RESTRUCTURING, FIRM PERFORMANCE AND CONTROL MECHANISMS

by

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Abstract

Restructurings are the order of the day. Various major companies have just experienced or are in the midst of a major restructuring. This paper presents an overview of the literature on restructuring, firm performance and control mechanisms. To study the phenomena coherently, the concept of an overall restructuring process is presented. Theoretically restructuring has not yet been defined in the framework of the restructuring process formula. Neither have different forms of restructuring found their places within such a structure. Empirically several issues of the process have been studied but on a rather partial basis and mainly in statistical approaches only. Attention for all-inclusive case studies came from Donaldson (1984, 1994).
This paper aims at laying the foundation of doing case study research studies with respect to Dutch firms in the 1990s.

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1 Introduction

Restructurings are the order of the day. In the early 1990s, many large Dutch companies, such as Fokker, ABN-AMRO, and Shell experienced a major restructuring. In spite of the many similarities, the performances of these companies were dissimilar in several ways. First of all, while ABN-AMRO and Shell reported record profits and thus showed no obvious need for restructuring, Philips and Fokker announced deep red figures, and therefore they simply had to restructure to survive. Also, owing to the stimulus of different control mechanisms, ABN-AMRO and Shell were able to implement the changes voluntarily, while Fokker was forced to restructure. The structures affected were also not identical, ABN-AMRO and Shell focused on the asset and organizational structure, while Fokker had to focus on the asset, and organizational as well as on the capital structure.

Research on stand-alone (restructuring) activities, such as mergers and spin-offs, has been comprehensive. Less attention has been paid to the combination of these activities as the outcome of an overall restructuring process. Also, the literature largely ignores that activities like a reorganization or an asset sale are not stand-alone activities, but may be just one component of a consistent overall corporate strategy. Research should therefore be conducted into the overall strategy, since the results of one stand-alone activity may be offset or reinforced by the related activities. The purpose of this paper is to give an overview of the literature on restructuring, firm performance and control mechanisms as part of an overall restructuring process (see Figure 1).

This restructuring process starts with the goal of the firm, which can be related to either the balanced stakeholder or the shareholder view (section 2). One possible outcome of the restructuring process is a change of the goal of the firm necessitated by, for example, a changed environment. The five basic firm structures used, that is asset, capital, governance, cost and organization, are modelled in the light of the ultimate corporate goal to be attained (section 3). These five structures, influenced by market and industry factors, determine the performance of the company. This performance can be measured in several ways, for example in accounting earnings, market returns and discounted cash flows. The merits and drawbacks of some of these measures are discussed in section 4. Applying the appropriate performance measures is one of the prerequisites of triggering voluntary change. Section 5 elaborates on the internal control mechanisms, namely the board of directors, works council and blockholders as well as on external control mechanisms, which are the defence measures, the market for corporate control, the product, capital, and labour markets. The function of these control mechanisms is twofold. First of all, the control mechanisms supply management with a day-to-day feedback on its performance, giving management a chance to gradually adjust the firm-specific structures. Examples of this feedback are the stock market

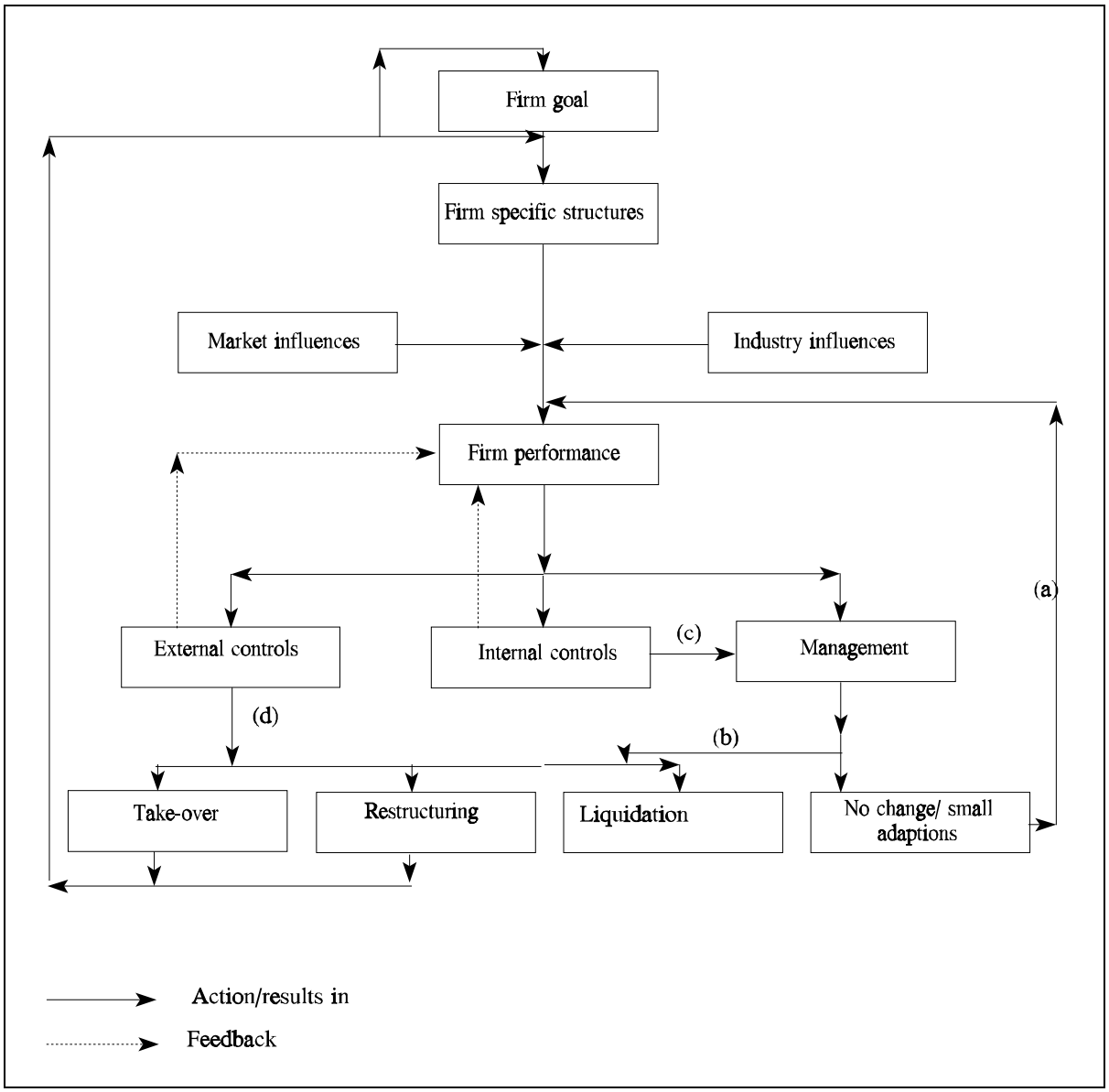

Figure 1 The restructuring process

reactions to announcements of acquisitions or divestures and the turnover rate in personnel. Secondly, the control mechanisms can either induce or even force management to the execution of major structure changes, i.e. changing the relationship among the key elements. Firm performance must therefore be seen as consisting of firm results (e.g. ROI) and feedback from the control mechanisms (e.g. stock price).

Control forces, whether internal or external, are not always the driving force behind change. The control mechanisms can also delay a restructuring process, initiated by management. A firm showing (record) profits, but still not earning a competitive return, should restructure in order to increase its returns. Because eventually, when investors are not provided with an adequate returns

on their investments and a change for the better is not expected, they will move their capital to another company or even to another country. For this reason, management has to convince other stakeholders, in many cases especially unionized labour, of the company's financial position. Financial sacrifices of top management, dividend cuts, and reported losses which are "*..to a large degree driven by special earnings charges that reflect managers' real restructuring decisions, but whose timing is discretionary across (..union..) negotiation and non-negotiation years"*, can be used for this purpose.

Consequently, the following events can occur when firm performance is not satisfactory (the symbols used correspond to those in Figure 1):

(a) Although firm performance is not satisfactory, and the need for change therefore exists, management only makes minor adjustments to the existing strategy and structures, or changes nothing at all. Firm performance will deteriorate even further, until eventually event (b),(c) or (d) will occur. However, it may take several years before actual intervention by either the internal or the external controls will take place.

(b) Management is aware of the need for change, and, while still in control, implements the necessary changes by either liquidating the firm, restructuring or a takeover/merger. Management may have two opportunities to do so under normal governance procedures, namely

(1) voluntary, changes are prompted by the feedback from the internal or external control mechanisms

(2) involuntary, changes are prompted by threats from the control mechanisms

(c) The internal controls resort to firing the incumbent management, management looses control.

(d) The external controls intervene and force either a restructuring, takeover or liquidation of the firm, here also management looses control over the firm.

Section 6 discusses the consequences of involuntary versus voluntary changes. A change is implemented involuntary when it is a response to an overt or threatened adversarial pressure by control mechanisms, i.e. an hostile attack on incumbent management.[1] The distinguishing feature between feedback and threats is that feedback is supplied by the markets, and threats are raised by parties involved. The dismissal of incumbent management by the board and the subsequent restructuring effectuated by the new management has an intermediate form. The dismissal is a hostile attack on incumbent management, and therefore poses an involuntary change. The new management however implement the changes voluntary. The above mentioned events are discussed in section 7, along with the outcomes of the process, viz. liquidation, restructuring, doing

nothing or take-over. Section 8 reviews the literature on voluntary, internally motivated, changes. Section 9 concludes this paper.

Donaldson (1990, 1994) is one of the few scholars who performed detailed case studies on restructurings. For twelve public corporations he identified how they, voluntarily, (tried to) achieve increased efficiency over the years, by changing corporate goals, strategy, and structures. This efficiency was measured by improved financial performance, as measured by amongst others return on investment, and by the response of investors, as measured by stock market performance. He concluded that "*voluntary restructuring may take longer to achieve the same ends, but it has greater and more universal potential for successful adaption to change than that which is imposed from the outside*". However, a voluntary restructuring can be far more costly than an involuntary change, owing to the longer time needed to restructure and to the superior negotiation position of many stakeholders like employees. Changes in asset and capital structures can be effectuated within a relatively short period, but changes in contracts takes considerably more time. Also, the former changes can be (easily) effectuated by a raider, while the latter changes requires a deep insight in the business and bargaining positions of the diverse stakeholders, and are therefore more easily achieved by the (incumbent) management. Consequently, the longer time needed to effectuate a voluntary restructuring should be weighted against the disadvantages of an involuntary restructuring, such as more drastic measures. Especially understanding the reasons why certain companies are able to restructure voluntarily, while others have to go (almost) bankrupt before something changes, can provide valuable indications how to structure a responsive corporate governance structure.

2 The goal of the firm

A firm has various groups of stakeholders, each group with its own interests and its own (potential) claim on the revenue stream of the company. The undiversified investor in human capital (including management itself), for example, is interested in money, career opportunities and/or prestige (corporate jet and luxurious headquarters),and total risk, while the diversified investor in financial capital is interested in the systematic risk and shareholder value added. An example of this conflict of interests is the divergent views of both parties on diversification. For an employee, diversification stands for upward mobility, more prestige and job security. On the other hand, the capital investor is only interested in diversification if the return on the capital invested by him per unit of risk increases, and not when just the total return of the company increases, that is he prefers quality of earnings above quantity.

The 1960s and 1970s favoured human capital, which resulted in the 1980s in "*an increasing suspicion that the natural instincts of career professionals led them to place the well-being of long-*

term investors of human capital, including themselves, ahead of the well-being of investors of financial capital".[2] This erosion of trust necessitated considerable changes in the firm's structures and strategy. Those changes were often aimed at reducing management discretion over investment, for example by returning excess capital to the investors, reducing capacity or rethinking of operating policies and strategy decisions.

The conflict of interests between the various groups of stakeholders requires a continuous compromising of top management, although most of the times the scales are tipped to the group with the highest bargaining power.

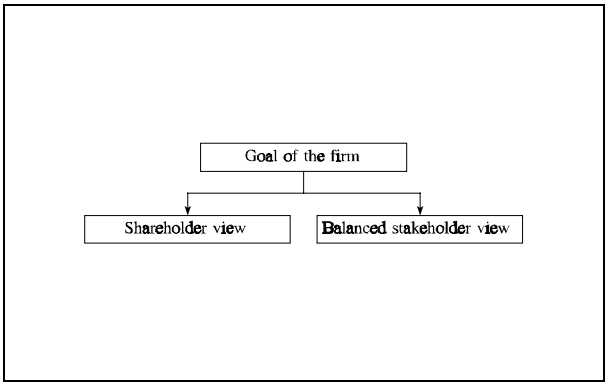

Figure 2 Goals of the firm

The balanced stakeholder and the shareholder view are the two main views regarding the ultimate goal a company should pursue (Figure 2). The balanced stakeholder view weights the shareholder interests together with the interests of the other stakeholders, such as creditors and employees. In this view, the company is not an annex to the shareholders, but a stand-alone entity, striving for corporate wealth and growth, with limiting conditions as stability, and, especially, continuity. Of course, this view does not release management from its obligation to earn a rate of return on invested capital required by its shareholders! This organic concept of the firm is mainly found in Germanic countries. In the shareholder view, the shareholder interests are set over the interests of the other stakeholders, given the prices of the inputs of goods and (financial) services.

The distribution of the proceeds is characteristic of each of the views mentioned above, and not especially the performance indicators used.

A firm has 100 to invest. The choice is between two projects, each requiring an investment of 100, while the risk does not change. The first results in shareholder value added of 20, and has no consequences for the employees. The second project results in no shareholder value added (the required rate of return is the actual rate of return) and results in an, not quantifiable, increase of career opportunities for personnel. The first project will be chosen when maximizing shareholder value, while either the first or the second project can be chosen in the balanced stakeholder view.

Figure 3 Example of stakeholder versus shareholder view

In the shareholders view, an investment should be made when either (a) the risk decreases, given the return or (b) the return increases given the risk. But for the balanced stakeholders view a third factor should be considered, namely the, mainly not quantifiable, interests of other stakeholders (see Figure 3). Since the required return by equity-investors should be met in the latter

view also, the balanced stakeholder view will result in sub-optimal solutions as seen from the shareholder, but will still result in satisficing solutions.

Consequently, a clear-cut distinction should be made between (a) the valuation approach, used to, for example, determine of the proceeds of a new investment, and (b) the distribution of the proceeds over the stakeholders (Figure 4). Stewart (1991) for example, advocates in his "Quest for value" economic value added, for which an adjusted profit concept is used. The advantage of this approach is the use of easily available, but adjusted, book values instead of the, subject to estimation errors, theoretically correct Discounted Cash Flow method (DCF).

Determining the proceeds, based on:	- Discounted cash flow method - stock market values - book values - adjusted book values
Distribution of proceeds, based on:	- shareholders view - balanced stakeholders view

Figure 4 Distribution of and determining the proceeds

Although different views on how to solve the conflict of interests between groups of stakeholders, still exist, these views are becoming more congruent due to the globalization of investment and capital flows. For example, even the Japanese keiretsu seems to be voluntarily adjusting itself to the globalization[3], by doing more business with foreign partners, diminishing the cross-shareholdings, and buying more materials outside the group.

The prevailing American line of thought is the shareholder's view. For this reason, research has perhaps mainly focused on agency problems between managing directors and shareholders. Rappaport (1986, p.1) claims that "*... the principle that the fundamental objective of the business corporation is to increase the value of its shareholders' investment is widely accepted.....*". Indeed, (almost) all the recent American financial economics literature endorse this principle, but this axiom does not necessarily hold for all companies. Or, as Jensen (1993) says : "*No longer can we assume managers automatically act (in opposition to their own best interests) to maximize firm value*". European managers often state that they act in the interests of shareholders as well as other stakeholders, like employees. The Dutch government has even voiced the balanced stakeholders view in the law, by granting rights to the works council (Ondernemingsraad), the supervisory board, and founding shareholders and directors (priority shares) which are quite unknown in the Anglo-Saxon countries. Cools (1993) found empirical confirmation of this "balanced stakeholder" view. He interviewed the Chief Financial Officers of fifty listed firms in the Netherlands with the purpose to acquire an insight in the capital structure choice of these companies. He found that only 6% of these Dutch corporations saw maximizing shareholder wealth as their primary goal, as opposed to 78 % favouring profit maximization, aimed at continuity. Cools (1993) also found that

while 52% saw no hierarchy in the stakeholders of the firm, only 8% saw the shareholder as the most important stakeholder. He remarks "*Apparently, even the CFO, the executive who is most involved with shareholders is not inclined to even pretend that shareholders are the owners of the firm. This clearly illustrates the Dutch corporate governance system in which shareholders are just one of many other stakeholders who each try to get their piece of the pie*". Duffhues (1994, p. 46) suggests that some misunderstandings regarding the implication of wealth maximizing, may explain this controversy. Another indication of this view is the "Top 100 Nederland" published by a Dutch magazine (Financieel Economisch Magazine), ranking the largest concerns on net added value (net added value) base, because "*the Net Added Value conception stems from the view that a company has to generate a reasonable income not just for the shareholders, but also for all participants. The distribution over the participants of the generated net added value is therefore at least as interesting as the volume*".[4] FEM uses employees, providers of capital and government as participants.

Summarizing, the balanced stakeholder view is likely to be (still) prevailing in the Netherlands. Therefore, it seems not appropriate to use only the premises of the shareholder value approach in assessing Dutch companies. The differences between the Dutch and American business conditions should be thoroughly understood to be able to explain major changes in the structures of Dutch companies.

3 Firm specific structures

A firm consists of several structures. A "structure" can be defined as a "specific, stable relationship among the key elements of a particular function or process".[5] Frequently companies pursue a redesign of several structures in a time-span of several years. A restructuring effectuated by incumbent management may complete the following steps once the company becomes aware that it is performing below standard. The first step may be reducing the number of employees (cost structure) along with a reorganization of activities (organizational structure), followed by the sale of underperforming businesses, and by focusing on the core business (asset structure). The next step can be changing the incentives of management (governance structure) and the internal structures. If these restructuring activities do not result in the required improvements, a debt restructuring becomes a possibility (capital structure). Consequently, restructuring must not be seen as an individual transaction, but as a process, generally taking several years to complete. By reviewing the literature on firm response to poor performance, the same five basic structures within a firm can be identified. Wruck (1990) noted that "turnover in top management and changes in corporate governance indicate that corporate raiders are disciplined for poor performance", thereby referring to the governance structure. In addition, frequently taken actions in the poor performance period

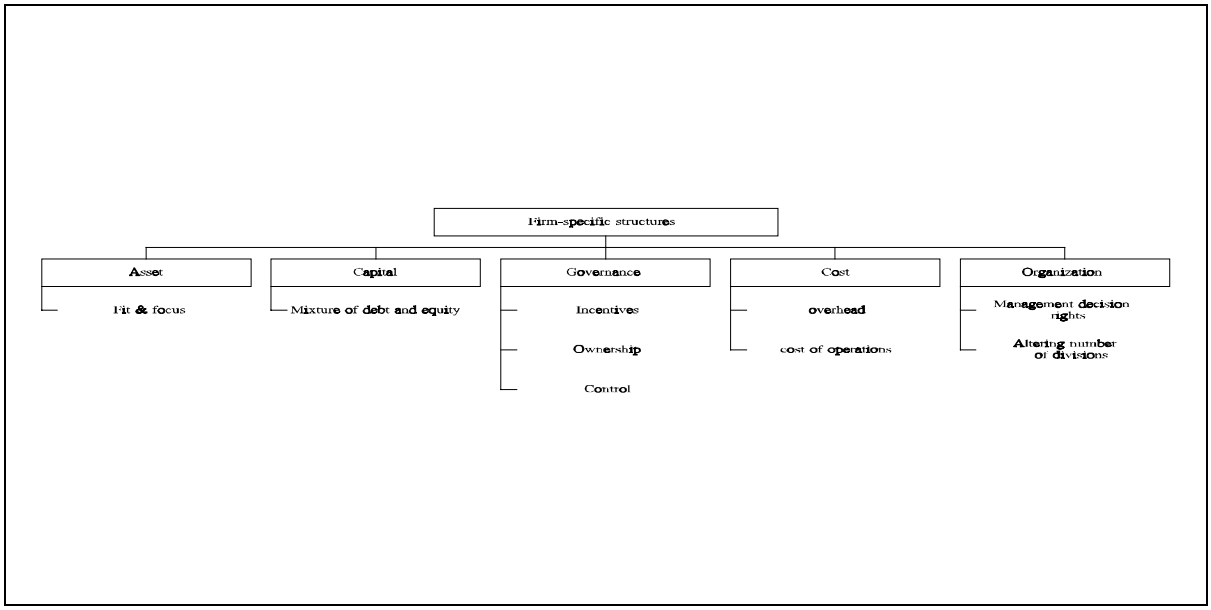

Figure 5 Structures of the firm

include (a) changing the size and scope of operations, influencing the asset, cost and frequently the organization structures, and (b) financial actions like debt restructurings, employee layoffs and overhead downsizing, influencing the capital and cost structures. The structures that can be distilled from these actions are the asset, capital, governance, cost, and organizational structure[6]. These five structures,as depicted in Figure 5, are affected by the applicable goal of the firm. When Figure 5 is merged with Figure 1, these structures describe the status quo of the firm, its point of departure of the restructuring process. These structures together determine firm performance. The outcome of the restructuring process is a change in one or more of these structures.

The various stand-alone changes in these five structures have been researched comprehensively. Empirical evidence on the consequences of a LBO, merger or share repurchase is considerable, while far less research is conducted into the combined elements of a restructuring. Of course, frequently only one structure causes the initial problems, while in time other structures are negatively affected. Consequently, the odds are that the longer management takes to react, the more radical the necessary changes will be. For example, performance decline can be the result of investments with returns below the required rate. In an early phase, cutting cost or disposing of the assets might be sufficient to solve the difficulties. If, however, management does not react, the organization can become highly leveraged and subsequently financially distressed. Now, besides cutting cost or disposal, debt restructuring is also necessary to solve the financial distress.

Another example of more radical changes necessitated by a negligent management reaction is a company using a sales prices denoted in US dollars, while its purchase prices are in Dutch guilders.

Now, when the exchange rate of the dollar falls against the guilder, the margin falls and management intervention may be necessary. In an early phase, the problem can be solved by forcing the suppliers to settle the accounts in dollars also, thereby shifting the risk to the suppliers. When management postpones intervention until financial distress is inevitable, more drastic measures such as a debt restructuring, bringing in of new equity capital or the cutting-down of the work-force may be necessary. Of course, suppliers will only be inclined to financial sacrifice if they are convinced that the company is in serious trouble.

3.1 Definition of restructuring

In most surveys, the term restructuring (corporate, financial etc.) is not explicitly defined. It is used as a general expression, including different transactions. Chew (1993, p. 462) gives a fine example of how the term "restructuring" is used by stating that: "The 1980s saw an unprecedented wave of corporate acquisitions, divestures, spin-offs, split-ups, ESOP's, partial public offerings, limited partnerships, and leveraged buy-outs - all of which have been yoked together under the name of 'corporate restructuring'".

Copeland and Weston (1988) regard corporate restructuring as a general term of many forms of corporate activities. Four groups of activities are identified, namely (a) activities involving the combining of assets (i.e. expansion; examples are mergers and acquisitions, tender offers and joint ventures), (b) activities involving the un-combining of assets (i.e. sell-offs; examples are spin-offs and divestures), (c) activities involving the establishing and defending rights to assets (i.e. corporate control; examples are premium buy-backs, standstill agreements, anti-takeover amendments, proxy contests), and (d) activities involving the altering the format of asset control (i.e. changes in ownership structure; examples are exchange offers, share repurchases, going private and leveraged buy-outs). This corresponds with the Rappaport's (1986) Phase I restructurings, namely consisting of one-time transactions, without altering the day-to-day management of the business.

On the other hand, Ellis and Williams (1993), and Copeland, Koller and Murrin (1990) based their grouping of transactions on the possible steps a company could take to maximize shareholder value, seen from the viewpoint of a potential raider. They argue that maximizing shareholder value should be the goal of management; in case the incumbent managers do not maximize shareholder value, others will do it for them. As a result, the battle for corporate control will be lost. The subsequent change in corporate control is then effectuated by replacing incumbent managers and/or an unfriendly take-over. For this reason, they claim it is in the best interest of both managers and shareholders to keep the gap between potential and actual value creation as close as possible. Management has several tools to reduce the gap. These tools can be classified into three sets of

strategies, namely (a) strategies to improve operations, like increasing revenues or reducing corporate overheads, (b) strategies based on acquiring or disposing of assets, like liquidation or acquisition, and (c) financial engineering activities, like share repurchase or financing mix. This approach corresponds with Rappaport's Phase II restructuring, in which shareholder value approach is employed not only in the one-time transactions, but also in the day-to-day management.

Summarizing, restructurings appear in many different gradations. Restructurings can be limited to a change of the asset structure (asset restructuring) only, a change of only the capital structure (capital restructuring) or a change in only one of the other structures. On the other hand, restructurings can also affect all elements of the corporate financial structure, described by Donaldson (1994) as *the allocation of the corporate flow of funds - cash or credit - and to the strategic or contractual decision rules that direct the flow and determine the value-added* [7] *and its distribution among the various corporate constituencies. The elements of the corporate financial structure include the scale of the investment base, the mix between active investment and defensive reserves, the focus of investment (choice of revenue source), the rate at which earnings are reinvested, the mix of debt and equity contracts, the nature, degree and cost of corporate oversight (overhead), the distribution of expenditures between current and future revenue potential, and the nature and duration of wage and benefit contracts*". This definition includes elements of all of the five structures. The characteristic of corporate restructuring is the re-arranging of ownership/control rights. Corporate financial restructuring indicates that the control and/or ownership structure should not necessarily change.

3.2 The individual structures

The *asset structure* is the result of the process of planning and managing the firm's investments, and can be described as the composition of the total assets the firm exploits to realize its goals. Consequently, the balanced stakeholder view and the shareholder view may result in a different asset structure. For example, constructions like franchising and subcontracting allow firms to control certain other companies or stages in the industry chain without actually owning them. While shareholders are in favour of these arrangements when they add value, employees can be more reserved, since career opportunities may be reduced. The fit and focus of the business (units) are reconsidered when assets are restructured. A typical asset restructuring consists of categorizing divisions/businesses into core and non-core. The non-core businesses are then sold, and the proceeds of these disposals are used to fund acquisitions in the core business. A change is accomplished in the number of segments in which the company is industrious, resulting in a change in sales and total assets. An asset restructuring has also its impact on other structures within the company, the capital structure usually changes since acquisitions have to be financed if the

proceeds of the disposals are not sufficient or when the proceeds are used to reduce debt levels. The change in investment base may also induce another organizational structure, for example from an product-oriented to a function-oriented organization.

The *capital structure* choice deals with the form and relative amounts in which securities should be issued to finance the investments and the price that should be paid for the use of the capital. The capital structure refers to, among others the specific mixture of long-term debt and equity the firm uses to finance its operations. Capital restructuring changes this mixture. An example of a capital restructuring is the diminishing of discretionary reserves. As a consequence, each new investment has to be assessed by the external capital markets, since the internal capital market has dried up. Now, the risk of unproductive investment, that is investment with a negative net marginal return, is eliminated. Especially managing directors of mature industries with limited growth potential are subject to the over-investment risk. Investment is those industries are often done to diversify or to maintain their earnings and sales. These investments are usually in the best interest of the employees, but not necessarily in the best interest of the capital investors. An other example of capital restructuring is a rights issue, frequently aimed at reviving a company. The proceeds of the issue are then used to cut down debt.

The *governance structure* is the "different sets of incentives, safeguards, and dispute resolution processes used to control and coordinate the actions of various stakeholders" (Kester and Luehrman 1993, p.439). In fact, an ideal governance system would give managing directors enough freedom to work and make them accountable for what they did with that freedom. Shareholders, and in the Netherlands employees as well, would have enough information to monitor the managing directors. While the governance system will be different for each country since it reflects legal, regulatory, and tax regimes, it is feasible to develop an optimal governance strategy for a company.

The two main components of *cost structure* are overhead and costs of operations (the distribution of the claims on the corporate revenue stream by the primary contributors to the productive process). Changes in cost structure can be effectuated by the redesigning of formal and/or informal contracts or new production methods. Examples of new production methods are the re-location of labour-intensive production to low-labour-cost countries or the shift from labour-intensive to capital-intensive production methods. In the 1990s cost restructurings are frequently effectuated by cutting (severely) back the work force, especially the overhead (=staff) departments. Cost restructurings are often combined with changes in the organization structure.

Changing the *organization structure* involves the altering of the number of divisions or subsidiaries or changes in management decision rights. This is defined as a reorganization. Brickley and Van Drunen (1990) found that "on average internal structure changes occur as a value-increasing response to changes in the environment facing the firm. Two cases where this change appears to occur are 1) when a firm's investment opportunities change and 2) when the firm is doing poorly relative to competing firms."

4 Performance

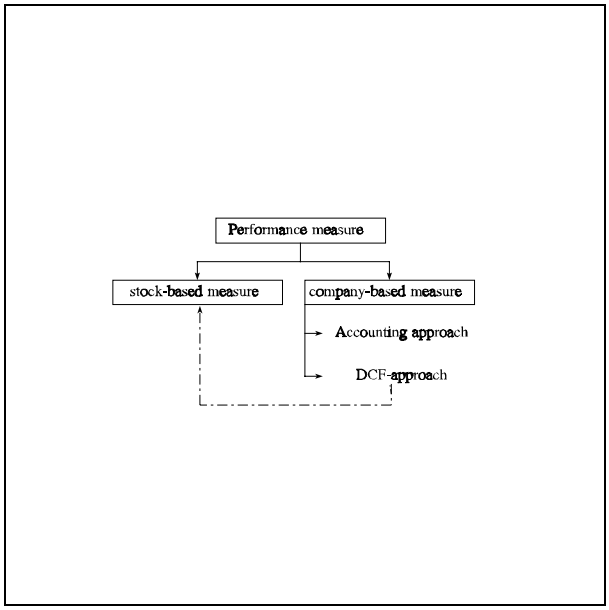

Figure 6 Performance measurements

The underlying reason for a restructuring is always the need or possibility to improve the performance of the company, or "*at the heart of restructuring is evidence of erosion of economic value and financial benefit associated with the strategy and structure in place.*[8]" Deterioration of firm performance can be detected by evaluating the applicable results against some standard, expressing the interests of the evaluating party. The possibly relevant data are stock market data and/or data from within the firm, the latter either based on accounting or on discounted cash flow techniques (Figure 6).

Although stock market data seems the most logic, generally least manipulable, measure to evaluate the company's performance, the use of stock market data has several drawbacks (section 4.1). The firm's results should be compared to the results of other companies, operating in the firm's own industry, as well as in the market as a whole (section 4.2).

4.1 Performance measurements

4.1.1 Stock market data

First of all, the "balanced stakeholders" view is incompatible with stock market data, since these data do not represent the interests of other stakeholders. Restructuring affects more stakeholders than only the shareholders. Employees may be affected through wage-cuts and lay-offs and bond-

holders by changes in bond prices. Even the government might be affected by an increase in unemployment benefits or a change in corporate taxes. This implies that when shareholder wealth, as measured by the stock returns, increases, this simply may be a redistribution of wealth, and not a real efficiency gain. Consequently, while stock market data is sufficient in the shareholders view, it proposes insufficient information to be used as unique performance measurement in the stakeholders view.

Secondly, anticipated structure changes altering future cash flows are already included in the stock price. As a result, abnormal stock returns can only be generated by unanticipated changes in performance. For example, a poorly performing company will earn a normal stock return when the bad performance is anticipated, and thus incorporated in the stock price. The reverse also holds, companies with an expected excellent performance will not earn an abnormal return. Consequently, stock returns can not be used adequately to measure the performance of the company over a given period of time. Stock data can be used for event studies, when the stock market reaction to an announcement of the firm is observed. However, even then only the unanticipated portion of the announcement is observed.
Also, in case the stockmarket is illiquid, and infrequent transactions determine the stock price, the quoted price may not reflect the value ascribed to the stock by "the market".
Fourthly, asymmetric information may cause a discrepancy between the market value and the economic value of the firm.

4.1.2 Standard from within the company

Since the stock market has its obvious merits as a performance measure, but also some drawbacks, another measure should be found derived from the company itself. This leads to the two competing valuation approaches, namely the accounting approach and the, theoretically superior, discounted cash flow approach. The major disadvantage of the DCF-method is the uncertainty of the necessary cash-flow forecasts. The results of the evaluation of performance based on DCF-methods will always be subject to discussion, since the outcomes depend on the modelling assumptions made. Only voluntary corporate liquidations produce enough information to permit discounting cash flow techniques, since the discounted value of actual cash flows generated by the liquidating firm can be compared with the stock price prior to the liquidation announcement.[9] Discounted cash flows link the stock based measures with the company based measures. For the stock market value can be seen as the capital the company currently has invested plus a premium (possibly less a discount) for its economic value added projected and discounted to a present value[10]. The Q-index

is an example of this linkage, and can be defined as the stock market value divided by the book value of equity[11].

The drawbacks of the accounting approach are the treatment of intangibles like goodwill, the influence of different accounting methods on the results and balance sheet, and the possible manipulation of the figures.

This controversy between stock data and accounting data can also be found in the research on effects of takeovers (Moerland, 1992). Moerland remarks that financial economists generally find, based on event studies, an overall wealth increase for a merger, while industrial economists, using accounting measures, do not find this result. He concludes that the differences in the overall result might well be explained by the differences in research method, such as the characteristics of the data used and the time frame. However, the finding that bidders at best break-even is not explained by either research examining the returns surrounding the announcement date or research examining the returns of a larger period. An example of a study combining a longer period (five years) and stock market data is the study of Agrawal, Jaffe and Mandelker (1992) which re-examined the post-merger performance of acquiring firms. They found that stockholders of the acquiring firms suffered a statistically significant loss of about 10% over the five year post-merger period. This may indicate that the merging firm is not showing value-maximizing behaviour, but hubris behaviour, resulting either from pursuing other goals than their shareholders' welfare or from being unable to pursue shareholder value.

But does it really matter which criterion is being used to measure performance? Douma and Kabir (1995) studied the correlation between six performance indicators, namely three accounting returns (return on equity, return on total capital and net profit margin), market return and two hybrid measures (P/E ration and Q-index). Their sample consisted of 123 firms listed at the Amsterdam Stock Exchange in the period 1988-1992. They found, for large firms only, a significant correlation between market return and the accounting rates of return. They concluded that measuring the performance of one company should be done with more than one indicator, while for a group of companies the difference between an accounting measure or market return probably will be negligible.

4.2 Comparing performance with market, industry or absolute.

The risk-adjusted performance of the firm can be assessed on a stand-alone basis, or can be compared to the stock-market or to its industry. This results in three levels of distress. Market

distress occurs when the company underperforms the stock-market in general. Market distress will not always lead to firm distress, a firm can underperform a long time before insolvency occurs. Industry distress only is defined as underperforming its industry.

Firm distress (or financial distress) is a situation where cash flow is insufficient to cover current obligations. Financial distress is often associated with the terms failure and default. According to Altman (1993) *failure* is the situation in which the realized rate of return on invested capital, with allowances for risk consideration, is significantly and continually lower than prevailing rates on similar investments. A company can be a failure for many years without going bankrupt, namely when all current obligations can be met and the debt is not enforceable. When a firm *defaults*, it violates the agreements with one (or more) creditor class(es). In case of a payment default, the company forgoes an interest or a principal payment. A technical default is when a firm breaches a financial covenant in the firm's debt, like the debt/equity ratio. Note that in both cases a formal default is not always necessary, terms of debt can be rescheduled privately.

Figure 7 shows the difference between market and industry distress. Industry and firm return are risk-adjusted. In example 1, the firm is in market distress, but not in industry distress, since the firm is evidently operating in a troubled industry. The market distress must therefore be caused by industry-specific factors. In example 2, the firm is in market as well as in industry distress, and is operating in a healthy industry. Firm-specific factors must be at the bottom of the poor performance. Exhibit 3 shows a firm in industry distress only, probably mainly caused by firm-specific factors.

	Market return	Industry return	Firm return
Example 1	10 %	5%	5%
Example 2	10%	10%	5%
Example 3	5%	10%	5%

Correction for risk included

Figure 7 Market, industry and firm return

Firm failure can be caused by industry and/or firm specific factors. Asquit, Gertner and Scharfstein (1994) found that underperforming their industry was the main cause of firm distress, and not a troubled industry or too much leverage. Others, however, indicated more industry-specific factors, like recession and regulatory initiatives (Denis and Denis, 1995). Khanna and Poulson (1995) even indicate that managerial incompetence is not the reason for firm failure, and that the market perceives this, as is reflected by negative announcement effects of the announcement of managerial changes.

5 Control mechanisms

The different views on the firm's goal have a direct impact on the functioning of the internal and external controls. The different control mechanisms are depicted in Figure 8.

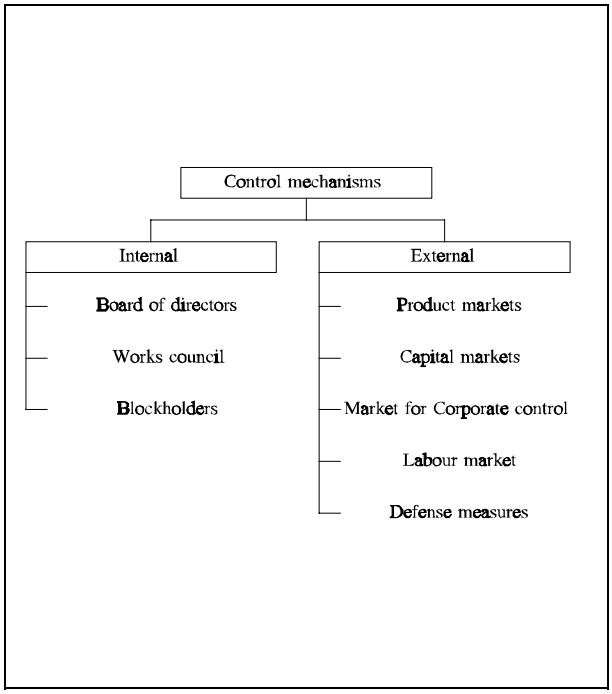

Figure 8 Control mechanisms

Control mechanisms are installed to monitor management, and, if a performance shortfall is observed, to compel change by threatening to or by actually disciplining management. The control mechanisms generally imply an increased monitoring by third parties, that is not management, either within or outside the firm. The labour market (Fama, 1980) monitors management, determining future career possibilities and rewards of the incumbent management. By posing a take-over threat, the market for corporate control disciplines management (Jensen and Ruback, 1983).

A greater reliance on debt, that is monitoring by the capital markets, is also able to improve performance (Jensen,1986a). The product markets influence the performance of the managers. In the US view, generally only two internal control mechanisms are important, namely blockholders and the board, the latter being able to set the incentives for, as well as being able to hire and fire management.

In the Netherlands, the works council is also a control mechanism, only not aimed at diminishing the agency problems between shareholders and management, but between employees and management.

The various control mechanisms have each their own possibilities and incentives to exert pressure on management. Agreement about the effectiveness of the various control mechanisms is not yet reached. Jensen (1993) says "*the chronic over-investment and overstaffing of such companies* (... GM, IBM, Xerox and Kodak) *reflects the widespread failure of our corporate internal control systems. And it is this fundamental control problem which give rise to the corporate restructuring movement of the 1980's."*

5.1 Board of directors and insider ownership

The Dutch board is fundamentally different from the Anglo-Saxon board. Not only does Dutch legislature prescribes the balanced stakeholder view (see section 2) instead of the in the US prevailing shareholder view, it also excludes, for large companies, the possibility of insider supervisory board directorship. This applies for large companies subject to the "structuurregime", which depends on the amount of the equity and reserves, the number of employees active in The Netherlands and the legal obligation to institute a works council.

The Dutch legislature has expressed the balanced stakeholder view in, for example, the required approval by the supervisory board of directors of certain management decisions. These management decisions are exhaustively listed, and include significant events like major mergers, disposals or investments as well as the forced dismissal of a substantial number of employees. Besides this element of control, the structuurregime also covers the re-distribution of power over the diverse stakeholders. The power is shifted from shareholders to the supervisory board, and thus to other stakeholders; the board now has the right to appoint and discharge management, and to assess the annual account. The shareholders may only reject or approve the annual accounts. This consideration for stakeholders other than shareholders alone is in contrast to the United States, where the directors legally have the duties of care and loyalty. The duty of loyalty means that a director must demonstrate unyielding loyalty to the company's shareholders, while the duty of care means that a director must exercise due diligence in making decisions.[12] Even though, Morck, Shleifer and Vishny (1989) found that "*even when board members know how to raise value, they may refuse to do so because the required changes in a declining industry (layoffs, investment cutbacks, and divestures) harm employees who are considered more important to the organization than shareholders who are only 'out for speculative profit'.*"

Dutch law explicitly[13] declares that the position of member of the supervisory board is incompatible with a position within the same, or within a dependent firm. Consequently, the American one-tier system, uniting insiders (managing executives) and outside experts on the board is unknown in the Netherlands. In the two-tier system, which is also applicable in, for example, Germany, the upper, supervisory, board consists only of non-executives, with the task of monitoring the lower, or managing board, whose task is managing the company. Owing to the Dutch regulation of incompatibility, some Anglo-Saxon tendencies relating to the board-composition, are not known in the Netherlands.

The first tendency is to increase the ratio of outsiders versus insiders. Research in this area has become extensive in recent years, and generally finds that greater outside representation on boards is more effective in monitoring top management.[14]

Secondly, combining the functions of chairman of the board, and that of chief executive officer was common practice in the United States. This combination of functions has several drawbacks. First of all, the interests to be protected by the CEO/chairman are incompatible. The main priority of the chairman of an American board has to be guarding his shareholder interests, while the CEO has to look after the interests of several groups of stakeholders. Also, the representatives of duality have been accused of influencing the board composition and tenure, setting the board agenda and controlling information flows, influencing development of corporate strategy and resisting executive change when necessary.[15] Therefore, duality may result in a reduced board independence and thus in a restricted board oversight. On the other hand, in favour of this duality (CEO as chairman) is a clear-cut leadership, and the existence of only one spokesman. Nowadays, these two functions are often separated.

Thirdly, American and Britain boards are becoming a "hybrid"-tier system, a one-tier board, with a clear separation of duties between executive and non-executive members, formalized through sub-committees as auditing, compensation and nominating.

While Dutch legislature on board incompatibility appears to be progressive, some comments can be made.

First of all, outsiders can be as dependent on management as insiders. While insiders can be dependent on management owing to career opportunities, the independence of outsiders may be undermined by interlocks, the 'old boys network' or business interests, and, perhaps the most important, the outsider's own stockholder group. In other words, the outsider's first responsibility lies with his own company and his own share or stakeholders, and this may influence his behaviour in another company's board.

Another problem hampering an efficient supervisory board is the availability of information. While insiders have continuous access to the relevant information, outsiders are dependent on the information they are provided with. Getting the right information on time and interpreting it correctly is therefore one of the main causes of the failure of the internal controls. Information on the financial performance should be subject to regular monitoring by board members. Donaldson (1994, p.207) indicates that the following information should be available regarding the investment and return on investment: the company's own past performance, the company's principal competitors in the same product markets and for the industry as a whole, the company's principal competitors for funds in the capital markets that lie in a comparable investment-risk category, and the response of investors to this performance over an extended period of time. This kind of information enables the board to

assess the performance of the company in three stages, namely absolute, relative to the industry, as well as relative to the stockmarket (see section 4). With this kind of information, the board can observe an erosion of economic value in an early stage and prevent intervention by external control mechanisms.

Thirdly, the post of chairman is now often occupied by the former (retired) CEO, as is the case in the United States. While the former CEO has an extensive knowledge of the company, he is also able to dominate the board and to retard radical, but necessary, measures, which should have but were not executed during his reign.

Although the structures of the American and Dutch boards are different, the two major means of power to exercise the governance role are the same. When the interests of management and the groups represented by the board are not aligned, management can either be dismissed and/or have its incentives altered.

Top management replacement following poor performance has received extensive attention in the literature, because (complete) top management team turnovers are associated with successful monitoring by the board (Morck, Shleifer and Vishny, 1989). These results are not conclusive, but generally indicate that the board is only effective at spotting and correcting poor performance relative to their own industries, and is ineffective at monitoring when the industry as a whole is performing below standard, ie. when the industry is not healthy (Ofek, 1993; Weston, Chung and Hoag,1990). Morck et al. concluded that "internally precipitated complete turnover of the top of the management team (,...,) is more likely to occur in firms that underperform their industry, but is no more likely to occur in troubled than in healthy industries". They argue that the board uses firms in the same industry as a benchmark for the results and only intervenes when poor performance relative to industry is assessed. Further, Morck et al. showed that the disciplining mechanisms differ. Poor industry performance tends to be disciplined by the market for corporate control, through a hostile takeover, while poor performance relative to the industry is disciplined by internal controls, by management turnover. This also indicates that the board will not be the main instigator of down sizing an industry.

The disfunctioning of boards in times of troubled industries is alarming since excess capacity, and thus the necessity of exit, has increased. Jensen (1993) discussed in his Presidential Address to the American Finance Association the causes of excess capacity which started in the 1980s. Among other things he points out the changes in technology,[16] globalization of trade and the organizational innovations like virtual organizations[17] and Japanese management techniques. The United States steel industry during the 1980s is an example of an industry with excess capacity (in fact the global steel industry suffered from overcapacity). This excess capacity, the result of

increased competition, a decline in demand and technological obsolescence of aging plants, resulted in huge losses for the industry as a whole ($9.5 billion for the seven major integrated producers, from 1983-1986)[18] as well as for the major seven companies.

Besides being able to dismiss the management, boards also determine the compensation of the managers. Especially the American boards are under a strain to link those salaries more closely to (share) performance. The SEC now even requires firms to explain the link between top salaries and performance, otherwise tax relief on large salaries will be difficult. In the United Kingdom, executive share options have become the focus of attention, due to among other things, the "windfall" profits realized by directors of the recently privatized utilities and the "pay bonanza" of top executives. In general, it might be difficult to control excessive pay for top managers, since, at least in the United Kingdom, the dominant institutional shareholders of these companies are governed themselves by those same top managers, sitting on the trustee boards.

5.2 Product markets

The product markets (both the input and the output market) are a major disciplining basic force. Pressure from the product markets is always present, except perhaps when competition is limited. Research on product markets interaction with capital structure finds that taking into account exogenous industry conditions will aid in explaining investment and plant closing decisions[19].

5.3 Labour markets

The internal as well as the external labour market may discipline management. A manager has a market value as well. His value is based on, among other things, performance of the firm in relation to the standards.[20] Since establishing the influences of this disciplining force is extremely difficult, this force will not be discussed any further.
The characteristics of management and/or the CEO are found to be important in explaining which control mechanisms will be used. Generally, the following characteristics are used: age of the CEO, the number of years the CEO has been with the firm, and his tenure as CEO, as well as whether he is the founder of the firm or not[21].

5.4 Large blockholders

Recently, research on concentrated equity ownership has been extensive. Small shareholders are generally less interested in actively monitoring management because of the free-rider problem: in

case the small shareholder takes action, most of the benefits would accrue to the other shareholders, while all costs are borne by the shareholder. The importance of the free-rider problem differs among the countries, since the concentration of equity in various countries is not the same. The profile of the average shareholder of the "Japanese-German" model is an institution with a big stake in the company (Germany) or cross-shareholdings (Japan). In Japan, the *keiretsu* exists, "an affiliation of related companies whose interests are aligned partly trough long-lasting and informal supply contracts, intercompany personnel transfer, and reciprocal equity ownership."[22] In contrast to Japan and Germany, about half of the shares in the United States are held by individuals, and the other half by institutions. Moerland (1995) described the Dutch market as rather illiquid, and gives the following figures of Dutch listed companies: the largest blockholder has an average interest of 31%, in about 25% of the listed firms the largest blockholder has majority, and more than 50% of the shares of the listed firms is in the hands of blockholders (more than 5% control). Owing to these large stakes in the company, shares become more illiquid, thus forcing these shareholders to be involved in monitoring the managers. Based on these figures, prerequisites for control enforced by large blockholders in the Netherlands are present.

5.5 Banks and Institutions

Banks and institutions are important control mechanisms, providing debt and/or equity to firms. The workings of these institutions differ among countries. For instance in Japan, the company's main bank monitors the company more closely, and, because the bank provides often debt as well as equity, is able to intervene in a much earlier stage of performance shortfall than their American counterparts, providing only debt. Although American banks may have the right information and expertise to assess the need for change, they may not have the right tools to force this change. When banks provide only debt, and the loan covenants contain solely absolute performance indicators, intervention is only possible if the company is in actual distress and forfeits a payment or other obligation. Consequently, banks are unable to intervene when a company is underperforming its industry, and is not earning an adequate rate of return, but is still able to fulfil its obligations.

Institutions however, are in a different category all-together, because of their equity-holdings as well as of the sheer size of these holdings. In the United States, institutional investors owned in 1989 about 56% of the equity of the top 100 companies, and this percentage is still growing. While most institutions are still inactive, some institutions are becoming more involved with the management of their portfolio firms. A well-known example of an active pension fund is CalPERS, the California Public Employees' Retirement System. This pension fund monitors the effectiveness of the firms in its portfolio, and (tries to) lead the way to an increased performance by forcing restructuring.

However, this increased monitoring also brings up other issues like the impact of insider trading. According to Maug (1995b) institutional investors wish to acquire information relevant for valuing companies, without receiving information labelled "price sensitive" by the authorities. To avoid this problem, institutions may avoid to acquire sensitive information altogether, which reduces their effectiveness as monitors.
An other issue raised by the increasing importance of institutions is its role in the converging of the two corporate models. Institutions are not always strictly concerned with economic interests, but often with the interests of their pensioners. And these interests also include items such as the environment, health and education.

Seen from the firm's point of view, debt has a disciplining role; high-leverage firms generally respond faster to a decline in firm value than a low-leverage firm, because the first firm reaches the default-triggering value earlier than the less leveraged firm (Jensen 1986, Wruck 1990). Preservation of value is therefore one of the advantages of high leverage, the high-leverage firm will default and restructure earlier then its low-leverage counterpart. The positive relation between leverage and operational actions can also be explained by the monitoring role of debtholders after default (Ofek, 1993). Only, in general the firm will not default in case of stock base insolvency only, since creditors are not allowed to intervene. This implies an absence of a relation between leverage and the probability of operational actions affecting operational efficiency and/or asset use, when the firm is underperforming in its industry and not in financial distress, unless the bank covenants include some restriction on net worth.

5.6 The market for corporate control

The more serious the threat the market for corporate control can pose on management, the more managers will try to maximize firm value. A take-over often results in management turnover, and management pursues job security. Consequently, a more active market for corporate control will force managers to act in the interests of their shareholders. Once companies are "lean and mean" hostile raiders are less interested in those companies since the gap between actual performance and potential performance is small. Only, management has several possibilities to entrench themselves from the influence of the market for corporate control and thwart a takeover bid. A distinguishing characteristic of these management tactics is the necessity of shareholder approval. Dann and DeAngelo (1988) studied defensive restructurings, "corporate asset and ownership structure changes -acquisitions, divestures, and issuances and repurchases of voting securities- that target managers announced in response to hostile takeover attempts." They concluded that the results of these takeover defences support the entrenchment view and are not performed to benefit

the stockholders. When anti-takeover defences are installed to protect the company from the regulating force of the market for corporate control, unsatisfactory performance will remain unpunished.

Anti-takeover devices installed by the managers was one of the reasons shareholder activism increased in the United States. Those anti-takeover devices restrain the opportunity to remove incumbent management if someone else could control the assets better. Anti-takeover devices are now also in the focus of attention in the Netherlands, since the public opinion on hostile takeovers is changing. Even in Germany hostile takeovers are appearing.

5.7 Conclusion control mechanisms.

Control mechanisms are able to influence corporate strategy in at least two ways. First of all, control mechanisms supply management with a day-to-day feedback on firm performance, thereby giving management a chance to gradually adjust the firm-specific structures. Examples of this day-to-day feedback are the counselling functions of the board and the works council, and a drop in bond rating and stock price. Secondly, the control mechanisms can induce or even force management to execute changes in the major structure and/or strategy. For example, the board of directors is able to discharge management, the works council can appeal to the Enterprise Chamber and the capital markets can refuse to issue more loans. In Figure 9 the feedback and intervention possibilities of the diverse control mechanisms are depicted.

	Feedback	Intervention
Board of directors	Counselling	Discharge management or alter incentives
Works Council	Counselling	Appeal to Enterprise Chamber
Personnel	Turnover rate	Strike
Product Market	Sales	Bankruptcy filing
Market for Corporate control	Concentration, active market	Takeover
Capital market	Stock price, bond rating	Close down of capital market

Figure 9 Feedback and intervention methods of some stakeholders and control mechanisms

The board is effective at spotting poor performance relative to its industry, while poor performance relative to the market is less frequently corrected. When the whole industry is performing below average, boards are not inclined to punish management, since they are not convinced that management is to blame. When a firm is performing below industry average, however, board tend to blame management, resulting in a disciplining action. Debt, on the other hand, corrects an absolute, and not a relative, decline in value, and may therefore be complementary to the working of the board. Dutch banks have generally stipulated sufficient guarantees for their loans, and will therefore only enforce timely change when they also hold shares. The Dutch and American control

mechanisms have not always the same procedures, goals, or possibilities, although a converging trend is identifiable. While the Dutch market is rather illiquid, the American stock-market used to be characterized by small shareholders. Nowadays, the American institutions are playing a more prominent part. Large blockholdings make a market more illiquid. In illiquid markets, stock prices do not have to reflect the price that would have been effected in a liquid market, thereby reducing the feedback opportunities of the stock price. This is one of the reasons large blockholders should Also, only recently Dutch opinion is starting to accept a hostile takeover, which are the order of the day in the United States. Figure 10 summarizes the timely intervention prospects by the mechanisms.

Control mechanisms	Timely intervention prospects by the mechanism in the Netherlands
Board of directors	Depends upon, among others, information available, frequency of the meetings and independence of directors. Two-tier board is positive.
Large blockholders	Dutch market is rather illiquid, forcing involvement of these shareholders.
Banks/institutions	Dutch banks have generally stipulated sufficient guarantees for their loans, and will only enforce timely change when they also hold shares.
Corporate control	Dutch opinion on hostile takeover is changing to acceptance. Dutch anti-takeover measures are under scrutiny. Intervention becomes more accepted.

Figure 10 Timely intervention prospects of some control mechanisms

6 Voluntary or involuntary?

Changes are implemented involuntarily when they are a response to an overt or threatened adversarial pressure by external mechanisms. Distressed firms that have defaulted and are trying to solve their financial difficulties are obvious examples of involuntary restructurings. Creditors are now able to intervene, and force changes within the firm. Going private as a response to a take-over threat, followed by a major reorganization is also an example of an involuntary change. Consequently, a voluntary change is accomplished under normal governance procedures, without a threat by external mechanisms to intervene. For example, one of the rights of the Dutch works councils is to object to a proposed appointment of a manager or a member of the supervisory board and, if management does not follow its recommendations, appeal to the Enterprise Chamber (Ondernemingskamer). Here, management acts voluntarily, that is within normal governance procedures, when it retraces its steps and follows the council's recommendation. In contrast, the same act is involuntarily when they do so forced by the Enterprise Chamber. Of course, between

voluntary and involuntary change lies a grey undefined and undefinable area, since when is a "threat" exercised? Must stock be actually acquired by a hostile firm, or is a large takeover turmoil in the industry sufficient?

To my best knowledge, no empirical research has as yet been conducted into the consequences of a voluntary versus an involuntary restructuring. There are some indications that a voluntary restructuring generally preserves more value. One of the advocates of this view is Stewart (1991, p.599), who claims that "a voluntary restructuring produces a company that is more cohesive, more valuable, and more financially flexible than those in which a third party has set the agenda. We have found the most effective financial restructurings to be those initiated by management and not an outsider, either all at once as a preemptive strike or, maybe even better, as a natural complement to the company's ongoing business strategy". Maug (1995a) developed a specific model in which he contrasts independent outside directors with alternative control mechanisms. His model provides a ranking, depicted in Figure 11, of the alternative governance structures. "Strong' and "weak" relate to the bargaining position of the directors versus executive management. Maug provides two reasons why weak directors are the worst possible solution, namely (1) management is able to extract excessive compensation and (2) the link between managers' benefits and their performance is loosened. In the managerial control case managements' benefits are fixed, while only managers have control. His overall conclusion is that "independent directors can thus be seen as an institution that permit the same kind of negotiation in a widely held corporation in which shareholders cannot influence production decision directly. The important insight is that in widely held companies control had to be delegated to two institutions or agents: managers, who are in charge of the day to day running of the firm, and directors who monitor and review contracts and use this right as an instrument to influence business decision."

Figure 11 Maug's (1995) ranking of alternative governance structures

A shift in bargaining power is one of the four reasons why a voluntary restructuring is preferable to an involuntary, see Figure 12. Usually this shift in power occurs from management and shareholders to debtholders, consequently the firm has to implement the changes involuntary. Even so, who actually gains power and who loses it, and the subsequent redistribution of wealth over the various claimants, depends on the underlying reason for distress, and the trumps held by the stakeholders. The conflict of interests between equity-holders and creditors of a firm in distress is partly due to the priority of their claims. The claims of equity-holders have a low priority and an unlimited residual claim, while creditors have a limited claim and a higher priority. Consequently,

Problems with an involuntary restructuring	Consequences
(Imminent) financial default	Shift in bargaining power
Debtholder Opportunism	disoptimal capital structure
Free-rider problem	Failure of exchange offer
Limited time available	More drastic measures

Figure 12 Problems with involuntary restructurings and the consequences

equity-holders are in favour of continuing the firm, hoping that the firm will turn around. Liquidating the firm when the proceeds are not sufficient to meet the claims of the creditors is the worst case for equity-holders. Even continuing the firm and incurring more losses is preferable to liquidation, since the losses are charged to the creditors, while possible gains will be allocated to the equity-holders. Consequently, a wealth transfer takes places from creditors to equity-holders. Normally, creditors will look for measures to limit this wealth transfer.

An undesirable consequence of an involuntary change is a possible disoptimal capital structure, due to a debtholder opportunism problem, resulting in overleverage. This failure to delever occurs because debtholders are unwilling to forgive more debt than is necessary to cure the present default because other debtholders will capture any surplus. In a voluntary restructuring the firm is able to gradually adjust the capital structure, instead of having to negotiate with debtholders. As a consequence of this over-leveraging, the bankruptcy rate for financially distressed firms that renegotiate their debt, is thirty times as high as the rate for an average firm.[23]
The free-rider problem also does not exist in a voluntary restructuring. This theory states that the creditor has no incentive to accept a debt restructuring offer, when each creditor considers himself insignificant to the success of the offer. Because of this, unconditional exchange offers will fail. On the other hand, if a positive relationship between tendering and the priority status when the firm goes bankrupt exists, the exchange offer will succeed.[24]

The time frame of an involuntary restructuring is also different from that of a voluntary restructuring, for there is no time to lose. As a consequence, the measures taken are often more drastic and draconian then they would have been had the restructuring taken place at an earlier time.

7 Outcomes of the restructuring process

In Figure 1, the direct relationship between the goal of the firm and firm performance has been shown. Firm performance is compared with the standards set by internal and external controls,

followed by, if necessary, intervention. Consequently, inadequate results are caused by either (a) the optimally set firm goal is not reached, or (b) firm goal is not optimally set or operationalised, i.e. the mistranslation from firm goal to management goals. An example of the former cause is a critical change in the product market; structural changes have decreased or even eliminated demand, or competition has become excessive. An example of the latter cause is over-investment, i.e. management has undertaken investments with a negative net present value.

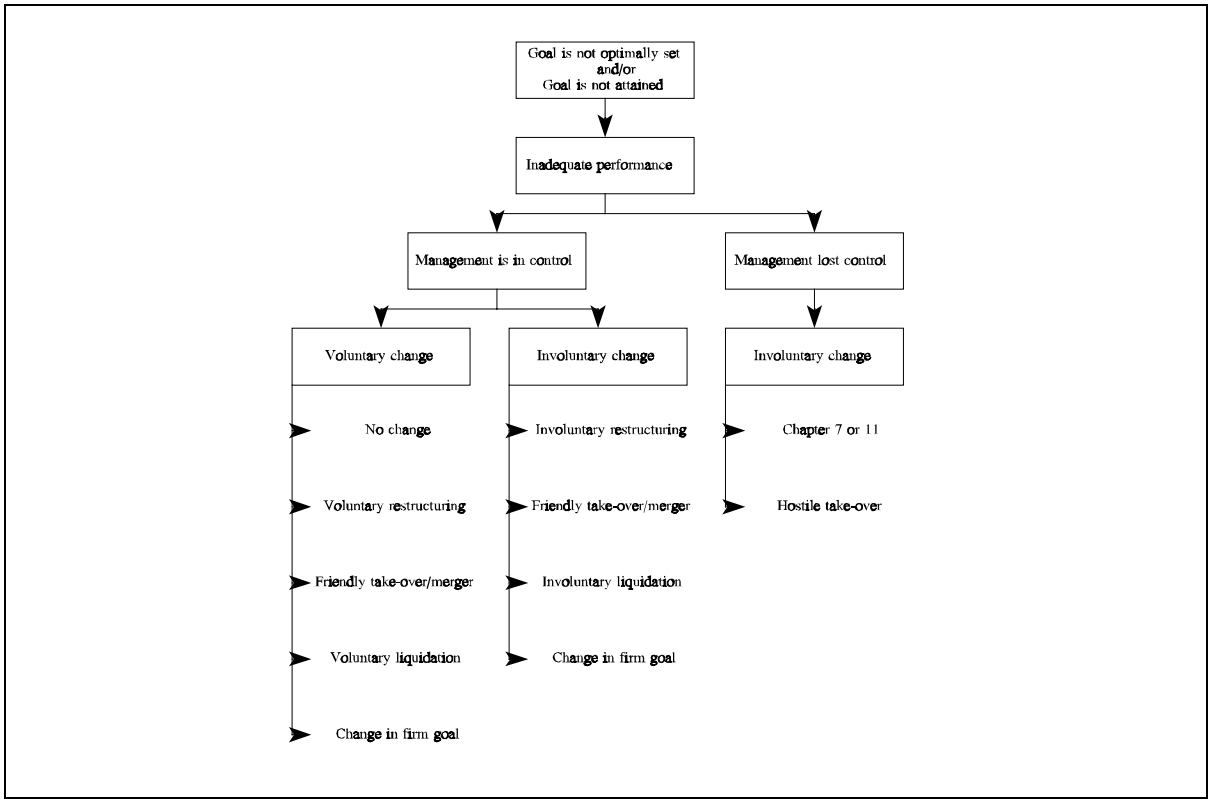

Figure 13 Outcomes of the restructuring process

Two main categories of reactions to an inadequate result are possible, namely (1) reactions with management remaining in control, and (2) reactions with management losing control (Figure 12).

7.1 Management remains in control

Management remains in control, and either management reacts to the need for change or does not act. In the latter case, although firm performance is not satisfactory, and the need for change therefore exists, management only makes minor adjustments to the existing strategy and structures, or changes nothing at all. Firm performance will deteriorate even further, until eventually a control mechanism will intervene. However, it may take several years before actual intervention by either the internal or the external controls will take place.

Once management is aware of the need for change and is still in control, they can implement the necessary changes by either liquidating the firm, restructuring or a takeover/merger. Management may have two opportunities to implement changes under normal governance procedures, namely (1) voluntary, changes are prompted by the feedback from the internal or external control mechanisms, and (2) involuntary, changes are prompted by threats from the control mechanisms. The distinguishing feature between feedback and threats is that feedback is supplied by the markets, and threats are raised by parties involved. Voluntary changes are then prompted by for example a falling stock price, the downgrading of debt, uncompetitive labour prices, decreasing sales prices, increasing purchase prices, liquidity problems or a combination of these feedback signals. Threats on the other hand can be uttered by parties like equity or debt holders, works councils, suppliers and buyers, or other companies.

7.2 Management looses control

Management looses control, either because the firm is taken over or because debtors take over as a result of financial distress. When the firm can not fulfil its obligations, several ways for a debt restructuring or liquidation exist. In The Netherlands, there are the following possibilities, namely (a) bankruptcy (comparable to Chapter 7 of the Bankruptcy Code), resulting in liquidation of the firm, (b) bankruptcy resulting in an agreement with the creditors, (c) surséance (comparable to Chapter 11 of the Bankruptcy Code) followed by bankruptcy and (d) surséance followed by settlement, and (e) private work-out or negotiated restructuring. At present, the interests of the creditors are paramount in Dutch Bankruptcy proceedings, while a surséance is directed at continuing the -slimmed down- firm, although it is usually the porch of bankruptcy.

The in-court process usually takes a long time, and in the Netherlands more than 90% of the firms in surséance are finally liquidated. Also, absolute priority is not always maintained in-court. Another disadvantage of an in-court restructuring is the publicity, the firm's difficulties are made known to suppliers and customers, thus hindering the normal conduct of business. The out-of-court option refers to the process in which firms try to restructure their debt privately rather than through formal bankruptcy.

One of the major differences between an in-court and an out-of-court (informal) restructuring is that in-court all creditors' securities must be exchanged, while in an out-of-court restructuring only a subset of securities outstanding have to be exchanged. Consequently, an out-of-court restructuring seems easier. Whether it indeed is easier is influenced by the number of creditors in the restructured class and their motivations. In-court, a limited percentage of the creditors have to agree,

while in an out-of-court restructuring all of the creditors in the class have to agree. So when one creditor holds out for better terms, the offer may fail. Gilson, John and Lang (1990) state that when the net costs of an out-of-court settlement are lower than the net costs of an in-court settlement, the shareholders and creditors as a group will benefit. The different categories of claimholders should agree on how to share these cost savings. Once individual claimholders are holding out, because they expect to get more benefits, the in-court restructuring becomes more likely. Another factor affecting creditors' willingness to settle privately is the type of debt that is restructured. They found that 90% of the outstanding bank debt was restructured, versus 69.8% of publicly traded debt. This means that firms, which restructure privately, do not need to recontract all claimholders, but only those whose claims are in default, resulting in lower transaction costs. A hybrid-form of debt restructuring has emerged in the United States, namely the pre-packaged Chapter 11. In a pre-packaged bankruptcy, the firm agrees upon a restructuring with a sufficient number and amount of claimants and then legally files for bankruptcy (Altman, 1993).

8 Research on changes implemented by incumbent management

In this section a first overview of research on change implemented by incumbent management, as a response to inadequate results, is presented. The research on lost control cases is outside the scope of this paper.

8.1 Restructuring

Studies on restructuring under normal governance procedures can be divided into case studies and statistically large-sample studies. Donaldson (1994, 1990) and Baker (1992) focused on case studies, while Ofek (1993), John, Lang and Netter (1992) and Brickley and Van Drunen (1990) used the latter methodology, but each with a totally different angle (see Figure 14).

One possible large-sample study approach is to sample on basis of some action the firm has taken, such as an unit liquidation, or unit merger. Subsequently, the thereupon following stock market reaction and/or change in earnings is measured (event study). This approach has been followed by

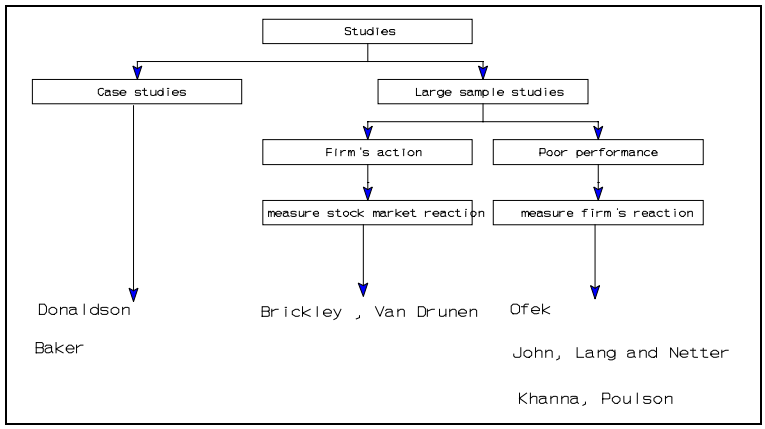

Figure 14 Research methodology

Brickley and Van Drunen (1990). The opposite approach is to sample on basis of stock or earnings performance, and look at the actions the sampled firm undertakes as a response to this performance. This approach has been followed by Ofek as well as by John, Lang and Netter.

Brickley and Van Drunen (1990) investigated the factors motivating changes in the organizational structure of the firm. They sampled on basis of the action taken by the firm, such as unit liquidation, unit mergers and unit split-ups. Subsequently, they measured (a) the shareholder wealth effects of announcements of the organizational restructurings and (b) the stock price as well as the earnings performance in the years surrounding these actions. They found that restructurings often occurred without evidence of take-over threats. Except for unit liquidations, the stock market tends to react favourably on the restructurings both when the restructuring is performed to increase efficiency and when it is performed as an expansion strategy. Remarkably, earnings performance declines in the three years after the restructuring, probably caused by restructuring-related expenses, such as employee severance pay, which tend to reduce reported earnings. Earnings performance was measured as the market- and industry-adjusted rates of return on equity as well as the market-adjusted net sales-equity and expense-equity ratios. The sampled firms experienced poor stock as well as poor earnings performance in the period prior to restructuring, only if the stated reason for restructuring was to increase efficiency. Otherwise prior performance was normal. This indicates that the market pressured for more optimal organizational structures.

Ofek (1993), in a sample study of 358 firms, investigated the relation between capital structure and a firm's response to short-term financial distress. Stock market data were used to identify the firms with poor performance and a rapid decline in value. This decline is defined as an annual stock return in the bottom 10% of all returns in the market after having been in the top 67% the year before. Reported earnings declined also substantially (-39% median change in earnings before interest, taxes and depreciation, standardized by sales). No background information is provided on the reasons why this drop in value has occurred, while the reason for such a decline might have a direct relationship with the actions the firm undertakes. For example, the response to a decline in value caused by a major law-suit will be different from a response to a decline caused by a loss of market share.

The firm's responses to the performance were classified into the categories asset restructuring, employee lay-off, top management replacement, debt restructuring, bankruptcy filings and dividend changes. Ofek found a positive relationship between leverage and operational actions as well as leverage and financial actions. Remarkably, this relationship is missing for firms in industry distress only (underperforming its industry, but not the stock market in general). He concludes that this emphasizes the importance of an absolute decline in value.

John, Lang and Netter (1992) used negative earnings as a measure of firm performance, and gave no explanation for the exclusion of stock market data. A sampled firm has had at least one year of negative earnings, followed by three years of positive earnings. They found that firms reacted quickly on a performance decline, with actions such as a cut-back of the labour force, dividend cuts, and assets sales.
They did ask management the reasons (giving more than one reason was allowed) for the performance decline, which was generally said to be due to exogenous factors including economic conditions (95%) and competition (57%, foreign 43%). Other reasons mentioned were endogenous factors like accounting changes (37%), failed acquisitions (37%) or too much debt(13%). They did not, however, relate the reported reasons for negative earnings to reported responses to poor performance.

A related study of Khanna and Poulson (1995) identified the managerial actions executed in the three years before filing for Chapter 11. Subsequently, in an event study, the average abnormal stock-price reaction to these actions is registered, and compared to the results of a control group. Overall, they find that both groups make similar decisions, and conclude that financial distress is due to conditions outside the control of managers, and not a result of managerial incompetence.

Debt restructuring has been examined as one of the reactions following poor performance. Voluntary debt restructurings can also occur, for example when a highly leveraged firm wants to invest in a positive net present value project, and therefore needs to reschedule its debt repayment schedule. No research in this field has come to my knowledge.

The above studies leave many questions about details unanswered, which is of course due to the large-sample design. Case studies are able to provide some answers on these questions.

Donaldson (1994) described twelve case studies, diverging from purely voluntary to involuntary restructurings. These firms were followed for two decades or more, thereby allowing a deeper insight in the firm's actions and reactions in a changing environment. He points out that while some preconditions of voluntary restructuring exist, such as the willingness and ability to act, some environmental shock is often necessary to trigger the restructuring, such as the retirement of a CEO.

Baker (1992) described the history of Beatrice, an American firm. During these 100 years, Beatrice grew from a local creamery into a diversified firm by acquisitions, and slimmed down again by a leveraged buy-out and sell-off. Baker analyzes how, during this period, value was created, and

destroyed. His central question was *How could the acquisition of hundreds of companies create value, and then the subsequent divestures of these same assets thirty years later also create value?* By answering this question he provides a detailed insight in how diversification could add value (Beatrice could eliminate the knowledge as well as the financial gap of the acquired smaller companies), how the reversals could also add value (change in economic environment, the financial and managerial resources were now also available for small firms) and in the importance of organizational structure and governance. For this purpose, he used performance measures like cumulative abnormal dollar returns, book values of assets, market reactions to announcements of acquisitions and divestures and return on assets.

Summarizing, Brickley and Van Drunen found that the stock market generally reacts favourably to restructuring activities. Research designs such as those of Ofek provide insight in why firms choose certain responses over others, while the case studies open-up the black-box of the firms and provide detailed , mainly institutional, background on issues raised by the large-sample studies. The case studies also cover an extended period of time, thereby linking changes in the economic environment, the responses of management, and the consequences of these responses. Therefore, case studies, despite its well-known drawbacks, provide an essential complement to large-sample studies.

8.2 Friendly and hostile take-over/merger

Many reasons have been advanced why take-overs and mergers take place. For a discussion of these reasons see Weston, Chung and Hoag (1990), who identified no less than thirteen reasons/theories and also reviewed the research on these subjects.

After the take-over/merger, restructuring often takes place after all, but now executed by the acquiring firm. Raiding a company is only effective when a firm is not managed based on the shareholders' wealth principle. Because when it is, the firm is already "lean and mean", with no excess staff. Putting takeovers parallel to restructuring in the restructuring process (see Figure 1) without a connecting loop might seem surprising. However, the takeover is the result of the intervention by present control mechanisms. As a matter of course, these control mechanisms and perhaps even the goal of the firm, changes after the take-over, thereby necessitating another round of the restructuring process.

8.3 Liquidation

Liquidation executed by incumbent management, as well voluntary as involuntary, corresponds with voluntary corporate liquidation, which involves the piece-meal selling of the entire firm. It should be executed, from the shareholder's point of view, when the liquidation value is higher than the firm's going concern value less the face value of its outstanding debt. A voluntary liquidation is preferable to a merger only when the separate pieces can be used for higher-valued-uses by the different buyers than one buyer could have for the total firm, because only then the receipts of liquidation will be higher. A voluntary liquidation differs from an involuntary liquidation since it is a management decision, instead of (generally) a bankruptcy proceeding. Of course, threats may be exercised and studies by Erwin and McConnell (1995) and Kim and Schatzberg (1987) found frequent attempts, either friendly or hostile, to change control prior to the liquidation (both studies find attempts in about one third of the sample).

Both studies indicate that the voluntary liquidation is an value-enhancing decision for the existing shareholders. Erwin and McConnell found that the discounted value of actual cash flows (i.e. the actual receipts of liquidation) generated by the liquidating firm was on average 16.6% higher than the stock price prior to the liquidation announcement, while the average of the announcement period returns of 19.8% was found. They have not investigated whether any wealth transfer from bondholders or personnel to shareholders has taken place. Kim and Schatzberg do investigate whether wealth is transferred from bondholders to stockholders, and they conclude that on average bondholders have profited. Whether any wealth transfer exists from personnel to shareholders is not investigated.

Erwin and McConnell concluded that the firms in their sample are confronted not so much with low current profitability as with the absence of future growth opportunities[25]. Low growth opportunities are however not decisive, decision makers should also be shareholders and/or the founder (family) should be present on the board.
Voluntary liquidations can also exist on plant level. In this case the firm's stock market value after the liquidation announcement does not only depend on net present value of the liquidation decision, but also on the information content of the announcement. Blackwell, Marr and Spivey (1990) as well as Brickley and Van Drunen (1990) found a significant negative stock market reaction to unit liquidations. This could indicate that the negative value of the information content of this message exceeds the positive net present value of the liquidation found in the corporate liquidations. Both studies do not investigate governance related items such as managerial holdings or board representation.

9 Conclusion

In this paper the relationship between restructuring, firm performance and control mechanisms has been described, by means of an overall restructuring process. It has not been the intention to give an opinion on how the corporate goal should be set. One of the consequences of not pursuing shareholder value may be pursuing growth, and thereby emphasizing quantity instead of quality in the asset structure, or the availability of more excess capital in the firm.

The overall restructuring process starts with the goal of the firm, which depends, amongst others, on the bargaining power of the various groups of stakeholders. According to Donaldson (1994), the United States experienced a shift to the domination of capital investors away from the domination of the human capital investors. In the Netherlands, the balanced stakeholders' view is still prevailing, because of, amongst others, rights granted to works councils and supervisory boards, as well as a secondary importance of the market for corporate control. However, world wide views are converging, owing to amongst others the globalization of investment and capital flows. Signals are the occurrence of hostile take-overs in Germany and the loosening of the keiretsu relationships.

The five basic structures, asset, capital, governance, cost and organization, are directly related to the goal of the firm, and state the status quo of the firm at the beginning of the process. These five structures, however, are always in a process of change. A firm should adapt to the continually changing environment if the firm wants to survive in the long-run. When the firm, operating under normal governance rules, is unable to adjust, external control mechanisms will enforce the change. Ideally however, changes should be implemented while performance is still (almost) up to standards. Performance measurements should consist of firm results (e.g. ROI) and feedback signals from the control mechanisms, such as stock market data and labour turnover. The reaction to substandard performance can be five-fold: (1) management does not implement changes, in time this will be followed by one of the other four events, (2) management implements the changes voluntarily, (3) management implements the changes involuntarily, as a result of threats from internal or external controls, (4) the board of directors fires the incumbent management and hires a new management which implements the necessary changes, and (5) external controls step in and force changes. Changes are involuntarily when implementation is a response to an overt or threatened adversarial pressure by external mechanisms. Four of the differences between a voluntary and an involuntary restructuring are a shift in bargaining power, overleveraged after debt

restructuring, the possibility of the free-rider problem and more drastic measures. Whether externally enforced restructurings are more efficient than internal restructurings is still open to debate, and is an area open to further research.

Dutch and American control mechanisms operate in different environments, and have different characteristics. For example, the Dutch board is fundamentally different from the American board, since (1) the balanced stakeholder's view is prescribed in the Netherlands, while (2) insider supervisory board directorship is excluded. Consequently, the American discussion about the ratio of outsiders versus insiders as well as duality is not carried on in the Netherlands.
The board should assess the performance of the company in three stages, namely (1) absolute, (2) relative to the industry, and (3) relative to the stockmarket. With this kind of information, the board can observe an erosion of economic value in an early stage and prevent intervention by external control mechanisms. Also, the Dutch stockmarket is rather illiquid, forcing involvement of the large blockholders. Dutch banks have generally stipulated sufficient guarantees for their loans, and will only enforce timely change when they also hold shares. Dutch opinion on hostile takeover is changing to acceptance, while Dutch anti-takeover measures are under scrutiny. Intervention by the market for corporate control becomes more accepted.

While some evidence exists about which factors trigger an early reaction to poor performance, such as predistress leverage, it is still hardly understood why some firms are able to restructure voluntary. Insight into this matter can shed light on the reasons why other firms are unable to adapt, eventually resulting in firm distress. Frequently only one structure causes the initial problems, while in time other structures are negatively affected. Consequently, the odds are that the longer management takes to react, the more radical the necessary changes will be.

Evidence on restructurings is brought forward through studies with a different design. Brickley and Van Drunen found that the stock market generally reacts favourably to restructuring activities. Research designs such as those of Ofek provide insight in why firms choose certain responses over others, while the case studies open-up the black-box of the firms and provide detailed background on issues raised by the large-sample studies. This is necessary because restructurings may consist of the following sequential steps, after the company becomes aware that it is performing below standard. The first step may be reducing the number of employees (cost structure), followed by the sale of underperforming businesses, and by focusing on the core business (asset structure). The

next step can be changing the incentives of management (governance structure) and the internal structures. Consequently, restructuring must not be seen as an individual transaction, but as a process, generally taking several years to complete. Case studies cover this extended period of time, thereby linking changes in the economic environment, the responses of management, and the consequences of these responses. Therefore, case studies, despite its drawbacks, provide an essential complement to large-sample studies.

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1. DeAngelo and DeAngelo, 1991

2. Donaldson, 1994

3. Financial Times, 30 november 1994, Loosening of the corporate web.

4.In Dutch:"Het NTW-begrip komt voort uit de opvatting dat een onderneming niet alleen voor de aandeelhouders, maar voor alle daarin samenwerkende participanten een redelijk inkomen moet zien te genereren. De verdeling van de gegenereerde netto toegevoegde waarde over de participanten is dus minstens zo interessant als de omvang".

5.Donaldson, 1994 p.7

6.Khanna and Poulsen (1995) studied wether firms failed because of poor managerial decisions. Therefore, they compared managerial actions of firms that filed for Chapter 11 protection and the control group of firms not experiencing financial distress. The managerial actions observed where :"asset sales, plant closings, reductions in personnel, acquisitions and expansions, new debt and equity issues, equity for debt swaps, and debt restructuring." Their evidence suggests that managers of distressed firms "are not perceived to be taking value-decreasing or poor decisions before the Chapter 11 filing."

7.is defined as the present value of future cash flows.

8. Donaldson 1994 p.41

9.Erwin and McConnell, 1995

10. Stewart, 1991

11. Duffhues, 1994, p. 90

12. Monks and Minow, 1995

13. BW Boek 2, art. 160

14. Fama, 1980; Fama and Jensen 1983; Weisbach 1988

15. Moyer, Ram Baliga and Rao 1995

16.Jensen (1993) says that "..Some estimates indicate the price of computing capacity fell by a factor of 1,000 over the last decade.....A change of similar magnitude in auto production technology would have reduced the price of a $ 20,000 auto in 1980 to under $ 20 today".

17.Defined by Jensen (1993) as " networked or transitory organizations where people come together temporarily to complete a task, then separate to pursue their individual specialties."

18. DeAngelo and DeAngelo, 1991

19.Kovenock and Phillips, 1994

20. Moerland, 1995

21. Agrawal and Knoeber, 1994ab

22. Kester and Luehrman, 1993 p.444

23. Aggarwal, 1995

24. Gertner and Scharfstein, 1991

25. Future growth opportunities are here measured by Tobin's Q, where Q is measured as the market value of equity plus the book value of debt divided by the book value of assets.