at large. In both finance and strategy literature we find a range of prescriptions of turnaround strategies. These studies also provide reasons why these often fail. In this study we compare the strategies of recovery and non-recovery firms in a sample of 166 financially distressed UK firms, and evaluate their effectiveness. We examine the frequency, timing and intensity of use of the prescribed strategies including operational, asset, managerial and financial restructuring.

The results show that higher proportions of non-recovery than recovery firms restructure their operations, cut/omit dividends and restructure their debts in each of the two post-distress years. Non-recovery firms also appear to restructure more intensively than recovery ones, significantly so in the case of operational restructuring and dividend cut/omission. Our univariate analysis and multiple regressions show higher levels of such restructuring to be associated less with the probability or size of recovery.

This result does not point to restructuring strategies being the cause of non-recovery. Indeed, some of the restructuring actions taken by non-recoverers in the later years of distress may be occasioned by the failure of actions in the earlier years. The major difference between recovery and non-recovery firms is that, with the latter, ineffectiveness of restructuring in early years leads to more intensification of strategies. However, when the restructuring intensity is cumulated over the post-distress years, these strategies nevertheless do not contribute to recovery.

We also find that the strategic choices of recovery and non-recovery firms diverge over time with recovery firms choosing investment and acquisition to lead them out of trouble, whereas non-recovery firms are more internally focused on operational and financial restructuring. The shifting pattern of the relative frequencies of different turnaround strategies suggests that recovery firms adopt more forward-looking, expansionary and external market focused strategies than non-recovery firms, which are still preoccupied with internal changes. This preoccupation is consistent with the behaviour of sharpbenders observed by Grinyer, Mayes and McKiernan (1988, ch. 4). The shifting pattern is also consistent with the two-stage turnaround process noted by Bibeault (1982), Robbins and Pearce II (1992) and Slatter (1984).

Our analysis of the time pattern of restructuring activities by distressed firms suggests that they should be examined over time, allowing for the long-drawn out nature of recovery and for the feedback effects of early-stage strategies. Such a temporal analysis provides more insight into the dynamics of corporate recovery than analysis of single-period strategies. Recovery strategies are not one-shot actions, but may be calibrated to respond to the pace of recovery or the effectiveness of earlier actions. Thus the temporal pattern of deployment of recovery strategies may differ between recovery and non-recovery firms and be conditioned by the success of earlier strategies.

Intensive adoption of prescribed restructuring strategies is an insufficient condition for corporate recovery from poor performance. Our research emphasizes the need to explore the process and microstructure of turnaround strategies and identify factors impeding their

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determinants such as corporate governance, board structure, creditors' monitoring etc in the distress year and the two post-distress years. The models include many variables that are a priori expected to influence the choice of restructuring strategies. Severity of distress is one of these. He finds that severity of distress does not influence operational restructuring in any of the three years. It increases the likelihood of dividend cut or omission in all three years but it is one of two or three other determinants. The explanatory power of the logit model is in the range of 13% to 16%. Thus the association between severity and dividend change is very modest. Severity of distress significantly increases the likelihood of debt restructuring only in two years, distress year and distress year + 1. Again it is one of two or more significant determinants. The explanatory power of the models is modest at about 15%. Thus, while severity of distress is indeed associated with at least dividend change and debt restructuring, the degree of collinearity is quite low (Lai, 1997, ch. 9). Further, in spite of this collinearity, all four variables – severity of distress, operational restructuring, dividend change and debt restructuring – are significant in the linear model in Table 8. Thus, while severity of distress is correlated with dividend change and debt restructuring, the correlations are not strong enough to invalidate the results in Table 8.

effective implementation, as suggested by Barker III and Mone (1994) and Hoffman (1989).

We have focused on generic turnaround strategies suggested in the literature, while controlling for broad industry-wide influences through industry proxies. These may not fully capture the dynamics of performance decline and recovery in specific industries, partly accounting for the low explanatory power of our multivariate models. This also explains why we observe, counter-intuitively, a large similarity between recovery and non-recovery firms in the use of many restructuring strategies. This emphasizes the need to identify turnaround strategies beyond the generic ones. How firms in specific industries achieve turnaround in response to industry-specific causes of financial distress is an interesting area of further research, requiring a rigorous conceptual development. This framework can map out a precise strategic link between causes of distress, e.g. technological uncertainty or failure of expected market for the industry's products to develop, and turnaround strategies in an industry and suggest more refined proxies for the latter. Large industry-specific samples would then allow a robust testing of the conceptual model predictions.

Further research may also include other turnaround strategies such as revenue enhancement strategies which, for want of publicly available data, were excluded from the current study. Such an extension may strengthen the conclusions reported here. Strategies such as top-management replacement have an indirect impact on financial performance. The length of time required for the effect of a strategy to show through in the firm's financial performance is indeterminate. Future research needs to refine its methodology to overcome these limitations.

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Restructuring Valuation

– Towards a Framework of Principles to Mitigate Multi-Party Valuation Fights in Workouts –

Given the current market unrest and turbulent economic climate, we see an increasing focus on the need for business restructuring and debt workouts, partly fueled by the changes in legislation in the area of financial restructuring outside of insolvency proceedings. Obviously, this also affects the practice of business valuators. Simply put, the need for valuation support in restructuring cases (we coin the term “Restructuring Valuation”) is growing, both out-of-court and in-court.

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I. Introduction

Business restructuring can be described as the holistic process of taking strategic, organizational, leadership, and financial measures to recover a company's short and long-term viability. A workout can then be described as a voluntary agreement concluded between the affected parties with a financial interest in a company in distress and regards the review of conditions pertaining to available funding. It often constitutes a reduction of nominal debts through payment of a percentage in combination with remission of (part of the) remaining debt, a so-called "haircut".

Another option is the conversion of (part of the) debt into a subordinated loan or a so-called "debt holiday", i.e., temporary relief from installment repayments and or interest obligations. A "debt-for-equity swap" is another possible option, where lenders become (part) shareholders in exchange for a certain degree of debt alleviation leading to the debt burden being relieved.[1]

In this article, we focus on common bottlenecks in such processes, specifically those of valuation fights. Research and practice show that workout negotiations are often hindered by or even fail due to disagreements on the (perceived) value of the company to be restructured. Lengthy debates and negotiation processes are not uncommon, during which the financial state of the distressed company further deteriorates, and chances of survival often disappear. Moreover, perceptions can vary in such a way that dissenting parties simply cannot bridge the value gap consensually. For example, in our first contribution to this journal, we discussed a restructuring case in which there was a (maximum) difference between the calculated valuation outcomes of two parties of EUR 171 million.[2] Obviously, these differences in opinion – often leading to multi-party valuation fights – are detrimental, if not fatal.

We first discuss research on why restructurings fail in practice. We then address the problem of so-called cognitive biases and "noise" – as potential drivers of valuation fights in workouts. Third, partly based on results from an explorative study, we present a "framework of principles to mitigate multi-party valuation fights in workouts".

II. Why restructurings fail and the role of valuations

There is a great deal of empirical evidence for why restructurings fail. We include a list of the most common failure factors:

- Management and shareholders have a passive attitude towards the necessary restructuring, i.e., there is a lack of urgency to quickly take harsh measures.
- Partly because of the above, insufficient strategic, operational improvement, and cost-cutting measures are taken. Moreover, necessary business model change is neglected, commonly referred to as "management is rearranging the deck chairs on the Titanic" thus not handling the underlying problems.
- The company is unable to provide sufficient insights to key stakeholders into the actual financial situation, i.e., stakeholders are in the dark about the current and short-term cash position.
- Lack of a proper business turnaround plan. The plan should serve as a compass for company management in the turnaround process, not least in the negotiation process with lenders.
- Objective cashflow prognostications, showing a certain degree of going concern viability, are missing.
- Reliable valuations of the company are unavailable, and stakeholder negotiations are frustrated by different perceptions and multi-party fights on the value of the company. The result is an ongoing negotiation process in which parties increasingly take set positions, often fueled by their valuation advisors. Meanwhile, the company drifts into a state of bankruptcy.
- For the most part, because of the above, the company is unable to timely access bridge capital, for instance in the form of a cash injection from (new) lenders and or shareholders. Bridge capital should serve as the "oxygen" for a distressed company to explore and discuss long-term options with its key stakeholders, as well as to provide the company enough time to „fix the business".[3]

It is probably no surprise that these failure factors are in fact opposite and, consequently, supportive (like a "mirror") to the success factors of business restructurings as found in practice. Furthermore, these factors often tend to stem from the execution rather than the planning process itself. In other words, the behavior of management and key stakeholders regarding the problems is critical.

1 For an overview of financial instruments, see among others, A Toolkit for Corporate Workouts, Washington: World Bank Group, 2022.

2 Broekema/Adriaanse, Valuation Ambiguities under the European Directive on Preventive Restructuring Frameworks: Insights from the Netherlands, The European Business Valuation Magazine, vol. 1, no. 1 (2022): 4-10.

3 For an overview see Slatter/Lovett, Corporate Turnaround, Managing Companies in Distress, 1999; Adriaanse/Van der Rest (ed.), Turnaround Management and Bankruptcy, Routledge Advances in Management and Business Studies, 2017.

For the purpose of this article, it is important to stress that the chances of survival of a distressed company significantly increase when parties quickly agree on the reorganization value (i.e., assuming a renewed going concern premise) and liquidation value, as this brings clarity on the fair and economic position of all parties involved. This then opens the way for constructive and more objective (or better: less subjective) negotiations between management, lenders, creditors, and shareholders on the way forward, and on who should bear losses, and to which extent. This is often referred to in the insolvency industry as "being in or out of the money". However, although this sounds logical, practice is far more capricious, with factors like "cognitive bias" and "noise" playing a major role in restructuring valuations. We elaborate on this in the following section.

III. The problem of biases and "noise" in valuations

In recent years, the topic of "psychology in business" has been gaining popularity, both in academia and in practice. Academic research in the valuation and insolvency law domain is increasing, especially regarding decision-making processes. For example, empirical research shows that judges, bankers, valuation experts, and insolvency law experts are susceptible to many forms of cognitive biases or „fallacies" when in a situation where they are required to make rational judgments and professional decisions.[4] These professionals are not alone in this; all human beings are susceptible – no one is infallible.

Biases can be defined as patterns of irrationality i.e., humans can be affected in their judgments and decisions by factors that should if they were to behave fully rationally, not have any bearing on these judgments and decisions. A number of common biases observed in the field of restructuring valuation are:[5]

- *Engagement bias:* In experimental research by Leiden University, it was found that business valuators tend to unconsciously favor their client's interests. They adjust the perceived value of a company significantly downwards when representing a buyer, and upwards when representing a potential seller. The same information and valuation method were used; therefore, the theoretical outcomes of the experiment should have been similar. In valuation restructuring practice we observe the same phenomenon; we are rarely confronted with a valuation outcome that intuitively contradicts the economic interest of the represented party.
- *Anchoring bias:* In the same study, it was also found that business valuators are susceptible to anchoring bias, i.e., when confronted upfront with a desired result – expressed through an anchor like a value – from a client's perspective (in the specific context of this article, this could be lenders in a debt workout who desire a certain low outcome to justify a debt-for-equity swap). It unconsciously leads to an outcome in the range of that result. A control group, that did not receive any information upfront about the desired result, was significantly less likely to adjust an outcome in a certain direction.

Obviously, these biases form a breeding ground for (destructive) conflicts in a workout situation.

Another disturbing topic is the psychological concept of "noise", a phenomenon that has recently gained interest due to the work of Nobel prize winner *Daniel Kahneman*, together with fellow researchers *Oliver Sibony* and *Cas Sunstein*.[6] Noise concerns the occurrence of unwanted variability in judgments that should in fact be identical (or at least more or less equivalent) when asked to a group of experts with similar professionalism. It is therefore not about bias. The latter rather concerns a systematic deviation in a certain direction, while noise lacks systematics. However, it should be noted that noise may also occur within the phenomenon of bias. The starting point is that with an accurate decision, all decision-makers (read in this context: professional business valuators) should end up approximately in the middle of an imaginary dartboard („*bull's eye*"). Thus, they all take (roughly) the same decision based on a specific case description and equal information. Where the decisions actually go in all directions, that is noise. Incidentally, the possibility of an accurate or correct/best decision (the bull's eye) does not always play a role.

This also applies to valuations in a restructuring situation. However, this does not lessen the problem of noise. Even when no (in)correct answer is possible, a large degree of variability is undesirable, especially in a workout context where a high degree of variability leads to multi-party conflicts, uncertainty, and possibly, a drift into bankruptcy.

4 For instance, Broekema/Strohmaier/Adriaanse/Van der Rest, Are Business Valuators Biased?: A Psychological Perspective on the Causes of Valuation Disputes, Journal of Behavioral Finance, vol. 23, no. 1 (2022): 23-42.

5 Authors acknowledge that up till today, more than 150 biases have been discovered in the social sciences. For further study see, among others, Ghisellini/Chang, How Many Real Biases Are There? In: Behavioral Economics, Palgrave Macmillan, 2018.

6 Kahneman/Sibony/Sunstein, Noise. A Flaw in Human Judgment, London, 2021.

Decades ago, the American judge Marvin Frankel drew attention to major differences in perception, analysis, and decision-making by professionals, although he did not call it "noise" at the time. He commissioned a study of the judgments of fifty judges on a series of cases that were identical for each participant. He concluded, "Absence of consensus was the norm". As an illustration, the sentence for a heroin dealer ranged from one to ten years, and in a judicial case of blackmail, the sentences ranged from a $ 65,000 fine to twenty years in prison.

Other studies also show a similar, significant degree of noise in judgment and decision-making. For example, research into a thousand verdicts from juvenile courts in America showed that stricter sentences were handed down on Mondays if the local American Football team had lost the weekend before, an effect which also trickled down to the rest of the week, albeit to a lesser extent. That the mood of a judge influences a verdict has also been demonstrated in France. An analysis of six million judgments over a period of twelve years demonstrated that judges were more lenient if it was the suspect's birthday. Finally, a four-year study of 270,000 asylum applications found that an asylum application was less likely to succeed on hotter days.

In short, noise in professional judgments apparently arises from relative differences between evaluators, their personal characteristics, and arbitrary situational factors.[7] In this article, it is relevant to observe that valuation professionals are probably also vulnerable to noise. Combined with the biases, this leads to the conclusion that many valuation conflicts in corporate workouts probably arise due to at least these psychological aspects. In the next section, we discuss whether it is possible to mitigate their effects.

IV. A framework of principles to mitigate valuation fights in workouts

A review of the literature shows that, in practice, mitigating biases and noise is difficult. For example, even when decision-makers are explicitly made aware of the fact that biases may occur, they still can be trapped. However, it is worthwhile exploring ways to mitigate biases and noise, especially in cases where specific strategies and principles for practice are developed. We present a framework of principles to mitigate potential valuation fights. We first discuss the conceptual idea behind such standards. Then, we present seven specific principles for workout practice and discuss how these should be applied in the field.

1. The conceptual idea behind principles

The literature on the impact of principles on professional performance is mixed, with some studies reporting little evidence of a significant effect, with others demonstrating a more significant impact.[8] In particular, research in the private sector, where most business valuators operate, highlights the importance of effectively implementing principles as part of a learning process that involves instillation, reinforcement, and measurement. However, a sudden and full adherence to new principles to address biases and noise in restructuring valuation practices may be unrealistic given the autonomy of professionals in the field. Nevertheless, a framework of principles with a certain purpose (mitigating biases and noise as proposed in this article) serves as a reflection of the need to protect both the private interests of the profession – read: *credibility* – and the public. In this specific case, we refer to stakeholders in a restructuring context, with economic and legal rights that need to be respected and protected.

The extent to which the implementation and enforcement of the principles we propose will benefit the valuation profession and the restructuring field requires further study, but findings in a similar area provide a starting point. In 2000, INSOL International – a worldwide federation of professionals with over 10,500 members who specialize in turnaround and insolvency – introduced the „Statement of Principles for a Global Approach to Multi-Creditor Workouts".[9] It was drawn up by more than 150 restructuring experts and endorsed by the World Bank, the Bank of England, many international commercial banks and consultancy agencies, as well as the British Bankers' Association (with 320 banks as members; established in more than 60 countries).

The core of this statement – consisting of eight principles to be applied in restructurings and workout negotiations – soon became recognized by professional stakeholders in the restructuring field, who now regard the principles as a *best practice* for dealing with complex workout negotiations.

The main characteristics of the eight principles are summarized in table 1.

7 For further information on the studies see Partridge/Eldridge, The Second Circuit sentencing study: A report to the judges of the Second Circuit. Federal Judicial Center, 1974 and Chen/Loecher, Mood and the Malleability of Moral Reasoning: The Impact of Irrelevant Factors on Judicial Decisions, 2016.

8 For an overview of the literature on (the difficulty of) debiasing strategies and principles in practice, see among others Morewedge/Yoon/Scopelliti/Symborski/Korris/Kassam, Debiasing Decisions: Improved Decisions Making With a Single Training Intervention. Policy Insights from the Behavioral and Brain Sciences, vol. 2, no. 1 (2015): 129–140.

9 For more information see www.insol.org. In 2017 a slightly revised version of the statement was introduced under the name „Statement of Principles for a Global Approach to Multi-Creditor Workouts II".

Table 1: Summary of principles of the INSOL Statement of Principles for Multi-Creditor Workouts

Principle	Characteristic
1	The relevant creditors voluntarily mark time, i.e., create an informal cooling-off period
2	None of the creditors takes any individual action on the condition that their relative positions remain intact
3	The debtor (the company in financial difficulties) does not take any actions which may jeopardize the relative (economic) positions of the creditors
4	To speed up the communication and decision-making process, creditor groups are formed (groups of secured, senior, and junior creditors for instance)
5	To be able to evaluate proposals for solutions, the debtor must grant the relevant creditors timely and full access to all relevant information
6	All proposals for workout agreements must be formulated based on prevailing legislation and the relative economic positions of the creditors
7	All information must be available and should be treated confidentially
8	When new (bridge) financing is provided during the restructuring and as part of a workout deal, it must be given priority status by all participating creditors

The fundamental objective of the INSOL principles can be defined as follows: (i) jointly creating a relatively stable situation where none of the parties take any individual action to prevent a chaotic and, for the company, potentially life-threatening "race to collect"; (ii) to create a free flow of information on which all parties within the process can take informed decisions, without worsening their relative economic positions. In other words, this informal set of principles ensures:

> "...a cooperative basis by which lenders/creditors recognize individual and collective risk at a point in time and keep that balance throughout an agreed debt recovery strategy [workout] that seeks to preserve business".[10]

The INSOL statement underlines two aspects. First, it shows that professional practitioners can and will use principles when it is (potentially) beneficial for desired outcomes. In the case of workouts, this is a more efficient process with less risk and more benefit for all stakeholders involved. Second, a specific statement of principles to mitigate valuation fights as proposed in this article may help to spur the chances of success of a workout in which the INSOL principles are already applied. More specifically, it can help mitigate conflicts between involved parties regarding their economic positions (see principle six).

To conclude, the general lack of formal regulations ("hard law") in the field of business valuation means that the use of informal principles ("soft law") might counteract the effects of bias and noise among valuators in the context of workouts. This approach seems well suited to the nature of the valuation profession, and the underlying idea is supported through the widespread adoption of soft principles and standards by other professional organizations, such as federations of corporate professionals (accountants, lawyers, brokers, bankers) and organized professionals such as surgeons or archivists. Principles may also serve as practical guides for ethical behavior, beliefs, and evaluations, as formal rules are commonly too restrictive for that purpose.

2. Exploring a framework of principles

In this section, we present the framework of principles to mitigate multi-party valuation fights in workouts [hereafter: the framework]. We first introduce the methodology followed by a detailed substantiation of each step of the framework.

a) Methodology

The framework has been inspired by previous research into the use of principles and the application of principles used in different professions.[11] We used this as a starting point and tailored it to the specific context of workout situations.

b) The seven principles framework

The overarching objective of the seven principles is to help increase the chances of survival of distressed companies. The principles should be seen as mutually supporting (co-dependent) and together they form an entity – the framework.

Principle 1: Valuation biases, noise, and workout conflicts awareness training

Part of business valuators' education should be mandatory training to create awareness around biases, de-biasing strategies, and noise, especially in the context of workouts. The underlying aim of this training program is to enable business valuators to experience the (negative) effects of their own biases, what noise is, and how biases are formed by others. Participation in this awareness training program will contribute to preventing unconscious decision-making processes in the context of business valuation and workouts.

10 See World Bank Group, op. cit. (footnote 1): 31.

11 Among others see Wessels/Boon, Soft law instruments in restructuring and insolvency law: exploring its rise and impact, TvOB, no. 2 (2019): 53-64.

Moreover, valuators should train themselves in the specific field of corporate turnaround and financial restructuring to understand the (basic) concepts: (i) cause of decline analysis, (ii) strategic analysis and risk assessment in distressed situations, (iii) turnaround planning, (iv) insolvency legislation, and (v) stakeholder dynamics in restructuring. Although this may sound obvious, it is our experience that not all valuators understand the specific complexity and challenges of companies in distress. For example, the "hold-out" problem with creditors or the uncertainty surrounding commercial opportunities of distressed companies when financial problems become public can result in going-concern scenarios "overnight" becoming insolvency scenarios. Furthermore, company management – the prime provider of input information for the valuation process – might be too optimistic or have other reasons to claim and substantiate (perceived) going concern value.

Simply put, the valuation of a distressed company is often far more complex than the valuation of a successful, fast-growing, or mature company. To conclude, valuators' being aware of and understanding "distress dynamics" is crucial to mitigate conflicts in practice.

Principle 2: Debiasing and noise-reducing information processing protocol

Biases and noise often result from exposure to irrelevant and or prejudiced information. To reduce this risk of bias and noise, such information should be withheld from a business valuator. To protect the executive business valuator from being exposed to potentially predetermining information, a second person (i.e., the lead valuator) conducts the intake with the client and filters out the irrelevant information.

As discussed, engagement bias leads to business valuators unconsciously favoring their clients' wishes, while from a purely theoretical perspective, it should not matter to valuators whether they work for, in the case of workouts, the company, its shareholders or (a syndicate of) lenders. By building in a "filter" to separate irrelevant information, for instance, prejudiced, unsubstantiated opinions about the market, the company itself, and/or its strategic outlook, from relevant, substantiated, objectified information, deviations are (theoretically) mitigated. As a result, conflicts among parties regarding value outcomes decrease.

Principle 3: Avoiding knowledge of the client's value perception

When business valuators are asked to value a business or a business interest in a workout situation, they should avoid having any knowledge of the client's value perception towards the valuation object, either through the client or through the client's representative. This principle specifically addresses the phenomenon of anchor bias.

Financial distress concerns a situation in which the stakes are high, the more because the parties involved (e.g., lenders, shareholders) realize that their investments are likely to (partially) vaporize. This can initiate the "race to collect", where parties try to get as large a "piece of the pie" as possible. Clearly, while involved in intense restructuring negotiations, these parties will regularly pressurize the hired valuator to devise a favorable outcome for them, given the specific situation and legal or economic position.

As an example, shareholders will probably want to avoid a debt-for-equity swap as with that they (fully or partly) lose economic and or voting rights. With that in mind, the so-called reorganization value of the company should be as high as possible as then shareholders will be "in the money", in a theoretical liquidation scenario. The consequence is that lenders cannot, in principle, force shareholders to give up shareholder rights because, in a pure theoretical bankruptcy scenario, all lenders should and will be satisfied. Thus, shareholders have an incentive, as clients, to pressurize business valuators to propose an outcome that proves otherwise. If not, they might put pressure on the business valuator to adjust the outcome with "suggestions", for example, alternative insights on the company and its market or the cost of capital.

We earlier introduced the phenomenon of engagement bias, so in the scenario sketched above, this increases the risk of business valuators (unconsciously) being manipulated. Alternatively, this may also occur when lenders are the valuators' clients, with a preference for a low outcome, for example, to merely make a debt-for-equity swap happen. To conclude, the business valuator should avoid interference from the client as much as possible while executing the valuation process, in particular about the preferred outcome for the workout deal to be negotiated.

Principle 4: Signaling subjectivity and performing a debiasing and noise-reducing exercise with a colleague

When business valuators are engaged through a client or another professional such as an insolvency lawyer to support a client's interests, they should be aware of any subjective party information that might influence their perceptions regarding the valuation object. At the initial stages of the engagement, the business valuator must check which elements might affect the perception of the valuation case using a practical "valuation biases and noise checklist". When finalizing the valuation work, valuators then compare their work with the initially listed elements together with at least one colleague who was not engaged in the project and amend the valuation assumptions if necessary.

Principle 5: Criteria setting on quality of valuation to align mutual expectations

When business valuators are requested to conduct a valuation in a workout situation, the executive business valuator discusses (principle 2) the (non-technical) client evaluation criteria before conducting the valuation. In case of doubt regarding mutual expectations, the executive business valuator takes the initiative to discuss this with the business valuator. The topics of “potential valuation biases and noise” must form part of the discussion with the client.

Principle 6: Four-eyes principle

Business valuators should, through confidential conversation, discuss their valuation assumptions and valuation outcomes with at least one colleague, the Four-eyes principle. Preferably, the discussions should include several peers before releasing the final valuation report. The topic of “potential valuation biases and noise” should explicitly be discussed and documented among engaged peers.

Principle 7: Mirroring to assess the “other party” perspective

Business valuators should always consider an alternative valuation scenario – in addition to their initial valuation outcome – from the perspective, position, and potential criticism of their client’s counterpart(s). The initial valuation outcome should then be reconsidered and amended if necessary. In a workout situation, this means that at least one or two additional perspectives should be considered, for example from the lenders’ and or shareholders’ point of view if the business valuator represents company management, and vice versa.

V. Conclusion

In this article, we introduce a framework of principles to mitigate valuation conflicts in workouts. The framework has been designed to serve as a discussion starter for the professional business valuation field. The urgency to discuss the role of business valuations in financial restructurings is especially relevant because of the increasing turbulence in the European business climate. Simply put, “the restructuring season is starting” and the business valuation community should be critical of its role in the restructuring field. Lessons need to be learned, and practices should be improved to ensure the profession is considered fully credible in the eyes of the other parties at the workout table, including insolvency practitioners, lenders, creditors, and board members.

It is evident that the debate on how valuation fights can be mitigated in workouts should also take place among the sector organizations active in or relevant to the international restructuring practice e.g., the European Association of Certified Valuators and Analysts (EACVA), the International Valuation Standards Council (IVSC), valuation professional organizations (VPOs), INSOL International and INSOL Europe. The international academic community can also make an active contribution to establishing mitigation principles. Meanwhile, individual business valuators can apply the principles proposed in this article, or critically review the current use of self-developed principles and quality procedures in this regard. ◆

Business Valuation is a Question of Trust

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The European Business Valuation Magazine

1

Page 1 – 63
Volume 1
Issue 1, Fall 2022

Articles

Data

News

IVSC VPO's Introduce Themselves

Editors:

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Valuation Ambiguities under the European Directive on Preventive Restructuring Frameworks

– Insights from the Netherlands –

Increasing attention is currently being paid to the topic of business valuation related to the implementation of the European Directive on Preventive Restructuring Frameworks. This directive essentially aims at preserving value for those companies which are, in principle, economically viable, yet which are experiencing financial (cash) difficulties. However, opposing views by creditors on the value of these companies and on the extent to which a creditor should waive a claim makes the valuation process susceptible to unwanted external pressures. Using a recent landmark case in the Netherlands as example, this article discusses valuation-related ambiguities and bottlenecks that may negatively affect the outcome of the restructuring process. Possible remedies to mitigate these effects are proposed.

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I. Introduction

1. Background

In 2019, in the aftermath of the 2008 global financial crisis, the European Union (EU) adopted the European Directive on Preventive Restructuring Frameworks ('the Directive')[1] as part of a broader program to create a Capital Markets Union (CMU) in Europe. Originally, the Directive was to be transposed into national legislation by the 27 EU Member States no later than 17 July 2021. Although several Member States – including the Netherlands – had already translated the Directive into national legislation before this date, some Member States have requested a postponement until 17 July 2022.[2] Historically, most Member States have neither offered a court-supervised possibility to implement a debt restructuring plan based on the approval of the majority of creditors (outside of a formal insolvency procedure) nor have they felt any urgency to implement such a sophisticated hybrid restructuring process. Nonetheless, in the aftershock of Covid-19, many companies in Europe need to restructure yet want to avoid formal bankruptcy. Policy makers and practitioners are now being pressured to develop and implement efficient restructuring procedures and best practice principles.

2. The Directive at a Glance

The many publications related to the Directive indicate that its objective is twofold. First, it aims to minimize discrepancies between Member States concerning the range of restructuring tools available to debtors in financial distress, partly to avoid so-called "bankruptcy tourism". Second and more important, the Directive aims to prevent the insolvency of economically viable businesses and seeks to preserve as much economic value as possible by facilitating early and relatively easy access to preventive restructuring frameworks characterized by both informal and formal – hence hybrid – elements. To achieve these overarching goals, the Directive introduced several workout instruments such as moratorium proceedings to facilitate the negotiation process, and the so-called cross-class cram-down that allows a restructuring plan to be confirmed – subject to several conditions – by a judicial or administrative authority even if the plan was not approved by all classes of creditors. Furthermore, the debtor-in-possession proceeding was introduced, meaning that company directors should be able to remain in control of the company during the restructuring process instead of being replaced by an administrator or trustee. These newly introduced tools should facilitate debtors in (i) restructuring their business, (ii) minimizing the risk of dissenting creditors obstructing a fair and realistic restructuring plan, and (iii) aligning the restructuring process across all EU member states.[3] From the creditor's perspective the Directive also offers certain advantages. First, the restructuring plan can only be confirmed if the going-concern value of the company exceeds its liquidation value, proving that the underlying business is viable. Second, the best-interests-of-creditor-test ensures that creditors should never be worse off under a restructuring plan when compared to liquidation proceedings.

Considering the new Directive, two important valuation concepts come into play. The first is the liquidation value and the second the reorganization value; concepts already known under the US Chapter 11 procedure. In general, the reorganization value can be defined as the enterprise value of the reorganized debtor[4] whereby the enterprise value can then be interpreted as the net present value of future free cash flows or, from a going-concern perspective, the value in which the debtor's future earning capacity should be considered.[5] More specific, in the context of WHOA, reorganization value can be equated with the company's total enterprise value and defined as the value distributable for the company's existing capital providers (i.e., shareholders and non-operational creditors) at the time of the confirmation of the restructuring plan and in accordance with their (legal) rank.

Both liquidation value and reorganization value appear straightforward, but in reality, their application turns out to be less so. As the concept refers to the reorganized debtor, the going-concern value should be determined after the restructuring plan's implementation, a process susceptible to many assumptions. In practice, the complexities in both valuation concepts can lead to serious disputes due to conflicts of interest between the different stakeholders of the subject company, be it (not limited) shareholders, management, senior and junior lenders, trade creditors, as well as tax authorities.

Disputes in bankruptcy cases regarding the debtor's enterprise value are relatively underexplored in the academic literature. Nonetheless, in practice, valuation and restructuring experts frequently disagree strongly about the key inputs in both a Discounted Cash Flow (DCF) and multiples-based valuation, although disagreement about the key inputs occur more frequently in DCF compared to the latter.[6] In this context, determining a hypothetical going-concern value

1 European Union, Directive (EU) 2019/1023, 26.06.2019, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32019L1023, last access 07.05.2022.

2 This article was finished and submitted before July 2022.

3 IVSC, Mitigating valuation risks arising from the new EU restructuring directive, 28.05.2021, www.ivsc.org/mitigating-valuation-risks-arising-from-the-new-eu-restructuring-directive/, last access 28.05.2022; preliminary memo and speaker notes by Broekema (18.05.2021).

4 Pantaleo/Ridings, Reorganization Value, The Business Lawyer, Vol. 51 (1996): 419-442.

5 Eu, Valuation Issues in the UK Restructuring Plan, NUS Law Working Paper 2021/001 / EW Barker Centre for Law & Business Working Paper 21/01 (2021): 1-27.

6 Ayotte/Morrison, Valuation Disputes in Corporate Bankruptcy, 166 U. PA. L. REV. 1819 (2018): 1819-1851.

for a company subject to some degree of distress and in urgent need of a workout solution with creditors is a potential tinderbox. It often leads to fierce debates between stakeholders, given that economic claims and interests on the value of a reorganized debtor may have to be waived. Moreover, defining the future of a company without distress is often less complex and sensitive than that of one which must undergo a tough restructuring and operational turnaround process, and whose nature of operations and assets may change as a result. Consequently, there is inherent uncertainty in estimating a hypothetical going-concern value compared to the observable cash distribution sum in a liquidation value[7] due to time constraints, ambiguity of information, and the unavailability of and inaccessibility to relevant and objective inputs required for the valuation.

II. Valuation Challenges and Implications for Practice: insights from the Netherlands

The Directive was implemented in the Netherlands on 1 January 2021 and is known as the Act on the Confirmation of Private Plans (in Dutch: "WHOA"[8]). To illustrate the relevance of business valuation and subsequent challenges under the Directive, a recent landmark case in the Netherlands[9] has shown that stakeholders have strongly divergent views on the debtor's financial outlook and performance, as reflected in a substantial range of values. For the context it is important to emphasize that, as is generally the case with other schemes under the Directive, the WHOA provides a framework on the basis of which the court can ratify a private debt restructuring agreement informally negotiated between a company and its creditors and shareholders, i.e., without active intervention of a judge along the way. Approval means that the agreement is binding to all creditors and shareholders involved in the agreement. Interestingly, the WHOA acknowledges two types of procedures, namely the public and closed agreement procedure, which is of importance for reasons, amongst others, of confidentiality.

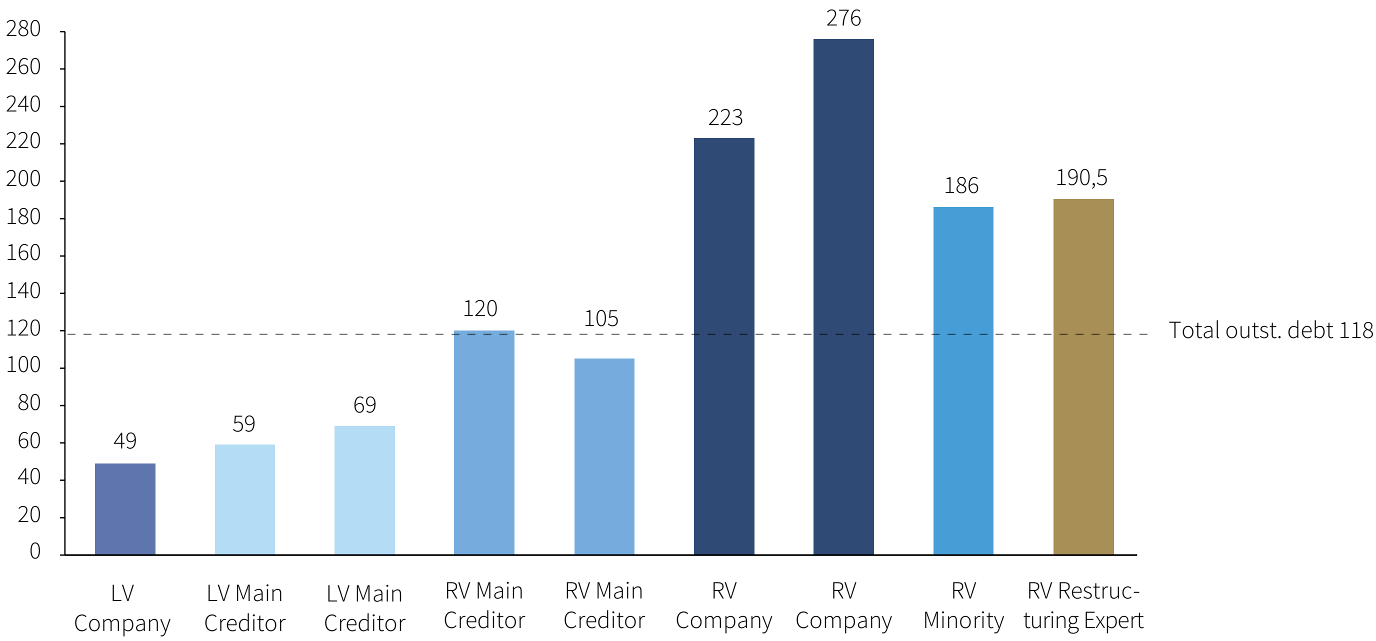
This article uses the aforementioned landmark case example in which an undisclosed company faced financial difficulties following the Covid-19 pandemic. The company was financed by equity contributions of its (indirect) shareholders and by debt through a senior facilities agreement facilitated by a group of financiers, de facto controlled by one main creditor with a senior ranking.[10] Based on the recently implemented WHOA and through a closed agreement procedure, the company offered, after informing its creditors about a proposed so-called stay, a restructuring plan to its creditors mainly involving a postponement of interest payments, temporary non-testing of covenants, and some technical adjustments of the facilities agreement. Based on the proposed restructuring plan, the shareholders were also willing to provide an equity contribution of €4 million. The main creditor on the other hand, demanded an early loan repayment and wanted to exercise their (security) rights. Furthermore, the main creditor requested the court to appoint an independent restructuring expert (a legally defined role within WHOA[11]) as they had little confidence that the debtor's management would take sufficient account of their interests when preparing and offering a definite restructuring plan. The WHOA stipulates that each creditor may request the appointment of a restructuring expert who can take the lead to offer a plan to (some of) the debtor's creditors and shareholders. If this request is granted by the court and the expert is appointed, the debtor may no longer offer a plan independently while remaining a debtor-in-possession. As the majority of the creditors (the main creditor represented over € 107 million of the debtor's total outstanding debt of € 118.0 million[12]) supported a court-appointed restructuring expert, the court decided in favor of this request.

Additionally, the WHOA stipulates that a restructuring plan (in this case proposed by the restructuring expert) must inform the creditors and shareholders of the debtor's liquidation and reorganization value. Hence, both the company, the shareholders, and the main creditor hired professional, independent valuation experts to determine these two values. Yet where the debtor's valuation experts determined the liquidation value at € 49.4 million, the main creditor's two valuation experts determined a liquidation value of € 58.6 million and € 69 million, respectively. Based on the calculated liquidation values it appeared that in the event of liquidation of the debtor's assets in a bankruptcy, it was to be expected that the distribution of proceeds would be insufficient to cover the main creditor's entire claim. In other words, the liquidation value 'breaks' into the creditor's debt. However, in this case the liquidation value was not a topic of debate between parties and any existing difference of opinion following from the calculated liquidation values would not result in different outcomes.

When it came to the reorganization value the views were not the same given the different valuation assumptions used. First, valuation experts hired by two minority shareholders and some creditors determined the reorganization value at € 186.3 million. The valuation experts on behalf of the company determined the debtor's reorganization value

7 Determining the liquidation value may not be as straight forward as it seems and may also involve a fragmented asset sale where assets (e.g. business units) are continued on a going-concern basis.
8 The Dutch name for Act on the Confirmation of Private Plans is Wet Homologatie Onderhands Akkoord, hence abbreviated as WHOA.
9 ECLI:NL:RBAMS:2021:6521, https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBAMS:2021:6521, last access 30.05.2022.
10 In the case at hand, there was also a creditor with a super senior ranking however for the purpose of this article her position will remain undiscussed.
11 In Dutch named "Herstructureringsdeskundige".
12 ECLI:NL:RBAMS:2021:1876, https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBAMS:2021:1876, last access 30.05.2022.

Figure 1: Liquidation Value (LV) and Reorganization Value (RV)



at € 222.6 million and € 275.7 million, respectively. Finally, the main two creditor's valuation experts determined the debtor's reorganization value at € 105 and € 120.4 million, respectively. For the record, at that time, the debtor's total outstanding debt was € 118.0 million (book value). The figure above presents an overview of the different values that illustrate the opposing views of all parties involved. Interestingly, the company considered a much higher reorganization value compared to those determined on behalf of the main creditor, indicating the main creditor was in the money while the main creditor considered themselves to be out of the money.

The independent restructuring expert decided – although not legally obliged under WHOA – to engage an independent valuation company[13] unrelated to the interests of the parties involved, to determine the reorganization value from an objective and neutral view; this resulted in a reorganization value of € 190.5 million. Thereafter, the court considered that the independent valuation expert made it sufficiently plausible that the debtor's reorganization value exceeded its debts, so that the value 'breaks into the shares', i.e., that the company was in principle viable thus suitable for a workout plan and vote under WHOA. Finally, the court confirmed the restructuring expert's plan that had been accepted by a majority of the (classes of) creditors, which resulted in the need for a cram-down.

Needless to say, the presence of multiple, diverging valuations on behalf of different classes not only results in the process taking more time than planned. It also increases the risk of a further decline in value and even a possible bankruptcy scenario as the company will remain in a state of distress during this period.

III. Causes of Diverging Value Perceptions

While in general, practice shows that valuation outcomes often diverge in cases of opposing interests, estimating an enterprise value is even more sensitive in restructuring issues, as in this case. As the legal framework may force parties to waive part of their claims, in certain situations it can also give parties legal rights to pull the business strategically or opportunistically towards them by means of a debt-for-equity swap.

Causes of diverging value perceptions in restructuring processes are, in theory, many, so for the context of this article the authors discuss a selection. For example, Richter & Thery argue that uncertainty plays a prominent role as there is no real market verification. They state: "Another disadvantage of restructuring is that, although it may be chosen democratically and even legitimately by a majority of creditors, it involves a certain amount of uncertainty as to the enterprise value because there is no real market verification. The creditors do not divide the cash proceeds among themselves but instead have to resort to estimates of enterprise value which are unlikely to be as convincing. Based on those estimates, they will have to reinvest their liquidation distribution in exchange for which they will receive a paper under the Plan representing their pro-rata share of the restructuring value. And not all creditors will always be equally convinced by such reinvestment."[14]

13 For full disclosure, the authors of this article were hired by the independent (court-appointed) restructuring expert to act as independent valuation experts.

14 Richter/Thery, Claims, Classes, Voting, Confirmation and the Cross-Class Cram-Down. INSOL Europe (2020): 1-45.

Earlier, Baird & Bernstein recognized that uncertainty and ambiguity accompany any valuation procedure, however the valuation problem in a reorganization case is fundamentally different compared to more 'regular' cases, as uncertainty plays a more prominent role.[15]

Another cause of diverging value perceptions relates to the opposing interests of the different classes in which parties with a claim or interest in the debtor are categorized. Such opposing interests are possibly caused by creditors' risk appetite, their policies and other principles (e.g., tolerance, attitude, preference) that they adopt in order to pursue their interests. The allocation of 'creditor class' is of importance to the creditor because the reorganization value defines which class the creditor concerned is in, and therefore which classes are in the money or out of the money, i.e., who is for example eligible for a debt discharge or not (often referred to as a "haircut"). Consequently, categorizing those with a claim or interest into classes can result in diverging valuation perceptions depending on their position within the value distribution. Interestingly, according to Baird & Bernstein, small differences in valuation assumptions can easily lead to changes in the valuation by 10% or 20%; these assumptions can therefore easily be driven by forms of self-interest.

A third cause of diverging value perceptions may be attributed to cognitive biases. These can be defined as systematic patterns of irrationality human beings are exposed to. Their powerful effects on human judgments, particularly in situations characterized by high degrees of complexity and uncertainty, were revealed in the early seventies of the last century by the renowned social scientists Tversky & Kahneman.[16] Recent empirical research by Leiden University among valuation experts[17] has shown that perceptions are also susceptible to other biases, including the recently described "engagement bias".[18] The researchers defined engagement bias as when business valuators (or any professionals for that matter) are hired, they (consciously or unconsciously) are affected in their judgments to favor their clients' interests. In an experimental empirical survey study the researchers determined that when valuation experts represent their client's interest, this relationship affects the valuation experts' judgments so that these are more in tune with their client's wishes. If their client is looking to sell and would therefore benefit from a high valuation, the valuator gives the object a higher value than when the valuator represents a buyer who would benefit from a lower valuation.

Interestingly, when participants were asked to motivate their answers regarding the adjustment of the valuation, none of them hinted at the potential influence of engagement bias, and the researchers therefore assumed that engagement bias operates largely unconsciously, as well as that the participants had the tendency to rationalize their intuitions regarding the company's value post-hoc.

Furthermore, the researchers argued: "more worrisome in light of the impending aftermath of the COVID-19 pandemic, engagement bias ultimately risks unduly liquidating economically viable companies when the liquidation value of a company is erroneously deemed higher than the going-concern value after restructuring, or contrastingly the allocation of significant resources to save companies that in reality have little chance of surviving." In analogy to previous research, valuation experts representing the interests of creditors in potential in the money or out of the money classes in restructurings may thus be affected by the same engagement bias, with potentially the same consequences as in the case of buying or selling a company. In line with the literature challenging the independence of auditors, the researchers demonstrated that due to engagement bias, valuators' professional judgments can be overshadowed by the urge to satisfy clients, ultimately leading to suboptimal valuations and loss of value. Moreover, it may potentially broaden and extend disputes that might arise or have already risen between the different classes. Meanwhile, the distressed company may drift further into failure.

In practice, it is worthwhile exploring which remedies could mitigate strongly diverging valuation outcomes or, at least, contribute to a higher level of acceptance of valuation outcomes both by courts and individual stakeholders of the subject company. The case example may provide clues: these are discussed in the next section.

IV. Remedies to Minimize Valuation Disputes in Restructuring Contexts

In the case in this article, both the restructuring expert, the independent valuation team, and the engaged legal advisors quickly realized that some sort of engagement bias may have played a role, thus explaining the diverging valuation outcomes. They also understood that the independent valuation outcome could become subject of lengthy debates with and among the stakeholders. Given the company's problematic situation, this obviously was unwanted as it could jeopardize the chances of a fast and successful restructuring and with that, the prospects of survival. It was also thought that the broader the support base for the independent valuation outcome, the better the chance of successful negotiations with stakeholders, i.e., consensual agreement, or at least only a small part of the creditors that would need to be "cram-downed" under the WHOA.

15 Baird/Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale Law Journal (2006): 1930-1970.

16 Tversky/Kahneman, Judgment under Uncertainty: Heuristics and Biases: Biases in judgments reveal some heuristics of thinking under uncertainty. Science, Vol. 185 (1974): 1124-1131.

17 The authors were members of the research team.

18 Broekema/Strohmaier/Adriaanse/Van der Rest, Are Business Valuators Biased? A Psychological Perspective on the Causes of Valuation Disputes, Journal of Behavioral Finance, 23:1 (2022): 23-42.

To achieve this, it was decided by the independent restructuring expert to ask the court permission to hire an independent strategy consulting firm as part of the valuation process with the prime task of reviewing the company's business plan, as well as scrutinizing and validating the underlying assumptions regarding market outlook. With that, the inputs for the valuation calculation by the independent valuation team was largely objectified. By then giving all relevant stakeholders the chance to review the results and to give feedback, a further remedial step was taken to minimize diverging opinions and to create common ground for the eventual valuation outcome.

Based on the literature and the approach chosen by the hired consulting firm, a set of questions has been developed that may, in practice, help to objectify the valuation inputs in a restructuring situation. In essence, these should, help answer the one main question, i.e., despite its current debt-structure and given the market outlook, is the company able to survive?

Viability

The literature shows that many factors determine the viability of firms.[19] Taken together, these factors indicate that four key questions must always be addressed when assessing viability in a restructuring process:

1. Is the centrally defined customer need that can be solved with a product or service within the range of the unique resources, core skills, and competencies available to the enterprise, and can that be converted into positive cash flows?
2. Does the synthesis between the company's (idiosyncratic) resources match customer needs (i.e., strategic fit), or has a suitable market been found for this (i.e., resource-based approach)?
3. What strengths and weaknesses does the company have in relation to its (direct) competitors: what comparative (i.e., in resources) and what competitive (i.e., in market position) advantage and disadvantage does the company have, respectively?
4. Which external factors (e.g., political-legal, economic, socio-cultural, and technological) constitute opportunities, threats, and risks to the company's future revenue model?

Furthermore, the four questions can be divided into nine value-related clusters including specific (sub)questions. These clusters align with the following theoretical and conceptual perspectives: *Resource-Based View of the Firm*[20], *dynamic capabilities of firms*[21], *business models*[22] *and governance and accounting.*[23]

(1) Value proposition

1. How does the firm create value with the delivered products/services?
2. Who are the customers/target groups?
3. In what customer need do the products/services provide?
4. How distinctive are the products/services compared to competitors – for example in quality/price?
5. Does the company have an established customer base, good reputation?
6. Are there alternatives/substitutes with respect to the products/services, and how threatening are these in terms of quality and price?
7. Which marketing channels and promotion does the company use, and are they appropriate?
8. Which problems do the products solve for the customer; where exactly do the products derive their value and are customers willing to pay cost-effective prices?

(2) Value developments

1. How big is the market and what are the market's main (expected) developments in the next 3-5 years?
2. Is it a growth market or a declining market, and is it an innovative, dynamic and competitive market?
3. Can the company continue to distinguish itself from (potential) competitors?

(3) External value net [network of external stakeholders]

1. Who are the company's main (external) stakeholders and to what extent does the company depend on them?
2. Is the company under pressure from powerful stakeholders?
3. Who are the main competitors, is new entry taking place, and how does the company compare to its main competitors in terms of cost, quality, and image?

19 This section is partly based on [in Dutch] Adriaanse/Verdoes/Van der Rest in: Kerstens/Rikkert/Broeders/Feenstra (editor), Wet Homologatie Onderhands Akkoord, Insolad Jaarboek 2021: 1-20; See also Thomson, Dimensions of Business viability, Appendix H. Dimensions of Business viability (2005), http://bestentrepreneur.murdoch.edu.au/; D'Souza/Wortmann/Huitema/Velthuijsen, A business model design framework for viability; a business ecosystem approach, Journal of Business Models, no. 3, ed. 2 (2015): 1-29.

20 See e.g., Barney, Firm Resources and Sustained Competitive Advantage, Journal of Management, volume 17, issue 1 (1991): 99-120; Amit/Shoemaker, Strategic Assets and Organizational Rent, Strategic Management Journal, no. 14, ed. 1 (1993): 33-46; Kraaijenbrink/Spender, Theories of the Firm and Their Value Creation Assumptions (presentatie), SMS 31st Annual International Conference, Miami, US, 2011.

21 See e.g., Teece/Pisano/Shuen, Dynamic Capabilities and Strategic Management, Strategic Management Journal, no. 18, ed. 7 (1997): 509-533; Bowman/Ambrosini, Value Creation Versus Value Capture: Towards a Coherent Definition of Value in Strategy, British Journal of Management, no. 11, ed. 1 (2000): 1-15; Bowman/Ambrosini, Identifying Valuable Resources, European Management Journal, no. 25, ed. 4 (2007): 320-329.

22 See e.g., Teece, Business Models, Business Strategy and Innovation, AJIBM, no. 2 (2010): 172-194; Morris e.al.,The entrepreneur's business model: toward a unified perspective, Journal of Business Research (2005); D'Souza/Wortmann/Huitema/Velthuijsen, A business model design framework for viability; a business ecosystem approach; Journal of Business Models, no. 2 (2015): 1-29.

23 See e.g., Bushman/Smith, Transparency, Financial Accounting Information, and Corporate Governance, Economic Policy Review, no. 9 (2015): 65-87; Monks, Creating Value Through Corporate Governance, SSRN Paper 314284 (2003); Moxey/Berendt, Creating value through governance – towards a new accountability: a consultation, London: ACCA (2014).

(4) Internal value chain and valuable resources
1. Which unique (comparative) resources (including intellectual property) does the company have at its disposal and can these be shielded (sustainably) from competitors?
2. What is the distinctive core of the enterprise from which it derives its uniqueness? And to what extent do products and services fit these core competencies?
3. To what extent is there an internal and external fit between the sources and products brought together?
4. How firm are the contracts that the company has concluded with its internal and external stakeholders?
5. What processes/activities does the company perform, and is it necessary for the company to perform them itself? Are there possibilities to outsource or (other) flexibilization of costs?
6. Is the production process efficiently organized?
5. Does the company focus on its core competencies?

(5) Adaptive value
1. Is the company flexible and adaptable in terms of material, personnel, and financial?
2. Can the enterprise react to changing circumstances and developments in the value chain?
3. To what extent is the company bound by contracts?

(6) Risk value [risk factors that can destroy value]
1. How sensitive is the value creation (and derived cash flows) to changes in turnover and cost structure?
2. What are the short and long-term risks represented by means of a PESTLE analysis (i.e., Political, Economic, Social, Technological, Legal, Environmental factors) and a SWOT analysis (i.e., Strengths, Weaknesses, Opportunities, Threats)?
3. Is the company dependent on a (major) customer(s), or supplier(s) or other stakeholders (e.g., landlords)?

(7) Governance value [management and oversight]
1. Is there a clear, streamlined information system and rules and procedures?
2. Is the management capable of giving direction, making choices, and motivating staff?

(8) Financial value
1. What do the key ratios liquidity, solvency and profitability look like, and what are the expectations?
2. What do the forecast cash flows look like and how do they relate to the repayments?

(9) Miscellaneous and ancillary value [additional value-creating or value-destroying elements]
1. Are there company-specific factors that could impede viability?
2. Is there conflict within the company, an impending departure of a crucial stakeholder, or disputes among stakeholders?

These clusters make the underlying narrative logical and visible, and show implicit assumptions, hypotheses, and/or paradigms in a coherent, transparent, and holistic way. This makes the viability issue more testable and, when used as inputs for the cashflow assumptions, more objective.

In sum, it can be stated that in the case study, it helped parties overcome some of their diverging opinions and even when differing beliefs persisted on some issues, the strategy process as a whole helped to create common ground and “language” for negotiations. To conclude, it largely contributed to the eventual successful confirmation of the plan.

V. Conclusion

To minimize valuation disputes in restructurings under the Directive, business practice benefits from a jointly supported business valuation, something that often appears to be a utopia rather than a reality. Nevertheless, one of the Directive’s aims is to prevent insolvency of viable businesses and preserve their inherent value by facilitating early access to preventive restructuring frameworks. Instruments that contribute to minimizing loss of value and legal costs following extensive debates on the distressed debtor are thus worthwhile exploring, with the aim of enhancing a distressed transaction (e.g., a debt discharge under WHOA) that is fair to all parties. In this context, the concept of fairness can best be understood in terms of fair dealing and fair price, as exemplified by the Delaware Court of Chancery[24]: “fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, and negotiated, and how the transactional approvals were obtained” and, “fair price focuses on the economic and financial considerations of the challenged transaction.”[25] In this article we have described complexities related to valuation in restructuring, as well as providing practical insights and ideas for remedies against valuation ambiguities, such as the appointment of both fully independent valuators and strategy consultants in the course of the early (informal) restructuring process, in order to create common ground and (a higher degree of) fairness. ◆

24 A non-trial jury court recognized as US’ most prominent forum for handling corporate disputes and involving the affairs of thousands of companies including the majority of Fortune 500 companies and those listed on the New York Stock Exchange and NASDAQ (see Broekema/Strohmaier, From Leiden to Delaware: How empirical legal research on valuation biases was used in a US courtroom, Leiden Law Blog (2022), www.leidenlawblog.nl/articles/from-leiden-tot-delaware-how-empirical-legal-research-on-valuation-biases-was-used-in-a-us-courtroom, last access 30.05.2022.

25 See Laster, Memorandum Opinion Addressing Claims for Breach of Fiduciary Duty in Connection with Freeze-Out of Minority Partners in Salem Cellular Telephone Company (2022), https://law.justia.com/cases/delaware/court-of-chancery/2022/c-a-no-6885-vcl.html, last access 30.05.2022.

INSOL INTERNATIONAL

GLOBAL INSOLVENCY PRACTICE COURSE

Work Out Clinic

Professor Jan Adriaanse
Dr. Marc Broekema

University of Leiden
Kroll

About us

- *Jan Adriaanse*
  - Professor of Turnaround Management, Leiden University
  - Director at Kroll, Amsterdam

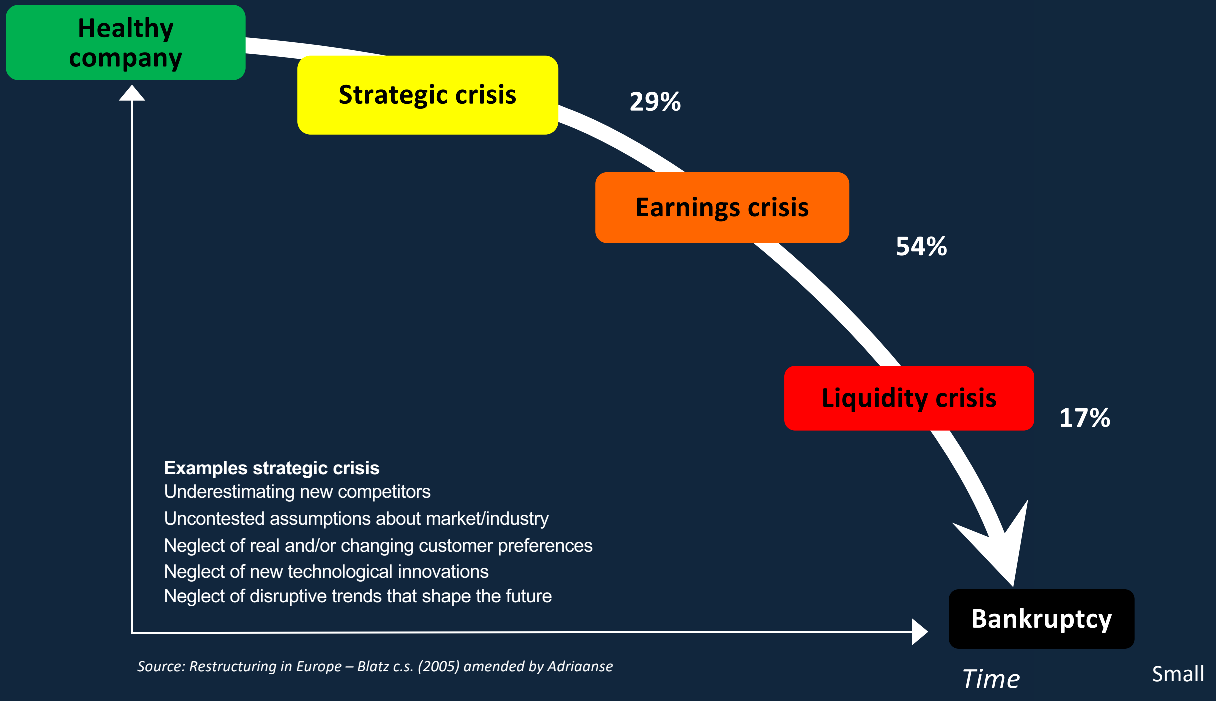
- *Marc Broekema*
  - Managing Director at Kroll, Amsterdam
  - Assistant Professor at Leiden University
  - Lay judge at the Enterprise Chamber of the Amsterdam Court of Appeal

- *Expertise and background*
  - Specialized in restructuring valuatoin and dispute valuation, business turnaround plans, and economic analysis in litigation
  - Recent example: valuation advisor for Steinhoff International re Dutch Scheme (WHOA)
  - Founders of valuation and investigation firm BFI which was successfully acquired by Kroll in 2023.

Agenda for today

- Why do companies drift into workouts?
- INSOL Turnaround Workout Game
- Valuation issues in debt workouts

Why do companies drift into workouts?



Examples strategic crisis
Underestimating new competitors
Uncontested assumptions about market/industry
Neglect of real and/or changing customer preferences
Neglect of new technological innovations
Neglect of disruptive trends that shape the future

Source: Restructuring in Europe – Blatz c.s. (2005) amended by Adriaanse

Some psychological explanations…

- Curse of success
- Groupthink ('harmony bias')
- Optimism bias
- Overconfidence bias (illusory superiority / hubris)
- Confirmation bias

INSOL Turnaround Workout Game

Playing a game: let's rescue the Utopia Hotel-Casino Group. Or not…?

Your important task for today…

- Save a 1,500 employees hotel-casino business
- Try to come to an “informal workout agreement” (and with that the rescue of the company)
- Training goal: “restructuring in the shadow of the law” i.e. rescuing without using judicial rescue procedures
- Background: informal workouts create less “value destruction” than formal routes however holdout problem and free-rider behaviour of stakeholders can occur

Six stakeholder groups

- O = Owners (1)
- A = Lender A (2)
- B = Lender B (3)
- C = Lender C (4)
- TA = Tax Authority (5)
- TC = Trade Creditors (6)

Two rounds to come to a solution

- **Round 1**: 30 minutes to prepare with your team
  - State/define your position
  - Initiative for 1st meeting taken by Owners

- **Round 2**: 90 minutes negotiation round to come to a (written) workout agreement

Your position in the game...

- Be cooperative and act in good faith yet keep a close eye on your legal and financial position at all times
- Behave the way you would behave in real life... (there are no right or wrong actions)

WHAT IF NO AGREEMENT?

What if no agreement…?

No problem… then company will file for bankruptcy proceedings

Potential bottlenecks however…

- Loss of control
- Negative effect on sales and brand (30%-50% turnover drop)
- Gaming authority has legal right to terminate license immediately
- Judge will only grant moratorium in case of “reasonable probability” that business can be saved and that rescue is better for all stakeholders as compared to immediate liquidation
- …1.500 employees might loose their jobs

So, there seems to be a good reason for an informal solution…

Game in action

A game in action


KEEP
CALM
AND
WORKOUT

Game analysis

Please take some time to evaluate the game together with your team and please answer the following five questions:

1. Did the stakeholders come to a solution? If so, what is agreed?
2. What were the hurdles to overcome in the workout process?
3. What's your team's opinion on the behaviour of the other teams (cooperative, professional, irrational, emotional etc.)? [rate on a scale 1-10]
4. What's your team's opinion on its own behaviour? [rate on a scale 1-10]
5. What are, if any, lessons learned for real-life?

How to make workout routes (more) successful in real-life?

Harvard negotiation framework

1. [People] Adopting a problem-solving approach and not allowing personality differences to side-track this [*dealing with frustrations and prejudgments*]

2. [Interests] Avoiding taking and defending positions but rather concentrating on parties' respective interests *[enlightened self-interest]*

3. [Options] Before making decisions, generating as many options as possible, particularly those creating mutual benefit *[tailor made solutions]*

4. [Criteria] Establishing objective and fair criteria for a resolution, rather than the judgment of either party
    - Turnaround plan (including independent business review)
    - Valuation (independent, unbiased)
    - INSOL Statement of Principles II as guideline for negotiations

Valuation issues in debt workouts

Valuation issues in debt workouts

- A note on cognitive biases
- Why should we care about biases in valuations and workouts?
- Some insights from research and practice

A note on cognitive biases

Biases

- Biases are the <u>result of</u> heuristics: failing to produce a correct judgment resulting in systematic patterns of irrationality in which people deviate from rational judgments.

- Bias refers to a systematic deviation from norm or rationality.

- In other words, bias is a tendency to favor certain outcomes or options over others, without considering all relevant information.

- Bias can occur at the <u>individual</u> level, as well as a <u>group</u> or <u>societal</u> level.

- Distinction between biases and error:
    - Bias refers to a systematic deviation from norm or rationality, whereas error refers to random or unpredictable deviation.

A note on cognitive biases

Cognitive Biases in Finance and Business Valuation

- **Overconfidence bias**: the tendency for individuals to overestimate their own abilities, performance, or outcomes. This bias can occur in a variety of situations, such as in decision-making, forecasting, and self-assessment.
- **Anchoring bias**: the tendency for individuals to rely too heavily on the first piece of information they receive when making decisions or estimates. This bias can occur in a variety of situations, such as in negotiations, pricing, and judgments of probability.
- **Confirmation bia**s: the tendency to search for, interpret, favor, and recall information in a way that confirms one's preexisting beliefs or hypotheses.
- **Self-serving bias**: bias that makes people tend to attribute their successes to their own abilities and characteristics and attribute their failures to external factors.

A note on cognitive biases

Cognitive Biases in Finance and Business Valuation

- **Hindsight bias**: ("I-knew-it-all-along" effect) the tendency for individuals to believe, after an event has occurred, that they would have predicted or expected the outcome, even if they did not have any information or knowledge of the event before it occurred.
- **Outcome bias**: the tendency for individuals to evaluate the quality of a decision based on its outcome, rather than the quality of the decision-making process.
- **Sunk cost fallacy**: the tendency to continue investing in a decision or project because of the resources that have already been invested, rather than based on the potential returns.

Multiple studies on biases

- Legal profession
- Medical profession
- Finance profession

A note on cognitive biases

Importance of recognizing biases in restructuring/workouts

- It can lead to:
  - unfairness, discrimination, and inequality in decision-making and behavior.
  - poor decisions, as biases can prevent us from considering all relevant information.

- Understanding bias is important for individuals, organizations, and society as a whole, in order to make fair and rational decisions.

- By understanding the impact of biases, individuals can take steps to reduce their impact and make more informed and rational decisions.

- This can include using techniques such as:
  - critical thinking;
  - seeking out diverse perspectives;
  - using data and evidence to inform decision-making;
  - organizations can promote diversity, equity, and inclusion to reduce the impact of biases on their decision-making and behavior.

Why should we care about biases in business valuation and workouts?

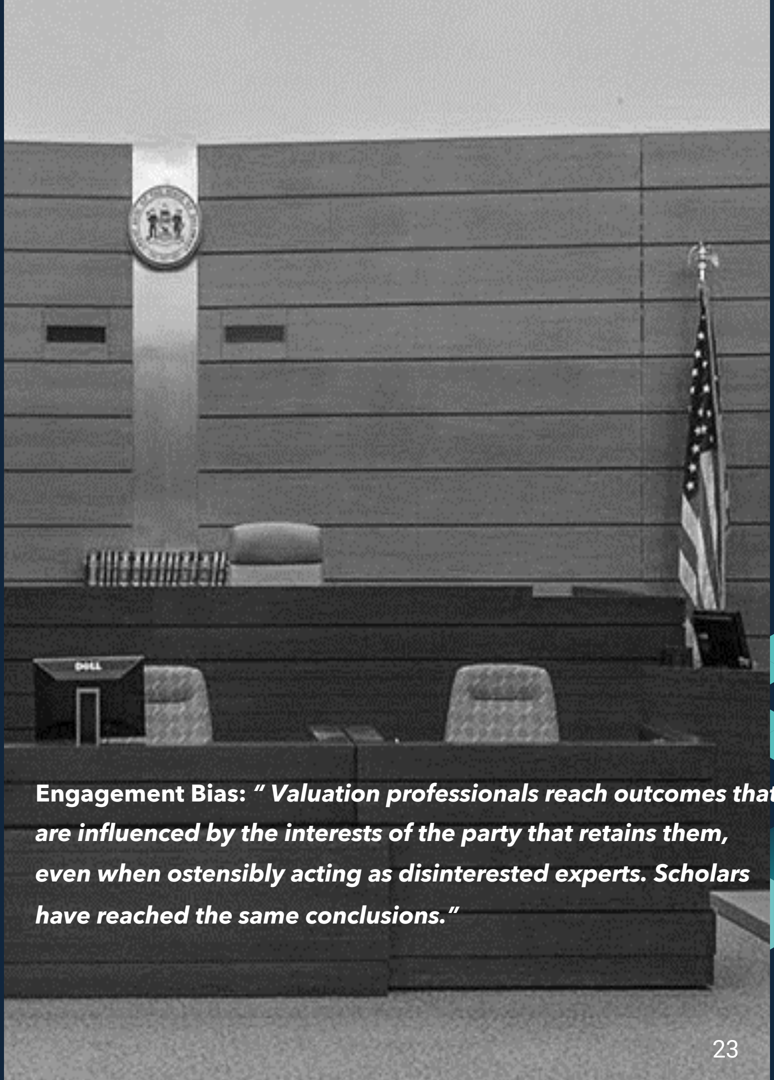
The valuation experts' role in legal cases

- The key role that valuations typically play in corporate and ownership disputes and the detrimental impact that psychological biases can have.
- The independence and objectivity of valuation experts.
- Delaware Court of Chancery in a recent Memorandum Opinion citing Leiden University's research. [1] [2]

[1] Memorandum Opinion Addressing Claims For Breach Of Fiduciary Duty In Connection With Freeze-Out Of Minority Partners In Salem Cellular Telephone Company.

[2] Broekema, M. J., Strohmaier, N., Adriaanse, J. A., & van der Rest, J. P. I. (2022). Are business valuators biased? A psychological perspective on the causes of valuation disputes. *Journal of Behavioral Finance*, *23*(1), 23-42.

For further information on this case: https://leidenlawblog.nl/articles/from-leiden-tot-delaware-how-empirical-legal-research-on-valuation-biases-was-used-in-a-us-courtroom



Engagement Bias: ***" Valuation professionals reach outcomes that are influenced by the interests of the party that retains them, even when ostensibly acting as disinterested experts. Scholars have reached the same conclusions."***

Study: Legal (insolvency) professionals

Sample

- 272 legal professionals from across the world.
- Male and female participants.

Biases studied

- Similarity bias
- Outcome bias
- Gender bias

Hypotheses / Conclusions

1. There is a positive relationship between legal professionals' perceived similarity with a valuator and their trust in the valuation, and the perceived trustworthiness of the valuator mediates the positive relationship between perceived similarity and trust in the valuation.
2. Valuators will be evaluated more negatively following an undesirable outcome of a deal, and more positively following a desirable outcome of a deal.

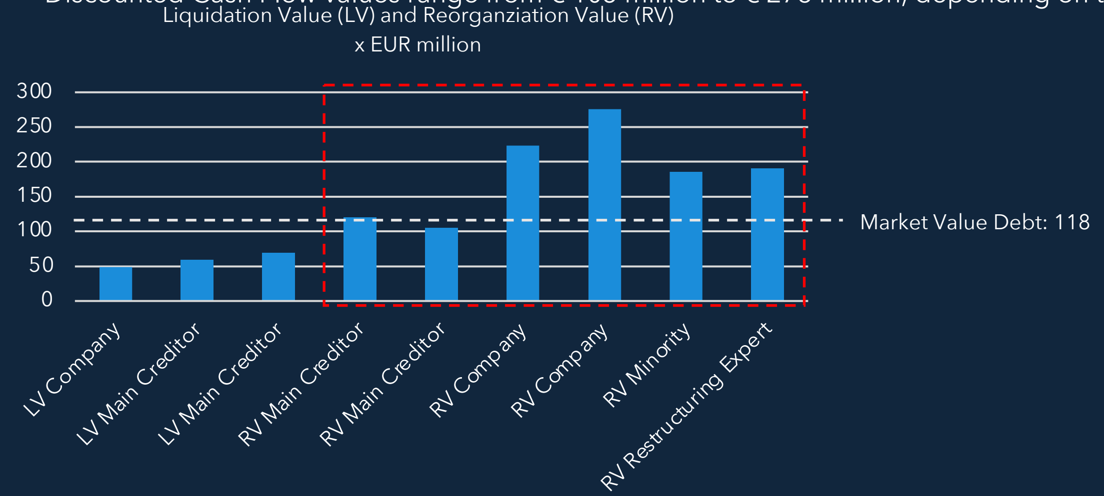
Why should we care about biases in workouts?

- Sound valuations are judged as poor, and poor valuations are judged as sound.
- Widely differing valuation outcomes can increase an existing dispute or even create a new dispute.
- It complicates restructurings/workouts and with that it decreases the chance of a successful outcome.
- Reputation, credibility, and trustworthiness of the valuation profession.
- Possible liability of valuation experts.

Biases in a Restructuring Context

A recent landmark case in the Netherlands

- European Directive on Preventive Restructuring Frameworks >>> “WHOA” (Dutch Scheme).
- The importance of the Restructuring / Reorganization Value.
- In essence, in this context a restructuring is viable when the Reorganization Value exceeds the company’s Liquidation Value.
- Discounted Cash Flow values range from € 105 million to € 276 million, depending on the stakeholder’s position.



On valuation fights in workouts
>>> additional reading (click on picture):

Restructuring Valuation

– Towards a Framework of Principles to Mitigate Multi-Party Valuation Fights in Workouts –

Given the current market unrest and turbulent economic climate, we see an increasing focus on the need for business restructuring and debt workouts, partly fueled by the changes in legislation in the area of financial restructuring outside of insolvency proceedings. Obviously, this also affects the practice of business valuators. Simply put, the need for valuation support in restructuring cases (we coin the term "Restructuring Valuation") is growing, both out-of-court and in-court.

Dr. Marc Broekema

Professor Jan Adriaanse

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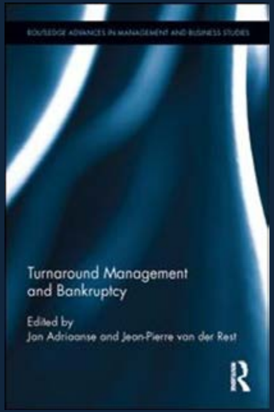
Let’s stay in touch:

More on turnarounds, workouts and bankruptcy…



Turnaround Management and Bankruptcy (Adriaanse, Van der Rest, et al., 2016) presents different viewpoints on turnarounds and business rescue in Europe and beyond. Presenting a state-of-the-art review of failure research in finance, such as on bankruptcy prediction, causes of decline, or distressed asset valuation. It also presents the latest insights from turnaround management research as well as giving a contemporary insight into law debates on insolvency legislation reform, cross-border judicial issues, bankruptcy decision-making by judges and competition policy in distressed economies. Finally, the book provides a regional and sector perspective on how the current crisis affects Europe, its government policies and industry performance.

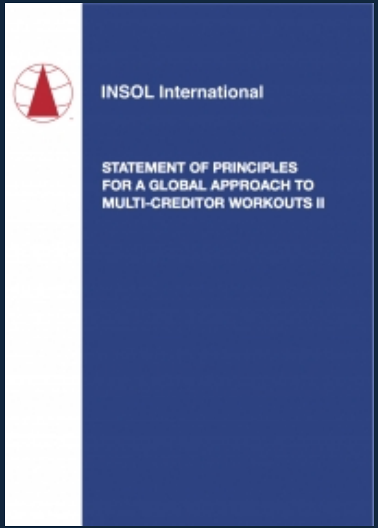
https://www.crcpress.com/Turnaround-Management-and-Bankruptcy/Adriaanse-Rest/p/book/9780367242879

Appendix

How to make workout routes (more) successful in real-life (and avoiding some common biases)?

Creating a more explicit and structured approach in the negotiation process that focuses on (restoring) mutual trust:

- Standstill agreement
- Transparency
- No individual actions allowed by creditors
- No actions allowed by debtor to gain advantage
- Conflicts of interest creditors to be dealt with quickly
- Confidentiality
- Reflection of applicable law (objective criteria Harvard)
- Additional funding prioritized



Appendix

Statement of Principles for a Global Approach to Multi-Creditor Workouts II

First Principle

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

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

Third Principle

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

Fourth Principle

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

Fifth Principle

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.

Sixth principle

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.

Seventh Principle

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

Eighth principle

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

INSOL International | Workout Clinic | GIPC Module A | 2023 2024

Lecturers: Professor Jan Adriaanse & Dr. Marc Broekema

INSOL Turnaround Workout Game

Let's rescue the Utopia Hotel-Casino Group. Or not…?

This case is based upon an existing situation. Details are as accurate as possible yet made anonymous. The case is written for EDUCATIONAL PURPOSES and CLASSROOM USE ONLY *and is NOT INTENDED FOR PUBLIC DISCLOSURE*

Back to the Future…

November 2019, somewhere in Utopia

Welcome to the INSOL Turnaround Workout Game! You are invited to participate in an exciting classroom gameplay. Moreover, you have the challenging task to save a well-known company from Utopia, that employs around 1,500 people. Also, the company is very important for the touristic industry of the country and wider region. Still, you have your own obligations and responsibilities towards the company you work for. Today, the stakeholders are:

- Owners Utopia Hotel-Casino Group company [O]
- Lender [A]
- Lender [B]
- Lender [C]
- Tax Authority [TA]
- Trade Creditors (consortium of two large suppliers) [TC]

Game play

This game consists of 2 rounds [further instructions are provided during the session]:

Round 1: Gather with your new "colleagues" and analyse the case together. Discuss what your position is and what you feel should be the best way forward. You have around **30 minutes** for the group assembly process and preparation with your team members.

Round 2: After Round 1 you are invited to join a meeting with all other relevant stakeholders to discuss the situation of the Utopia hotel-casino company and to express your feelings and ideas about how to move forward. The purpose of the meeting is to come to an **informal workout agreement**. There are **90 minutes** available to come to such an agreement including the standstill terms upon which to agree (see the appendix of this case for the INSOL Statement of Principles that might serve as a guideline and help). If an agreement is not reached after these 90 minutes, company management is forced to go to court to file for judicial reorganisation or liquidation proceedings (**bankruptcy!**) as cash by then has almost dried up... (and director's liability claims should be prevented).

Please bear in mind that all relevant stakeholders are in principle of **good faith** to come to an informal workout agreement. Still, all parties should always keep a close eye on their legal and financial positions.

Are you able and willing to save this company…?

Good luck!

Case: Utopia Hotel-Casino Group

Introduction

The Utopia Hotel-Casino Group (hereafter called: "Utopia Group" or "The Company") is facing a challenging financial situation. With changing market dynamics, the Company's assets, their three hotel-casinos in Utopia, are losing market share and have started to make substantial losses. Limited financial resources have prevented the Company from making large-scale renovations necessary to compete with new entrants or attract customers from hotel-casino alternatives emerging throughout Utopia and the region. As a result, the Company is in financial distress and does not have enough funds to cover current and future obligations.

The problem

Utopia Group currently generates positive EBITDA [Operational Profit]. However, the Company is loss making in terms of Net Profits and remains burdened by a high debt load. Current projections show that the Company will not generate enough cash to meet both interest and debt repayment expenses, and its planned Capital Expenditure (Capex). However, an underlying assumption in the projections analysis is that the management team will make headway in improving the Company's operational and financial health. As such, the projections show gradual operational improvements in the Company's performance. Specifically, these estimates assume greater efficiency and profitability in day-to-day hotel-casino operations and a positive impact from the Company's investment in property renovations.

The company is equally owned by a family of three (father, son, daughter) who together represent company management (CEO, CFO, COO).

A workout or bankruptcy proceedings? That's the question…

Despite the projected improvements, the Company is not able to meet its current interest and debt repayment obligations to lenders/creditors. Therefore, alternatives need to be considered also because most of the lending agreements will expire soon which basically means refinancing. A workout is necessary soon, otherwise the company needs to file for bankruptcy as cash will dry up and suppliers as well as employees can then not be paid anymore. Besides that, if nothing happens, some of the secured lenders will probably start judicial insolvency proceedings themselves, in order to seize the secured assets (the hotel-casinos) and have them sold (whether or not in a "going concern" sales transaction). The Tax Authority might also initiate seizure actions.

Alternatives

Ideally, restructuring solutions should increase value for stakeholders, or to put it differently, it should *decrease value destruction* for all. Some possible workout possibilities are presented below each having pros (benefits) and cons for parties involved given the current situation: (not limited)

Workout possibility	**Considerations/dilemmas**
New Equity Financing	▪ Current shareholders are not able to inject additional cash ▪ Current **shareholders want to keep the company within the family** and do not like the idea of external shareholders
New Debt Financing	▪ Company is not able to provide first lien securities for such financing as all assets are already secured by (some of the) current lenders

Debt-equity swap	▪ Current shareholders will (partly or fully) lose ownership and with that management control ▪ Upon agreement, the risk profile increases for secured lenders ('from risk-avoiding capital to risk-bearing capital') ▪ Return of investment can be substantial for agreeing creditors if the company manages to make a successful turnaround and resumes making profits
Debt write-off ("Haircut") by lenders; partial or full	▪ Secured lenders will probably not favour such route
Sale of specific properties	▪ Current management will probably not favour such idea as operational economies of scale ("synergies") are then weakened
Sale of entire company to a new legal entity ("newco") owned by current creditors based on respective economic positions	▪ Shareholders lose their company so they will probably not favour such option. ▪ Current lenders will only agree when new position ("prospective return") is not weaker than current one

Bankruptcy court
In case an informal workout agreement cannot be reached within the current timeframe, there is always the possibility to step into a judicial reorganisation process ("Chapter 11-like process"). Some considerations and dilemmas regarding such alternative in this situation:

Judicial reorganisation procedure	▪ Current stakeholders lose control over the situation as judges will step in to decide on the course of proceedings. ▪ A public procedure will have a negative effect on the corporate brand-image and will probably lead to substantial cancellations by corporate clients ("events and conferences") and other hotel guests/tour operators. This negative effect can lead to a permanent loss of sales amounting to 30% to 50% of current turnover. ▪ The Utopia gaming commission has the legal right to immediately terminate casino licences in case of (judicial) reorganization or liquidation procedures, unless there is a ***reasonable prospect*** that the company can be saved (and that won bets by gamblers can be paid out). The commission is known for being ***'risk-avoiding'***. ▪ Based on Utopia law, courts can only decide to grant a request for judicial reorganisation, including a so-called automatic stay ("moratorium"), if company management is able to show a ***reasonable probability*** that the business can be saved, and that rescuing is a preferable option for all stakeholders as compared to immediate liquidation of the company.

SWOT Analysis

A SWOT analysis for the Company' current operations, recently made by company management, is outlined below.

SWOT Analysis	
Strengths	**Weaknesses**
▪ Strong brand recognition ▪ Prime locations ▪ Experienced management team who are owners themselves ▪ Long established history in Utopia ▪ Recent upgrades	▪ Balance sheet limitations ▪ Operational inefficiencies versus peers ▪ Deteriorating market share ▪ Aging buildings in need of renovation

▪ Land reserve	
Opportunities	**Threats**
▪ Scarcity of hotel rooms ▪ Upgrade buildings to attract more high-end customers ▪ Expansion into new locations ▪ Margin improvement potential	▪ New entrants into the Utopia market ▪ Change in regulatory environment ▪ Economic downturn ▪ Higher cost of debt (“penalties”) due to current financial situation

Financial situation

Below some information can be found regarding the financial situation and debt structure of the Company as well as expectations (E) regarding profit and cash flow developments for the coming years (USD = US Dollar). Projections are based on a moderate positive scenario. **In a worst-case scenario, the expected turnover should probably be calculated x0.7 (about 30% less than expected in current scenario)**. The valuation of the company’s assets (the 3 hotel-casino properties) was recently done by an independent appraiser. “Holding” includes typical head office activities for all hotels, like HR, accounting, purchasing and ICT (all 3 hotel-casinos currently contribute proportionally to Holding costs).

CONSOLIDATED (USD * 1.000)	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Turnover consolidated	130.000	110.000	90.000	80.000	100.000	130.000
EBITDA	10.300	9.000	7.000	4.000	11.000	18.000
Net profit	3.160	-1.800	-1.370	-3.890	880	5.740
Gross margin/sales	70%	69%	68%	67%	69%	72%
Net profit margin	2%	0%	-2%	-5%	1%	4%
Cashflow from operating activities	9.390	6.580	5.310	3.370	8.330	13.240
Cashflow from investment activities	-7.000	-6.000	-5.000	-4.000	-8.000	-10.000
Cashflow from financing activities	-2.490	-2.550	-2.600	-2.600	-2.600	-2.600
Net cashflow	-100	-1.980	-2.290	-3.240	-2.280	640
Balance sheet total	229.780	254.780	252.230	319.700	272.200	223.200
Solvency (%)	22%	20%	20%	17%	20%	22%
Current ratio	37%	33%	32%	29%	33%	41%

HOLDING (USD * 1.000)	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Turnover consolidated	0	0	0	0	0	0
EBITDA	-3.120	-2.680	-2.170	-1.980	-2.320	-3.020
Net profit	-3.930	-3.810	-3.300	-3.200	-3.440	-3.940
Gross margin/sales	N/A	N/A	N/A	N/A	N/A	N/A
Net profit margin	N/A	N/A	N/A	N/A	N/A	N/A
Cashflow from operating activities	-3.680	-3.540	-3.030	-2.910	-3.140	-3.640
Cashflow from investment activities	-350	-300	-250	-200	-400	-500
Cashflow from financing activities	-2.490	-2.550	-2.600	-2.600	-2.600	-2.600
Net cashflow	-6.520	-6.390	-5.880	-5.710	-6.140	-6.740

HOTEL MASTER (USD * 1.000)	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Turnover consolidated	46.800	38.500	32.400	29.600	36.000	45.500
EBITDA	8.190	6.950	8.570	5.690	8.680	13.790
Net profit	4.080	3.070	4.220	2.050	4.090	7.660
Gross margin/sales	76%	79%	85%	78%	81%	88%
Net profit margin	9%	8%	13%	7%	11%	17%
Cashflow from operating activities	6.440	5.630	6.760	4.810	6.930	10.510
Cashflow from investment activities	-2.800	-2.400	-2.000	-1.600	-3.200	-4.000
Cashflow from financing activities	0	0	0	0	0	0
Net cashflow	3.640	3.230	4.760	3.210	3.730	6.510

HOTEL OAK (USD * 1.000)	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Turnover consolidated	44.200	39.600	32.400	28.000	35.000	45.500
EBITDA	4.550	4.670	3.060	1.940	4.540	6.300
Net profit	1.790	1.760	650	-270	1.510	2.730
Gross margin/sales	72%	71%	68%	69%	71%	72%
Net profit margin	4%	4%	2%	-1%	4%	6%
Cashflow from operating activities	3.780	3.920	2.780	2.050	3.890	5.130
Cashflow from investment activities	-2.450	-2.100	-1.750	-1.400	-2.800	-3.500
Cashflow from financing activities	0	0	0	0	0	0
Net cashflow	1.330	1.820	1.030	650	1.090	1.630

HOTEL GOLD (USD * 1.000)	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Turnover consolidated	39.000	31.900	25.200	22.400	29.000	39.000
EBITDA	3.380	60	-2.460	-1.640	100	940
Net profit	1.230	-1.180	-2.940	-2.470	-1.290	-710
Gross margin/sales	61%	55%	46%	50%	52%	53%
Net profit margin	3%	-4%	-12%	-11%	-4%	-2%
Cashflow from operating activities	2.850	570	-1.200	-580	650	1.240
Cashflow from investment activities	-1.400	-1.200	-1.000	-800	-1.600	-2.000
Cashflow from financing activities	0	0	0	0	0	0
Net cashflow	1.450	-630	-2.200	-1.380	-950	-760

Current debt structure

Stakeholder	**Term loan**	**Outstanding**	**Expiration date**	**Arrears in interest payments**	**Arrears in debt repayment**
Senior debt (secured) Lender [A] (first lien)		69.370	1 January 2020	Yes	Yes
Senior debt (secured) Lender [B] (second lien)		59.460	1 January 2020	Yes	Yes

Working capital facility (unsecured) Lender [C]		9.910	1 December 2019	No	N/A
Tax Authority [TA] (unsecured but right to seize assets)	N/A	17.930	Immediately	N/A	Yes
	The Tax authority in Utopia has a legal right to seize all current assets of a company in case of arrears in payment (in case of this company about 10% of total assets). In practice, the authority is willing to negotiate a workout deal for social reasons (e.g., employment retention) under the restriction that management is honest, and all other creditors are also willing to work on a solution that represents the legal and economic interests at stake in a fair way. In case of a 'haircut' she only accepts an offer that is twice the percentage that ordinary creditors are willing to accept (e.g., in case ordinary creditors accept 25% of the outstanding debt and write off 75%, the tax authority will accept 50% and thus writes off 50%). **Utopian tax inspectors are known to be "tough cookies" in negotiations as they distrust commercial lenders in general.**				
Secured debt provided by shareholders [O] (first lien, "pari-passu" with [A])		10.000	1 January 2020	No	No
Trade creditors [TC] (unsecured)	N/A	48.510	Company currently pays on average after 120-150 days	Payment shall be received 30 days from date of invoice according to contract terms	
	The two trade creditors that are at the negotiation table today can be considered crucial for the company's operations as they supply food & beverages (F&B) and daily cleaning services. It is hardly possible to switch to other such suppliers within 30 to 60 days as current suppliers (who represent about 95% of current trade debt) can be considered monopolists in the high-end hotel-casino industry. Also, new suppliers will probably demand substantial guarantees or cash-on-delivery.				

Valuation of the Company's assets (3 hotel-casino properties)

The valuations are based on the assumption that the hotel-casino properties can be sold relatively quick to e.g., a strategic or financial investor. Whether that is the case in practice remains to be seen and is also dependent on the negotiation skills and business connections of the seller.

VALUATION SCENARIOS (USD * 1.000)	**Out-of-court restructuring (going concern scenario)**	**Bankruptcy reorganisation proceeding (going concern scenario)**	**Liquidation (going concern scenario)**	**Liquidation (piecemeal sale of assets; not going concern)**
Total Group[1]	216.000	101.250	56.160	39.312
Hotel Master	132.360	62.050	34.416	24.091
Hotel Oak	60.480	28.350	15.724	11.006
Hotel Gold	8.990	4.210	2.336	1.635

[1] In case of a Total Group sale a surplus is expected, in any scenario, above the total value of the three individual assets.

Appendix

INSOL International Statement of Principles for a Global Approach to multi-creditor workouts II

First Principle
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.

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.

Third Principle
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.

Fourth Principle
The interests of relevant creditors are best served by coordinating 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 advisors to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

Fifth Principle
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.

Sixth Principle
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.

Seventh Principle
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.

Eighth principle
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.

About the lecturers

Professor Jan Adriaanse is full professor of turnaround management at the Leiden Law School, part of Leiden University. His research focuses on the interdisciplinary field of financial distress, turnaround management and insolvency law. He is also a director at Kroll, Amsterdam.

Dr. Marc Broekema is managing director at Kroll, Amsterdam, lecturer at the Leiden Law School and member of the European Membership and Standards Recognition Board of the International Valuation Standards Council (IVSC). Furthermore, he is a lay judge at the Enterprise Chamber of the Amsterdam Court of Appeal. Together with Jan he founded valuation and investigation firm BFI in 2016 which was successfully acquired by Kroll in 2023.

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