

University of Groningen

## Resolving financial distress in the Netherlands

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*Document Version*

Publisher's PDF, also known as Version of record

*Publication date:*

1997

[Link to publication in University of Groningen/UMCG research database](#)

*Citation for published version (APA):*

Couwenberg, O. (1997). Resolving financial distress in the Netherlands s.n.

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## 6

### Summary and conclusions

In this thesis four firms in financial distress have been studied. The methods the Dutch Bankruptcy System offers to firms to resolve their financial problems have been described, and theories addressing the efficiency of rules and behavior of participants in firms in financial distress have been discussed. These theoretical ideas have been contrasted with the actual behavior of the participants with the four firms in financial distress. In this chapter the answers to the research questions are reviewed and some suggestions for further research are provided.

#### 6.1 Review of objectives

In chapter 1, the objective of the study and the associated research questions have been discussed. The research questions were the following:

- 1) How do Dutch firms resolve financial distress?
- 2) Is the Dutch Bankruptcy System efficient, i.e., does this System not lead to the economically unjustifiable dissolution of firms, and does it not lead to the economically unjustifiable continuation of firms?
- 3) What public policy implications follow from a study of firms resolving financial distress?

To answer the first research question, the Dutch institutional structure and the methods to resolve financial distress have been described. In chapter 3, the second research question has been addressed by discussing incomplete contracting theory and the implied consequences for bankruptcy law. This analysis has yielded hypotheses concerning the behavior of firm participants. However, some of the hypotheses concerning the efficiency of the Dutch Bankruptcy System could not be disconfirmed. In order to disconfirm the hypotheses one would have needed to observe facts concerning the outcome of a strategy which the firm, or some of its participants, did not actually choose. Not one research design can solve this problem; evidence can only be circumstantial. In this study a case study research strategy has been chosen to "test" the hypotheses. The argument has been put forward that in studying actual behavior of participants, one can analyze the influence of rules on that behavior and in this way provide evidence to support the efficiency of the Dutch bankruptcy rules. However, the empirical findings do not support conclusions concerning the entire population of firms in

financial distress. Nevertheless, from the empirical findings conclusions may be drawn concerning theories about financial distress. Below, the discussion is summarized on the issue of how the four firms studied in this book resolved financial distress and why they chose to resolve their problems in the way they did.

### 6.1.1 How do firms resolve financial distress?

In studying the Dutch institutional structure pertaining to firms in financial distress, the term Dutch Bankruptcy System has been introduced as a shorthand to indicate all the rules, regulations and other institutions that determine or influence the process of financial distress resolution. This discussion has led to an overview of the methods firms might use to resolve their financial problems. The literature on the use of the methods - most of it is based on the situation in the United States - and (dis)advantages associated with these methods have been discussed. In the empirical part of this study the distress resolution activities of four Dutch firms have been described. In the analysis of the cases in chapter 5 it has become clear that they could not be considered "average" cases. For instance, the firm recovery rates were much higher than the aggregate recovery rate as published by the Central Bureau of Statistics (section 5.2.3). The reasons why these firms became financially distressed were related to the capital budgeting policy of the respective management teams and unique circumstances, such as recession and managerial problems (section 5.2.1). To resolve these problems, management and its consultants used different methods (section 5.2.2). With respect to these uses, the empirical study into the resolution of financial distress has yielded the following observations:

- i) The private asset restructuring was not used very frequently, probably due to the size of the firms studied (section 5.2.2).
- ii) The private financial restructuring was used in varying degrees by the firms, depending on the time available for (re)negotiations, the legal form of the firm, the attitude of creditors towards a settlement, and the number of participants directly involved in the negotiations (section 5.2.2).
- iii) All four firms resolved their financial distress via an asset sale. The two incorporated firms used the bankruptcy procedure to sell their respective assets. The two firms that were not-incorporated sold their respective assets and also proposed a debt settlement, either privately or in suspension, to their creditors. The debt settlement was necessary to limit the liability of the respective owners and to obtain a price for the assets above estimated liquidation values (section 5.2.2).
- iv) In resolving financial distress, (top)management lost its position, but in three cases was offered re-employment by the buyer on lower organizational levels. All four firms laid off personnel in varying degrees. The larger, incorporated, firms laid off 12% and 50% of the employees, the smaller, not-incorporated, firms 33% and 90%. No information

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could be obtained to determine whether and on what conditions the laid off employees might have found re-employment (section 5.2.3).

- v) Resolving financial distress took a long period of time. Although the sale of assets relieved the respective firms of their financial distress within three quarters of a year, the legal entity in which the activities of the firm originally had been organized, remained financially distressed. The financial distress continued because the sorting out and the ranking of claims of participants took a considerable amount of time (section 5.2.3).

In settling the financial distress of these four firms, high recovery rates were attained: from 36% to 100%. The proceeds of the sale of assets were distributed over the respective creditors. In chapter 2 the absolute priority rule was discussed. This rule holds that junior creditors should only receive monetary compensation when the senior creditors are paid in full. In three cases secured creditors were paid the (estimated) value of their respective collateral, before other creditors were paid. The contractual arrangement these creditors had reached with the respective firms was respected in resolving financial distress. One may conclude that absolute priority held on secured debt levels. However, absolute priority was not respected on preferred and ordinary debt levels. Creditors with claims ranked as preferred, ordinary or subordinated debt received partial payment on their claims. Only in one case did the secured creditor have to accept a distribution of the proceeds that violated the absolute priority rule on the secured debt level. Lastly, the total out-of-pocket costs in resolving financial distress varied between 3% and 14%, These costs were related to the size of the firm (section 5.2.3).

#### 6.1.2 Efficiency of the Dutch Bankruptcy System

In chapter 3 the Dutch Bankruptcy System has been studied by using incomplete contracting theory. The theory's main hypothesis is that behavioral problems in firms in financial distress are severe enough to warrant explicit rules that restrict individual rights. The behavioral problems are common pool problems, collective action problems, and opportunistic use. The problems of debt overhang and overinvestment arise, because collective action problems exist. To eliminate, or mitigate these problems, incomplete contracting theory holds that bankruptcy rules have to separate the decision on the usage of the assets of the firm from the decision on the distribution of the value of the firm. Furthermore, rules should protect creditors from being taken advantage of in bankruptcy, as a result of the opportunistic actions of other participants. These theoretical considerations have been summarized in hypotheses (section 3.8.1). With respect to these hypotheses, the empirical study into the resolution of financial distress has yielded the following observations:

- i) The out-of-pocket costs associated with the resolution of financial distress for the four firms did not differ substantially from the costs of resolving financial distress as these

have been reported in other studies. Furthermore, the period in which the four firms were actually financially distressed, was less than a year. Lastly, the four firms illustrated that the Dutch Bankruptcy System mitigated common pool and collective action problems (section 5.2.3, 5.3.1).

- ii) The empirical evidence showed that unsecured creditors were not able to opportunistically appropriate value from inadequately protected secured creditors. The potential problems were mitigated, because of the bargaining position of the secured creditors. However, due to the fact that the behavior of participants in financially distressed firms have been studied ex post, the observations permit no conclusions concerning the consequences of inadequate protection ex ante (section 5.3.2).
- iii) The possibility to use the bankruptcy procedure in order to lay off employees selectively, was not the main determinant in explaining the choice to use the procedure. Obviously the benefits of the procedure were taken into account in the choice of method, but these were only one aspect of the decision about how to resolve distress (section 5.3.3).
- iv) The conflicts over creditor rights on the compound bounded assets did not have material effects in the four cases. The proceeds of the asset sales were sufficient to satisfy the claims participants had on these assets. Furthermore, the Tax Authority was cooperative in completing the debt settlements of both not-incorporated firms (section 5.3.4).
- v) The asset sale in bankruptcy made it possible to eliminate the consequences of the debt overhang problem for the two incorporated firms. With the asset sale the decision about what to do with the economically viable parts of the firm and the decision about how to distribute the proceeds of the asset sale over the participants could be separated. The separation of these two decisions was not possible for the two not-incorporated firms. In these two cases the sale of assets did not relieve the respective owners of the two firms of their financial problems. These financial problems were ultimately resolved by settling the debts of the respective owners of the two firms either privately or by way of a suspension composition. In these two cases the funds could be made available to offer ordinary creditors a debt settlement. However, if a not-incorporated firm is indebted to such an extent that it cannot offer its ordinary creditors any payment, then the ultimate consequence of debt overhang may be that a economically unjustifiable dissolution takes place of this firm (section 5.3.5).
- vi) No evidence could be found to support the hypothesis that the bankruptcy rules were used by firm participants to opportunistically redistribute the value of the firm. Also no evidence could be found to indicate that the trustee had to approve of bargain prices when selling the assets of the firm (section 5.3.6).
- vii) Bankruptcy transferred the control of the firm to the trustee. This transfer of control might have mitigated the opportunistic redistribution of value that can occur in bankruptcy. However, the cases did not provide the evidence to conclude that this

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transfer of control was a necessary instrument in order to mitigate the consequences of value redistributive actions, or in order to prevent these actions (section 5.3.7).

- viii) No evidence was found in each of the four cases that a coalition of the shareholder and the bank considered the inefficient continuation of the firm as a method to appropriate value from other creditors. Furthermore, the behavior of banks in these cases pointed to the opposite of coalition behavior: they terminated their relationship with the firm (section 5.3.8). The cases did not provide enough data to discuss the hypotheses concerning the effect of differing liquidation values and bankruptcy costs on the behavior of a coalition of the shareholder and the bank.

The evidence presented in this study supports the conclusion that, with some qualifications, the Dutch Bankruptcy System did not induce to the economically unjustifiable dissolution of firms and did not lead to the economically unjustifiable continuation of firms. The Dutch System mitigated the consequences of common pool and collective action problems, offered a framework to resolve debt overhang problems, and mitigated, at least to some extent, the consequences of overinvestment problems in financially distressed firms. Nevertheless, based upon that same evidence the following three qualifications to this conclusion have to be made:

- i) debt overhang problems for not-incorporated firms might remain because of the unlimited liability of owners of not-incorporated firms (section 5.3.5);
- ii) opportunistic actions towards secured creditors and employees might redistribute value, possibly leading to less efficient contractual arrangements *ex ante* (section 5.3.6);
- iii) conflicts over creditor rights concerning compound bounded assets, specifically the right of the Tax Authority and Industrial Insurance Board versus creditors holding a silent pledge, creditors retaining ownership and the ownership rights of lessors, might impinge upon the resolution of financial distress (section 5.3.4).

## 6.2 Public policy recommendations

Above the conclusion has been drawn that the Dutch Bankruptcy System is, with qualifications, efficient. Therefore, this study does not provide the basis for arguing that a major revision of the System is necessary. In chapter 5, section 5.4, some changes have been suggested to the Dutch System that may enhance its efficiency. These changes concern the procedure of resolving financial distress and the system of creditor rights.

The argument has been put forward that the Sweet and Plastics cases showed that debt overhang problems played an important role in the way financial distress was resolved. Ultimately, both firms were restructured and the consequences of debt overhang problems were contained with, respectively, a private agreement and a suspension composition.

Nevertheless, in other cases debt overhang problems may prove to be less easy to resolve. Three ways of mitigating these problems have been reviewed:

- i) Limiting the liability of owners of not-incorporated firms in financial distress. One way of limiting this liability is to offer the debtor a fresh start. With a fresh start the debtor is discharged of all his debts, after all his assets are sold and the proceeds paid out to his creditors. This discharge of debts eliminates the debt overhang problem. Another, less extreme, alternative is to limit the time period in which the financially distressed debtor is obliged to pay a part of his future income to his creditors. Although debt overhang problems may be eliminated by limiting liability, this same limitation of liability may provide financially distressed owners with the incentive to act opportunistically in order to wrest concessions from creditors. Therefore, the liability rules ultimately determine, (i) the incentive to use suspension or bankruptcy opportunistically, and (ii) the extent to which debt overhang still affects the decision to whether or not the owner will engage in economically productive activities (section 5.4.1).
- ii) Adapting composition conditions. A bankruptcy composition procedure that mitigates the consequences of debt overhang problems has to allocate voting rights only to those creditors whose claims are not fully redeemed. However, such a procedure has very serious drawbacks. Firstly, the owner of the firm has no incentive to petition for a suspension of payment in order to restructure the firm. The procedure then offers the owner the opportunity to be discharged of his debts independent of the extent of his indebtedness. Secondly, a potential financier may exclude junior creditor classes from the negotiations over a bankruptcy composition by supplying an amount of money which leaves nothing for the junior creditors. Consequently, value redistribution may be very large (section 5.4.2.1).
- iii) Forcing firms in suspension. The consequences of debt overhang problems for firms in financial distress may also be mitigated when firms petition, or are forced to petition, for a suspension of payment at the moment at which a suspension composition may still be attained. However, defining the moment when firms should file is fraught with problems. The difficulties associated with the valuation of the firm, the estimation of its cash flows, and the distribution of information over firm participants, make it unlikely that firms will file for suspension at a moment when the procedure may still be useful. The German experience with "Überschuldung", a rule specifying that a firm with liabilities exceeding assets has to apply for the German equivalent of suspension or bankruptcy, made clear that the rule did not work in practice (5.4.2.2).

Of the changes discussed above, probably the most important one is the limitation of liability of owners of not-incorporated firms in financial distress. The consequence of such a limitation is that owners may act opportunistically towards creditors. Obviously, creditors of the firm will demand compensation, or security, for this risk. The empirical evidence

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presented in this study does not make it possible to estimate the balance of the benefits of limiting liability and the compensation creditors demand to cover the costs associated with the opportunistic actions of owners of not-incorporated firms (section 5.4.1).

Other changes to the Dutch Bankruptcy System that have been discussed aim at facilitating the restructuring of the firm. The argument has been put forward that facilitating the restructuring of the firm does not necessarily imply the restriction of creditors' rights more than the present procedure does. The Dutch Bankruptcy System offers enough possibilities, at least to incorporated firms, to restructure successfully. Consequently, a procedure that facilitates the restructuring of the firm by restricting creditor rights more than the present procedure allows, while offering certain (groups of) participants the possibility to opportunistically appropriate value from other creditors, is not needed (section 5.4.3). Nevertheless, three changes in the Dutch System have been discussed that may improve upon its use as a restructuring procedure. These are:

- i) The trustee should maximize the value of the estate. Explicitly recognizing this aim gives the trustee a clear assignment and identifies the participants for whom he is expending effort. However, the High Court has recently stated that a trustee should consider other interests than only those of the creditors and the debtor in deciding on the firm's future. Related to the aim of maximizing value, the argument has been put forward that the trend towards the specialization of lawyers into full time trustees should be encouraged. Furthermore, the accountability of all involved should be enhanced (section 5.4.3.1).
- ii) The trustee should be provided with a valuation report on the firm if participants in the firm propose to use the method of a financial restructuring via the asset sale to resolve financial distress. Although this duty to provide a valuation report is no guarantee that these participants will bid the true value of the firm, at least it may mitigate the incentive of participants to use the asset sale opportunistically (section 5.4.3.2).
- iii) The inclusion of a financial restructuring rule in the Bankruptcy Act which respects creditor rights. With this rule all obligations of the company are eliminated and substituted for shares in the company, or options on these shares. Such a rule respects the contractual rights of creditors, and eliminates the redistribution of value due to asset underpricing. Although the rule may be theoretically sound, practical valuation problems may diminish its effectiveness to such an extent that it may not be considered an improvement on the present procedure (section 5.4.3.3).

The evidence presented in this study does not allow the drawing of conclusions concerning the necessary changes in the system of creditor rights. This inconclusiveness arises, because the cases showed that conflicts over creditor rights, although present, did not obstruct the process of resolving financial distress. Only the consequences of some of the features of the present



system of creditor rights can be outlined. Based on the findings of this study this outline is the following:

- i) The elimination of conflicts over creditor rights concerning compound bounded assets either implies the elimination of the rights of the Tax Authority and Industrial Insurance Board, or the elimination of the rights of creditors secured with a pledge, the rights of creditors retaining ownership and the rights of lessors (section 5.4.4.1).
- ii) The elimination of the opportunistic use of the procedure to lay off employees is impossible if government aims to protect employees from labor market imperfections, but also aims to give financially distressed firms the opportunity to reorganize. This trade off may change in the course of time if, for example, labor markets become more efficient and perfect (section 5.4.4.2).
- iii) Secured creditors should be adequately compensated in bankruptcy at least during a stay of creditors. This makes part of the cost of capital associated with the use of the assets of the firm visible and forces participants to include this cost in their decision making (section 5.4.4.3).

As a last remark, the argument has been put forward that bankruptcy will become one of the tools of management to restructure the firm. Therefore, in designing bankruptcy rules or a change in the system of creditor rights, utmost care must be taken to ensure that no incentives are created to use bankruptcy opportunistically. The decision to petition for bankruptcy should be taken if no other methods are available to resolve financial distress. Those firms that do not have a profitable future should be dissolved quickly, those with a profitable future should be offered a procedure which gives participants the opportunity to restructure the firm. In arriving at the decision to restructure the firm, participants should include all costs of the strategy they have chosen in their considerations. This will only happen if the contracts of the various participants are respected in bankruptcy (section 5.4.4.4).

### **6.3 Suggestions for further research**

This study is one of the first in the Netherlands to inquire how firms resolve their financial problems and what role public and private contracts play in this process. A case study research strategy has been employed to study this process. In designing this strategy, I have tried to address and control the many potential problems associated with case study research. The strategy has paid off: it has increased insight into the process of resolving distress and insight into the efficiency of public and private rules. One avenue for further research would be to enlarge the number of available case studies on financially distressed firms. I can think of two ways in which enlarging the number of firms may prove beneficial to our understanding: (i) studying larger firms with a more complex legal structure and a more complex capital structure, and (ii) studying firms in which a coalition of a select group of

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participants has the possibility to appropriate value from other creditors by continuing the firm. The first enlargement may reveal whether the process of distress resolution becomes more problematic when legal structure and capital structure compound the negotiations. This complexity may obstruct the establishment of creditor rights, and may enlarge the possibilities to opportunistically use the procedure. One important source of additional conflicts may be information-asymmetries between insiders, quasi-insiders and outsiders. Studying the behavior of these groups of participants may reveal the strategies that are used by participants to cope with problems caused by opportunistic behavior and information-asymmetries. Such a study may also shed light on the question whether the problems in the bankruptcy of large firms warrant a procedure, different from the smaller firms. The second enlargement follows from the observation that in this study no evidence of coalitions, pondering the decision to continue the firm in order to appropriate value from other creditors, has been found. Studying cases in which a forming of coalitions is more likely to occur, may provide additional insights into the issue as to whether the Dutch rules are not only efficient with respect to the restructuring of firms, but also to the dissolution of firms.

In chapter 5, bankruptcy has been interpreted as a device that transfers control. This transfer of control is forced upon the participants by law, presumably because the participants could not use the control rights associated with their claim themselves. However, this transfer of control is a last resort method to restructure a firm's operating activities. With bankruptcy as an ultimate method to control participants, it may be advantageous to adjust control rights in such a way that participants still have ample opportunity to resolve financial distress themselves. For instance, the cases provided some evidence that the consequences of the capital investment policy, as this has been pursued by management, partly explained the financial problems. The observation of the consequences *ex post* does not imply that management, when faced with the decision to invest *ex ante*, actually and knowingly overinvested in the firm. However, these findings suggest that the control on the activities of a firm may be lacking in some aspects. Another avenue for further research would then be to take a step backwards from the brink of financial distress and study those firms in which the control on the activities of the firm may be lacking. Such a study would shed light on the issue of the content of residual control rights, which participants effectively exercise these residual rights, and to what extent and in what dimensions residual control is bounded by the other (financial) contracts.