Selecting Restructuring Strategies for Sick Companies: Incorporating the Decision-Making element

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Abstract

The paper provides a review of features of restructuring strategies, indicating that distress may limit the choice available. It then introduces the decision theory to show that the final choice may be influenced by objective criteria and by subjective or non-rational criteria as well as by social interactions. The authors propose a framework in which organizational and environmental variables, along with restructuring methods, influence the decision-making of restructuring strategy selected for declining companies. The authors provide a multidisciplinary point of view in which they consider such metrics as social and psychological variables in the study of decision in sick companies.

Key words: Bankruptcy, decision-making, decline, distress, social and psychological factors, recovery, restructuring, selection process

Introduction

Managers’ strategies in sick business are an important field of study for researchers because the economic and social implications are important. 1.7% of firms fail on the average (Claessens & Klapper, 2002). This could vary culturally and nationally from 0.02% in Spain to 7.61% in Sweden. Some of these companies could be declining and some growing faster than the sustainable growth rate. In addition, there are many sick companies who have not yet reached this distress level, but are still distressed according to the success factors decided by its management. All these firms need to be restructured. Restructuring includes a vast array of strategies which can be classified into governance restructuring, strategic restructuring, strategic alliances, financial restructuring, operational restructuring, employee restructuring, MIS restructuring, bankruptcy protection and state aid. The question addressed in this paper is how do you choose: what is the selection process for restructuring strategies for sick companies?

This theoretical paper is divided into six parts. Part I is a literature survey distinguishing our work from some other works in this field. Part II introduces our conceptual framework, parts III to V explain the different elements of the framework and Part VI concludes. Essentially, our argument is that each restructuring strategy has its own salient characteristics which may be more suitable depending on the environment and enterprise situation. The numbers of factors to be taken into account is considerable and complex. To some extent, the choice of restructuring strategy is eased by the sickness of a firm because many possibilities are eliminated. The final decision is based on subjective and social elements which are both important.

I. Literature review of conceptual frameworks for restructuring applicable to sick companies

There are quite a few studies about restructuring strategies of firms, and many deal with decline or distress. We comment on the ones closest to our field of study.

John, Lang & Netter (1992) studied firms in decline who recovered without filing for bankruptcy and who were not taken over. Our study is broader and includes a survey of the literature on bankruptcy restructurings also.

Johnson (1996) establishes a link between certain antecedents and refocusing strategies and between refocusing strategies and certain outcomes. Among the antecedents to refocusing, he lists environment, governance, strategy and performance with a one-way link and financial restructuring as a two-way link to...
show that it may continue during the down-focusing. Moreover, he finds that the antecedents are interlinked, e.g., environment influences strategy, which influences performance. However, Johnson's model of downsizing applies to healthy and distressed enterprises alike. We would like to establish a more general framework for determining all kinds of restructuring but especially applicable to sick enterprises.

Preble's (1997) model deals with crisis management. However, he details a model which takes into account crisis prevention in the strategic management process by integrating crisis audits, crisis strategies and plans, simulations, etc. He admits that crisis management could also include the management of crisis after it has occurred, but he does not develop this field further. This is our field, although we would further clarify that we are not linking our notion of distress solely due to crisis of the environmental disaster kind.

Sudarsanam & Lai (2001) found that recovery and non-recovery firms (those liquidated) have similar strategies. However, unlike us, they do not distinguish between restructuring strategies available for sick and healthy companies.

Ashta & Tolle (2004) reviewed factors which should be considered by decision-makers of declining and distressed firms but they did not go into the decision-making process. This has also been lacking in almost all the previously mentioned studies.

We believe that we should consider and include subjective and irrational factors in line with the development of subjectivity and irrationality in economic science (Santos, 1997). In fact, in the last decades, some authors have introduced psychological components in the study of economic processes (for example: Kahneman, Slovic & Tversky, 1982; Lea, Webley & Walker, 1987; Herrnstein, 1990; Lewis, Webley & Furham, 1994).

If we apply this approach to the decisions in restructuring processes, we could progress to a more comprehensive framework. In keeping with this point of view, an important question would be to determine if the decision is carried out in an objective and rational way, evaluating the costs associated to each decision or if it is modulated by personal irrational variables.

II. A framework for selecting restructuring strategies for sick enterprises

In this section, we present a framework of the selection process for choosing an appropriate restructuring strategy for a sick company. We add to the Ashta & Tolle (2004) model a box incorporating the decision-making process. Like them, we consider that some characteristics of the "Enterprise", its "Environment" and "Restructuring Methods" affect any decision of restructuring any kind of firm. "Enterprise" and "Environment" also take part in influencing the "Decline / Distress" (level or sources) that will determine characteristics of "Sick Firm". All these notions then interact in the process of determining the appropriate "Restructuring Selected" for declining or distressed enterprises. However, in addition to all the above objective criteria the decision-making itself has many other influences.

Therefore, we have included in our framework a non-objective box for the social and psychological factors which influence the decision maker and the decision-making process. We should keep in mind the influence of these factors on the person taking the decision. Graphically, the framework is illustrated in the figure. Decision is the result of a previous communication process, which has been influenced by different psychological and individual (perceptions, knowledge, abilities and previous experiences) and social factors (for example the group influence).

We detail this framework in the next three parts. In part III, we explain the factors influencing choice of restructuring for all types of enterprises including, but not limited to, distressed and declining ones. In part IV we distinguish selection criteria specific to sick enterprises. We admit that distress is a characteristic of a firm, just like growth. However, we maintain that distress assumes an importance to firms that merits it being studied separately from all the other characteristics of the company. Just as individuals do not take optimum decisions when exposed to losses (Hilton, 2001), firms also have restricted decision-making capacities during distress. In part V, we explain the different influences on the decision-making.

![Figure 1](image-url)
III. General criteria for selecting restructuring strategies (applicable also to sick firms)

As noted from the framework, the factors which influence the selection of restructuring are the enterprise or firm-specific factors, the environment and the characteristics of restructuring strategies or methods. All of these, discussed in turn, complicate the choice of a restructuring strategy.

A. The kind of enterprise influences the kind of restructuring

All the restructuring strategies are not suitable for all enterprises. We discuss below the relationship to restructuring based on managerial commitment, unit integration, capital structure, technology, size and age.

On managerial commitment, the kind of business and the degree of identification with its past and future could influence the restructuring strategy selected: the attitudes will not be the same for a founder as for an employee or for a liquidator (Busenitz, 1999).

By unit integration of the enterprise, we refer to establishment, company or group. On establishment level, if it is a multi-establishment company, some units can be sold off. But in a single establishment company, restructuring through selling off business units amounts to liquidation. Similarly, transfer prices can be used in a multi-product or multinational setting, but in a single product establishment, there is no way to redistribute profits and optimize taxes using transfer prices.

LBO groups could have distress owing to problems with either the parent or the subsidiary and their restructuring requires address of specific organizational issues (such as two levels of managers and two levels of debt-holdings) and legal issues (related to different classes of shareholders) (Colaert et al, 2002) . In a similar vein, there may be specific legal constraints for publicly held groups with perhaps stronger minority rights and for privately held groups. For example, private equity companies (LBO managers) often adopt a financial and operational coordinated control on the managers of the acquired company (Fetterman, 2003).

On capital structure, in debt rescheduling, long-term debtors gain at the cost of short-term debtors (Datta & Iskandar-Datta, 1995). As a result, short term debtors agree to restructure if there is low long-term debt in the existing capital structure. Also, if a firm is highly leveraged, it is less likely to be an LBO target.

As for technology, high technology companies may not be able to take much debt because bankers are loathe to lend against growth assets and intangibles (trade secrets, patents, rights in trade marks, copyrights, goodwill) although these assets are included in the security (Shapiro & Balbirer, 2000).

For high technology bankrupt companies, bankers recognize that the value of pledged assets is much higher than the debt. They may be willing to lend against the intangibles.

On size, there is evidence that size could influence the intervention of governments, on proportion between internal and external financing, on acquisition ability and on probability of bankruptcy. Williams (1984) suggests that large firms can ask governments to give loans directly or guarantees to creditors in return for continuing employment of workers. There is a lack of perfect substitutability between internal and external financing, especially for small firms (Mills et al, 1994). Small firms don’t have access to external capital markets. This means that small firms have to look for internal generation or private equity. There is also a scale effect in M&A: large companies can go in for acquisitions and divestments, which small firms cannot do (Sudarsanam & Lai, 2001). Besides, bankruptcy costs are more important, as a percentage of asset values, for smaller firms that for larger firms (Breachy & Myers, 2000).

On age, financial distress is inversely linked to the age of the enterprise. Research findings confirm that difficulties are more likely for new enterprises. So, Altman (1968) indicated that in 1965, over 50% of the firms that failed did so in the first five years of their existence; over 31% failed in the first three years. More recently, the inverse relationship is validated by Emery et al (2004) although they find some improvement for new firms: as opposed to 54% of failed firms being less than five years old in 1980, this figure drops to 44% in 1997. Prieto (1991) found in his European study that the time of failure changed from country to country. So, there could be cultural differences involved, which we develop further in the part relating to decision-making.

So, in this section, we have seen that the final restructuring strategy chosen will depend on the firm’s characteristics. We have just provided a few examples within six different headings. It is nowhere supposed that this is all inclusive. But even, if there were only six dimensions to be explored, it would require a manager with an extraordinary imagination and visualization capacity to include all the factors. In the next sections, we will see that all the preceding is just the beginning.

B. Environmental factors which may influence restructuring of enterprises

In addition to factors internal to the firm, typical strategic analysis indicates that we should also consider the external environment. Some examples of the influence of environmental factors on restructuring are legislative and economic environment.

Notable legislative fields impacting restructuring would be fiscal, antitrust and bankruptcy policies. On the impact of fiscal policy on restructuring, one may
note that the introduction of imputation credits in Australia (equivalent to the *avoir fiscal* in France) led to a decrease in the real cost of equity. As a result, companies undertook restructuring by increasing the proportion of equity in the capital structure (Mills et al., 1994). As another example, a fiscal policy which allows consolidated netting of group profits and losses attracts holding companies into a country.

Anti-trust legislation usually impedes mergers between large companies. Anti-trust authorities usually place constraints on the merger. This constraint becomes more complex in an international setting. An instance of such complications introduced by anti-trust policy would be the EU’s refusal of the merger between two American companies (Honeywell-GE, Worldcom-Sprint) even though this is not because of nationalistic reasons but because of cultural differences (Evans, 2002): Both EU and US legislations seek to protect the consumer, but the EU Commission wants to protect a minimum level of competition, while the US takes into account the gains for the consumer from reduced competition. This added legal complexity of approval by multiple legal authorities in international sale of subsidiaries means that it takes longer (Honeywell and GE have appealed to the European Tribunal) for mergers and there are fewer buyers to negotiate with in case of divestitures.

Bankruptcy is a very specific law that changes environmental conditions for restructuring enterprises. Once the firm goes in for bankruptcy, new creditors are in a better position under many bankruptcy laws and they may be willing to lend to bankrupt companies because they can get junior, equal and even senior liens to debt (Clement et al., 2001). However, bankruptcy legislation varies from country to country. Bankruptcy legislation could favor either the debtors (US) or the creditors (UK) or even other stakeholders such as employees (France, India), depending on the country. Moreover, this could change over time. For example, German bankruptcy legislation was more creditor-friendly till 1999 as a result of which few companies availed of bankruptcy protection. This changed with the 1999 reform of German bankruptcy legislation (Bolton, 2003).

In this way, bankruptcy protection is one possible method of modification of stakeholder interests, providing an implicit subsidy to the debtor to be borne ultimately by competitors and creditors. Other such modifications of stakeholders’ interests may include government guarantees or bailouts (Akerlof, 1970; Bolton, 2003) where the taxpayer is paying more directly.

Economic environmental factors could be technology, economic conditions and international competition which could lead to downturns and consequential need to specialize to remain competitive. For example, high technology companies can expatriate only within similarly high technology countries to ensure a ready availability of specific skills.

An example of economic conditions could be the diversification discount at which conglomerates trade. This may result in their being bust-up takeovers by raiders who will then break-up the company and sell individual parts.

So, in addition to all the complications of the nature of the firm, the restructuring strategy chosen has also to be appropriate to the environment the company is operating in. We have chosen the simplest presentation of strategic analysis, focusing only on internal and external analysis. However, all these could be complicated by the inclusion of the study of strategies of competitors, powerful customers and powerful suppliers, new products, close substitutes, etc (Porter 1979).

### C. Restructuring Methods

After having analysed the firm, which is the object of restructuring, and the environment or context in which it needs to operate, the manager has to decide which of the restructuring methods listed in the introduction should be applied. How quickly and effectively management responds to changing conditions determines to a great extent which firms will survive and which will not. Some restructuring options are quick to implement, others take a long time. Some are expensive, others are relatively cheap. Some are quick but temporary fixes, others are more durable solutions. The idea is to find a solution which addresses multiple issues of the enterprise. These could include cost, ease of application, speed of implementation, risk, effect on image and control required (Emery et al., 2004). In the following, we illustrate these factors for some restructuring strategies.

Some divestitures take time. While liquid assets and small equity participations can be sold fast, selling large stakes at subsidiaries create a sudden spurt in supply of equity and cause a huge fall in prices. Selling companies can therefore be even more time consuming than selling individual fixed assets. Maier & Stivala (2001) illustrated the importance of due diligence for any divestiture. In fact, during this stage, the selling company needs to maintain its control on this transaction and on the diffusion of sensitive information about its market in order to protect it from its competitors. At the same time, the selling company must take care of its on-going activity. The sale of part of the company could increase risks for the other activities1. If the market is aware that the company is divesting, this could affect the image of the company...
the company, especially if the unit remains on the market for a long time in the absence of buyers.

While treating refocusing and performance, Johnson (1996) notes that a conglomerate diversification strategy leads to high transaction costs (controlling unrelated businesses) and poor performance due to a lack of sufficient attention. The poor performance then motivates sell-offs (Exception: Good performance motivates spin-offs). The poor performance could be low growth or low cash flow. Sell-offs are also motivated by fear of take-over / LBOs. He also finds that the form of control during refocusing influences innovation and R&D. Financial controls reduce innovation while strategic control improves innovation. Moreover, down-scoping (into related businesses) increased R&D intensity.

On employee restructuring, the same study (Johnson 1996) shows employee morale actually seems to go up: insecurity may increase or decrease productivity. However, there is some evidence of turnover and increase in layoffs, but this is not statistically significant. A person will decide to continue or leave the firm in function of his evaluation of the future and present alternatives of the labour market. Some authors (Bretz, Boudreau & Judge, 1994) have called this a “market pull process”. But this hypothesis poses different problems (Vanderberg & Nelson, 1999). First, there is no empirical evidence (Steel & Griffeth, 1989). Second, the labour market opportunities don’t explain the individual behavioral differences in similar situations: why one person leaves and the other doesn’t. So, other authors have analysed the influence of perceptive and cognitive variables. From this vision, the most popular is the model proposed by Mobley (1977). He suggests that the many conditions of work affect the personnel satisfaction that will evaluate the utility to search other jobs, comparing the new alternatives with his present situation. In this sense the turnover would be correlated with disaffection: change in attitudes and an evaluation of cost and benefits of leaving the job.

Within financial restructuring, the trade-off between debt and equity may be quite complex. Internal funds are often considered cheaper for various reasons (Mills et al, 1994). Firstly, because of agency type costs or incentive problems. Essentially, with a real options viewpoint, equity owners would prefer extreme volatility (“high risk-high return” policy) because the downside risk is shared with debtors and value of their equity cannot fall below zero, while upside profits accrue to them. Secondly, debt raises the cost of equity because of the implicit financial distress cost. Thirdly, there is the problem of asymmetric information and adverse selection effect (Akerlof, 1970; Stiglitz & Weiss, 1981). Managers know their company’s worth better than lenders and shareholders. This implies that there is a premium being charged for debt and new equity issues need to be floated at a discount, owing to ignorance of true risk. This information asymmetry applies especially to public bondholders who are less aware of the real situation of the company (Datta & Iskandar-Datta, 1995). Williams (1984) signals that ignorance of restructuring risks lender dominance of the restructuring program. As opposed to all these problems of debt, free cash flow theory (Jensen, 1986) and private equity literature (Rogers et al, 2002), indicate that debt not only creates a tax shield, it also creates incentives to cut cost and avoids complacency.

Another form of restructuring is bankruptcy proceedings. These give an inherent advantage to a firm because it can renege or defer many contractual obligations. However, Williams (1984) and Brealey & Myers (2000) indicate that it suffers from a few problems. First, there is an adverse impact on reputation: dealers and customers worry about replacement parts, supplier demand cash, potential employees are slow to sign on. Second, legal maneuvers make process slow and inefficient. Third, management may lose control as an outside administrator is appointed. Fourth, as already noted, bankruptcy is costly owing to legal and administrative fees. Therefore, before going in for this strategy, these costs should be taken into account.

The above discussion is presented to illustrate cost, ease of application, speed of implementation, risk, effect on image and control required for some restructuring strategies. Often managers choose multiple combinations of restructuring strategies, hopefully, to increase the chance of success. But this can further complicate issues and brings uncertainty. For example, financial restructuring occurs simultaneously with asset refocusing (Johnson, 1996). This may be because LBO firms sell units that don’t fit with strategy or they sell assets to pay off debt. It may also be because LBO firms link incentives strongly with performance and this induces management to sell off what is not performing. It is also possible that financial factors influence the extent to which firms can undertake potentially profitable investments (Mills et al, 1994). So, an asset restructuring strategy may depend on financial restructuring. There is also evidence that unrelated mergers and acquisitions as well as LBO’s result in increase in financial risk owing to financial restructuring (Lei & Hitt, 1995). Thus the link between two restructuring strategies, combined together, is not very clear. Moreover, there is no reason to believe that combinations would be limited to two strategies. Asset restructuring can also lead to change in governance owing to increased diversification and new set of management skills required. The diversification also leads to increased use of financial controls and attendant short term-focus, causing operational restructuring and outsourcing to reduce costs and risks. All this leads to loss of strategic advantage for a firm as development of core competencies invariably moves out.
To summarise, restructuring strategies all have their own characteristics, which make them more or less suitable on different occasions. However since they are often used in combination, one has to be rather cautious in judging the end-game, keeping in view that the firm and the environment are both in dynamic progression.

IV. Criteria for selecting restructuring specific to distressed or declining enterprises

Strange as it may seem, the fact of distress may actually simplify the manager's decision. All the previous discussion related to all kinds of situations and kinds of restructuring. However, many of these are not applicable to distressed firms. Thus, the manager of a sick company actually has a less difficult choice to make. The discussion that follows indicates that the restructuring strategy may depend on the fact of decline or distress, the level of distress and the causes of distress which it must address.

A. The fact of declining or distress may modify restructuring options

Some restructuring options are clearly available for all kinds of enterprises while others are clearly not available for profitable organizations (for example, bankruptcy proceedings). We present the evidence on each of the different categories of restructuring.

Governance or Managerial Restructuring:

A decline in an enterprise's fortunes usually implies poor strategy. This in turn reflects on the management of the company. So, invariably managers need to be changed, especially at the top level. Replacing top management indicates to stakeholders (bankers, creditors and potential investors, but also employees) that the company is serious. For example, Tyco needed a very strong change in its governance in order to underscore that previous mistakes of managers will not be repeated. Tyco replaced Dennis Kozlowski (Pillmore, 2003).

Strategic or portfolio Restructuring:

Expansion is generally excluded for declining companies but they may use it to achieve economies of scale (reduce price to increase demand and reduce costs, get subsidies and tax benefits related to investing).

In a Mergers & Acquisition context, although constant buyers perform best, those who buy in recession phases of business cycles perform better than those who buy either in growth stages or in the doldrums (in-between) stages. But if these enterprises are not cash-rich, acquisitions for cash are generally ruled out (Rovit & Lemire, 2003). Mergers with complementary companies (profitable or cash-rich) using share swaps or LBO's is possible for sick enterprises (Higgins, 1998). There is evidence that if core areas are declining, it is better to build new businesses rather than focusing on declining cores. As a result, disconcentric diversification is usually ruled out while related linked diversification is still acceptable (Dye et al, 2003). Dranikoff et al (2002) report that 76% of divestitures are reactive and two-thirds of the reactive divestitures occur after the parent unit has suffered from weak performance for a number of years, resulting in fire sales or shutdowns. Williams (1984) warns that the trade-offs in divestitures can be particularly irksome once distress sets in: should one sell loss-making but strategically valuable businesses or cash-rich businesses rather than focusing on declining cores. As a result, disconcentric diversification is usually ruled out while related linked diversification is still acceptable (Dye et al, 2003). Dranikoff et al (2002) report that 76% of divestitures are reactive and two-thirds of the reactive divestitures occur after the parent unit has suffered from weak performance for a number of years, resulting in fire sales or shutdowns. Williams (1984) warns that the trade-offs in divestitures can be particularly irksome once distress sets in: should one sell loss-making but strategically important activities at a high discount or sell less important cash-flow generating businesses?

Financial Restructuring:

Dividends can only be decreased or omitted by distressed companies. Increase in dividends is rare, except if it has some signaling value for a share issue. Buy-back of shares is excluded for sick companies.

Debt reduction is not possible as a strategy for distressed companies, except through equity swaps. Rescheduling debt is limited to paying later (and not sooner). The problem for companies in financial distress is to determine how much to ask for. Asking too little may not be enough and asking too much may mean delays and jeopardy (Williams, 1984).

Although Platt et al (1995) argue that firms in financial distress cannot increase debt and therefore modify the sustainable growth rate model. Most researchers indicate that debt increase is possible if the asymmetric information and adverse selection problems can be reduced through government or other guarantees [Akerlof, 1970]. Bankruptcy protection of new debtors is one such guarantee.

Williams (1984) reports that usually the debt is converted into equity at highly diluted equity prices. The case of Metallgesellschaft AG (MGAG) reported by Jayaraman & Shrikhande (1997) is an exception to this rule because the equity was issued at a 400% premium. But this was a case where the governance structure of MGAG included large bankers as hausbanks who already had a large equity stake and wanted to preserve the value of that equity. Therefore, governance or managerial structuring can create a difference to a financial restructuring.

Operational Restructuring:

Williams (1984) suggests focusing on cash flows. He suggests transferring cash to banks from which no loans have been taken in the early-decline period. This is not applicable for prosperous companies because the idle cash incurs opportunity interest costs. Most distressed companies undertake rigorous cost reduction plans.

Employee Restructuring:

In the case of businesses in crisis or decline, a worker would have a loss of control perception over his
results in the business, causing an emotional withdrawal that finally cause a low involvement in his job, a low organizational commitment and consequently a low performance.

Bankruptcy:

Bankruptcy protection permits firms in some countries to raise new debts because these get special protection.

B. The level of distress influences the kind of restructuring

The next proposition in our framework is that the stage of decline would influence the restructuring selected. Different authors have different classifications of stages of distress and decline. Williams (1984) classified the decline into three phases: the early decline phase, the continuing downwards drift and filing for bankruptcy. Datta and Iskandar-Datta (1995) classify decline into two stages: before bankruptcy filing and after bankruptcy filing. Paul-Petit & Chastenet de Castaing (2002) use a three-stage classification of distress to recovery (Fond du gouffre, Milieu de gué and Sortie du Tunnel). Pate & Platt (2003) present a three-level classification of enterprises (bons élèves, mauvais élèves and les derniers). We present the available discussion and academic findings within the context of stages of decline and distress, developed by Ashta & Tolle (2004): (1) early decline, (2) initial distress, (3) acute distress, (4a) liquidation or (4b) early recovery, and (5) drive to normalization.

For mature industries, in the beginning of their decline (stage 1), it is possible that firms are cash-rich and are able to buy themselves new sectors of growth. Operational restructuring is more relevant in the first stage of initial decline. It may be better to launch equity and debt issues before credit lines are choked up. Strategic investments need to be deferred (Williams, 1984).

In the second stage, the continuing downward drift, Williams (1984) finds that firms start strategic restructuring by cutting back R&D and new product development and selling business lines.

Datta & Iskandar-Datta (1995) find that restructuring takes place before and after filing for bankruptcy, but the kind of restructuring undertaken is different. Before bankruptcy filings, firms go in for asset and governance restructuring. Moreover, they find that there are more governance restructurings before filing for bankruptcy. There is significantly less financial restructuring before bankruptcy proceedings. Financial restructuring is influenced by holdout problem among creditor groups: the lenders know that those who lend after bankruptcy filings will have greater rights and therefore prefer to wait. This holdout problem is greater if lenders are secured because these lenders have little to gain by scaling down their claims. As a result, they are not influenced by threats of bankruptcy filing. They also find that more restructurings are undertaken by firms with higher leverage.

In the third stage, when the enterprise is at the bottom of the trough, the problems may be so acute that delocalization to reduce costs is not an available option as the cash flow to physically delocalize is no longer available (Sudarsanam & Lai, 2001). Externalization is not possible because new suppliers don’t want to undertake such a risky commitment. Public equity or public debt would not be forthcoming, although it would have been forthcoming if the enterprise had still been profitable. Brealey & Myers (2000) indicate that firms in distress would find it difficult to sell off growth opportunities. Distress reduces the negotiating ability of the enterprise. As a result, any sale of assets is negotiated from a position of weakness. Sale of loss-making ventures would be difficult. Sales of profit-making ventures would also be at a much lower price (Dranikoff et al., 2002). This is because often there are only a few buyers for specific businesses and they are aware of the seller's economic desperation. (Sudarsanam & Lai, 2001) Financial textbooks (Brealey & Myers, 2000; Shapiro & Balbirer, 2000) also indicate certain games specific to bankruptcy (stage 3). First, shareholders would take higher risk with existing assets in an attempt to increase volatility and add option value to their share, even if this reduces firm value as long as value of debt is reduced by more than the reduction in firm value. Second, shareholders would not be willing to put in new equity for new profitable projects because old debt holders would get priority claims, before those of the shareholders. In fact, they may even offer themselves higher dividends before filing for bankruptcy, if they can get away with it. Indentures in debt contracts would usually not allow this. Platt et al. (1995) argue that firms in financial distress would be unable to raise new debt and would give no dividends for various reasons: protective covenants in bank credit agreements, managers' need for cash-flow.

Between stage 3 and 4, there is another pressure of transition: in a near future, the enterprise will either be in liquidation (stage 4a) or find a path to recovery (stage 4b). From a real options viewpoint, shareholders at stage 3 have nothing to lose. If the firm is liquidated (stage 4a), in any case there will not be enough to pay off creditors, leaving nothing for shareholders. As a result, if any restructuring works (stage 4b), they may get some advantages (Datta & Iskandar-Datta, 1995).

On the fourth stage, we distinguish between those who do not recover (stage 4a) and those who recover (stage 4b & 5). Sudarsanam & Lai, (2001) find that non-recovery firms (stage 4a) use dividend cuts and debt restructuring more often than recovery firms (stage 4b and 5), especially a year or two after distress (99% confidence). They also report that non-
recovery firms use an operational cost-cutting strategy more often, especially a year or two after the onset of distress, (90% confidence) than recovery firms do. We can hypothesize that agency problems and personal agendas keep managers from exercising this option, unless they are forced to do so by losses or by change in governance such as in a LBO. Sudarsanam & Lai also indicate that non-recovery firms restructure more intensively but are less effective in implementation of strategies. Recovery firms have growth-oriented and external-market focused strategies (acquisition and investment) while non-recovery firms go in for fire-fighting (operational and financial restructuring).

On the fifth stage, we found no specific research isolating recovery strategies from firms in stage 4b to those applicable in stage 5, on the one hand, and from stage 5 to normal healthy firms, on the other. John et al. (1992) studied strategies adopted by firms who restructure and go directly from stage 2 to stage 5. They found that the typical response of such firms was cost-cutting and shrinkage.

C. The problems causing the decline influences the kind of restructuring

The restructuring strategy has to address the causes of the decline (Sudarsanam & Lai, 2001). Emery et al. (2004) list poor governance, unwise expansion, intense competition, too much debt, massive litigation as a few of the possible causes. In general, we could say that causes may be linked to the internal management of the firm or due to changes in the environment (new threats, vanishing opportunities) or to a combination of these. John et al. (1992) indicated that managers of firms with negative earnings attribute these to exogenous factors (economy, competition) rather than to internal factors. However, since the ability to influence external factors is less, the response to distress is usually on internal factors. While the normal response is contraction, John et al. (1992) found that a quarter of the firms went in for some kind of expansion.

Examples of internal factors could be governance and unwise expansion. In some cases, the decline may have been caused by agency problems and unsound governance. Johnson (1996) finds evidence that when shares are diffusedly held, governance is weak. Inadequate governance led to inadequate controls: managers appropriated free cash flows into diversification and aggrandizement, subscribing to Jensen's (1986) Free Cash Flow theory. Epstein & Roy (2004) suggest using a balanced scorecard to measure and improve corporate board performance to address this problem.

Another governance problem would be that the executive directors' interests may not synchronize with the company's interests. Sudarsanam & Lai (2001) indicate that managers will not opt for restructuring solutions which may contribute to turnaround but hurt their self-interest. This can be overcome to some extent by block shareholdings, managerial shareholdings or keiretsu membership and bank relationships (Jayaraman & Shrikhande, 1997).

We have noted in several recent cases that managers would even perpetuate corporate fraud to enhance their interests. The case is well illustrated by Enron executives using non-consolidated subsidies to offset debt from its balance sheet and the executives selling their shares before the company sank. Worldcom hid operating expenses in capital expenditure. Ahold took into account receipt of supplier incentives which it had not even earned. The problem is essentially rooted in poor governance and the solution is in governance restructuring. In many cases, the solution has been class-action legal cases or criminal actions instituted against these managers (example Skilling for Enron, Kozlowski for Tyco, Messier for Vivendi, Tanzi for Parmalat). These recent examples contradict John et al. (1992) who find that top management changes for loss-making companies were not significantly different from those of all companies.

The decline of the enterprise may also be caused by unwise expansion (Higgins, 1977, 1998). Platt et al. (1995) indicate that for 1993, 47% of US companies had financial difficulties owing to this reason. If the financial distress is caused by growing faster than the sustainable growth rate, Higgins (1998), Govindarajan & Shank (1986) and Platt et al. (1995) indicate some ways to correct this would be operational restructuring methods such as increasing sales prices (which increases cash and slows down growth) or reducing costs or increasing the productivity of assets. This may include selling non-core assets or controlling inventory or receivables. Similarly, there may be a need to go in for financial restructuring, reducing dividends and increasing debt and equity. To all this, we could add the possibility of securitization of future sales income for industries with stable expected revenues.

An example of external factors causing distress could be low sales owing to industry decline, owing to the product life-cycle entering a post-maturity phase. Such enterprises typically have high cash flows but low growth opportunities. Jensen (1986) considers these enterprises as the typical ones splurging money in unwise conglomerate diversifications rather than decently returning money to shareholders through dividend increases or share buybacks.

Liquidity crisis can also be caused by a combination of internal and external factors linked for example to working capital requirements: holding too much stock, often inappropriate stock, or by competitive environment of long credit periods for sales and low credit periods for suppliers. Fixed or variable costs may be too high, creating high break-even point. All of these may manifest in an absence of free cash flows. However, depending on the reason for decline,
different restructurings are required. For example, if there is a cash flow shortfall, it is difficult to go in for a cash purchase of new enterprises. However, share swaps and even LBO’s could still be possible as long as the target is not over-indebted. If the financial distress is created by too much or inappropriate stock, the company needs to liquidate assets, rather than taking more loans to finance it, thus raising costs. In industries where suppliers do not provide credit, further externalization may only exacerbate cash flow problems.

So far, we have focused on the various objective criteria for selecting different restructuring strategies, which are external to the decision-maker. These included the enterprise, the environment and the characteristics of restructuring strategies. We then indicated that specific issues are addressed by sick companies, which limits the selection choice. However, as the reader may have noted, the selection choice remains vast and a host of issues need to be kept in mind. The question is how the manager chooses keeping all these issues in mind. The next section discusses some of the factors specific to the decision-maker which influence the final restructuring strategy selected.

V. The Decision-making

From the above, we have seen that the problem confronted by a manager is a general problem of decision-making given choices and the specificity of this general problem is the complexity of the different dimensions of a restructuring fit for a sick industry. A non-appropriate strategy applied to a healthy company costs money, but a non-appropriate restructuring applied to a sick company would spell its death or liquidation. Already the paradox of choice (Schwartz, 2004) shows that in consumer decisions, more choice is less conducive to happiness. In managerial decisions, where social responsibility complicates the issues, the selection decision assumes even more importance.

Traditionally, the restructuring process was assumed to follow a fixed and objective model on decision making which tried to explain human preferences by assuming that people are rational decision makers, using mental processes like a decision-tree, in as much that they make optimum choices in conditions where:

- they have abundant information
- they are aware of the relevant alternatives for that particular situation

they are aware of all the consequences for each of these alternatives

they make rational choices following a logical criterion of order.

Based on this rational model, the restructuring process becomes really simple: identify the problem – search for alternatives – choose the most successful option – execute and assess the chosen option. But, this process is not automatic, it’s carried out by a person. So, like decision-making system, we need certain specific conditions (Harrison, 1995): a single decision maker, a single objective, knowledge of all the solutions and the ability to calculate them in quantitative terms. In other words, for logical type decisions it is a matter of determining the decision tree that we are to use for choosing a solution from the thousands of possible options. According to this model, our preferences and alternatives would be perfectly arranged in any eventuality.

However, as appealing as this model may be, it is no more than a myth, having little or no bearing on the realities of human behavior in the decision making process. Indeed, our general decisions (and financial decisions too) are not based on a logical ordering of all possible alternatives, but rather on the retrieval of very few alternatives (in many instances just one single alternative) and their subsequent cognitive justification. Therefore, the rational model would only be fulfilled in those situations where the problem is fully defined and all solutions, along with their future consequences, are known. However, such premises are rarely fulfilled in the real world, where a manager has to make decisions without knowing the causes of the problem or the consequences of each alternative. The rational systems are approximated solutions to the problems, but not the optimal nor the only solution. We have tried, in the preceding pages, to detail the uncertainties regarding all the different aspects of the restructuring decision. Moreover, decision making in the real world becomes even more complicated due to the fact that decisions are generally taken by several people (or at least several people have a hand in the process). What is more, under such a rational schema, we would remove the individual differences that lead someone to choose a particular option based on the processes of socialisation and learning, on perceptive processes, but also on the personal cost and losses that each decision entails (Mellers, 2001), leading a person to choose a particular option even when this goes against all rational thinking.

Consequently, the decision-taking in risky situations (like restructuring) is conditioned by cognitive variables, which are in turn consequence of a person's
previous experience. One of the first studies was carried out by Atkinson (1957). For this author, the individual decision to carry out one or another task will be a function of three variables. A first component will be the person's motivation (M) to choose one specific action. A second variable will be the probability (P) or expectation of the person to succeed in achieving the proposed goal. The third element will be, finally, the subjective value or incentive (I) that each action has for each person. For Atkinson, these incentives can have diverse origins but all have a common characteristic: produce satisfaction for the person who takes the decision, either for the satisfaction from task completion or from the feeling of belonging to and acceptance of a closed group, or for the feeling of influence and control. According to Atkinson, a person will take the decision in function of these three variables (Decision = M x P x I). This incentive of the task will have an inversely proportional relation to probability or expected degree of difficulty to reach the goal (I=1-P), so if the person perceives a high probability to obtain success, lower will be his incentive or task subjective value.

Atkinson based part of his model on the works carried out jointly with McClelland and his motivation theory (McClelland, Atkinson, Clark, & Lowell, 1953). According to this theoretical model, each person is motivated by three basic needs (Affiliation, Power and Achievement), being the last one the most important to understand the human behavior. This Need of Achievement (nAch) has been defined as the relatively stable disposition of a person to fight or to endeavor for success. That is to say, a person with high need of achievement will be felt inclined toward those tasks that he considers challenging and difficult, so that when he achieves success, he sits down satisfied with the achievement. With this general model, Atkinson (1957) distinguished two personality types: one characterized by having a high motivation behavior toward success and the other that seeks a high avoidance of failure. To establish, in a theoretical way, the probability of a person to take one or another decision, Atkinson (1957) pointed out nine hypothetical situations with different degrees of difficulty or risk for each one of those groups. According to his model, persons with high motivation toward the success will have higher probability to select tasks with an intermediate difficulty and, therefore, of moderate risk; whereas, the persons with higher motivation toward the avoidance of the failure would prefer to reduce their own anxiety, choosing tasks with high risk, or low risk, leaving certain chance in their selection. Since restructuring decisions involve various degrees of difficulty, it is clear that the kind of attitude and cognitive variable of the decision-maker will influence the restructuring selected.

Another of the classical theories that has related personal cognitive factors with its subsequent performance has been the locus of control of reinforcement (LOC) theory (Rotter, 1966). This theory differentiates two groups of persons in function of their attribution of success or failure. A first group is those persons who perceive that the majority of the facts that occur in their life are consequence of their own responsibility (internal locus of control). In opposite, a second group would be those persons that attribute the facts that occur to good or bad luck, the Administration or other external factors (external locus of control). In this point of view, internal LOC persons have the belief that they have some control on any event and they are less influenced by their external pressures. In consequence, they are better adapted to stressful situation (Avtgis, 1998). There is some relation between the LOC theory and the Need of Achievement in such a way that the persons with high nAch had greater belief in their own ability or resources and a greater confidence in themselves (Diaz & Rodriguez, 2003). So, restructuring strategies selected by the two types of persons may be different. In line with all this, Hammer (2004) indicates that operations management is considered unglamorous compared to making deals (M&A). It may also be unfamiliar to most senior executives. As a result, few managers focus on operational innovation and restructuring. Training in application of innovative techniques is therefore desirable. Other authors, like Edwards (1954) or Simon (1976), have studied also how subjective and environmental factors can influence decision makers, especially so when making non-programmed, unstructured decisions.

But the greatest contribution in regards to how psychological factors influence decision making in the face of economic uncertainty and high risk comes from the works of Kahneman and Tversky. Shefrin & Statman (2003) provide a brief note on the contributions of Kahneman and Tversky to the undersanding of risk. They divide the contribution into two parts. The first is Prospect Theory (Kahneman & Tversky, 1979) which is useful in decision-making and portfolio selection with at least one risky asset, in contrast to using Mean-Variance Theory. Essentially, Prospect Theory is based on choice being influenced by changes in wealth; the individual is subject to loss aversion rather than risk aversion, but risk aversion in profitable situations and risk seeking in losing scenarios; but with overweighting of certainty and of small probabilities which could invert the choices. This overweighting of probabilities in decision criteria modifies considerably the expected utility theory. Further, framing of choices affects decision-making. As a result people do not take the mean-variance dominant portfolios and do not diversify adequately. The
second part of their contribution is to heuristics and biases which deals with how people assess risks and is useful for asset pricing, in contrast to Market Efficiency concepts. The price is not a function of fair value but of heuristics which have biases, which are systematic. For example, in the representativeness bias, over-reliance is placed on singular information and not enough on base-rate information in the assessing of Bayesian probabilities and risk. The work of Kahneman and Tversky can be applied to the world of finance and investment (Baker & Nofsinger, 2002) as well as to corporate decision-making in general and restructuring decisions in particular which require the financial evaluation of different alternatives.

The latest naturalist tendencies in the study of decision making (Zsambok & Klein, 1997) show how, on an experimental level, people in unpredictable situations, with incomplete (and sometimes contradictory) information, opposing objectives and pressured by time, create and assess a single solution that has a high likelihood of solving the problem (even though many more solutions could be created and assessed). This simplification is probably due to the fact that our brain needs to reduce both the amount and complexity of the information that it receives on a particular problem, thus removing other variables and alternatives, focusing instead on a far more limited number (heuristic simplification).

Indeed, some authors (Klein, 1998) have highlighted the “personal experience” variable for complex decision making linked to the economic environment. In other words, faced with a given problem, a manager will attempt to identify similar signals in his memory that will allow him to apply the same decision and assess just one of the alternatives. This identification and retrieval of memories is what Kahneman (2003) has defined as accessibility and is conditioned by such factors as the similarity of situations, the emotional and affective condition of the decision maker or random propensity.

Yet we should consider decision making not just as a (single) cognitive process, but also as a social process (mainly). Thus, the manager is not only influenced by internal variables, but also by those of a cultural and social nature. So, for example, there have been a lot of studies which have argued the importance of culture in the perception and other psychological process (Triandis et al., 1988; Hofstede, 1980, 1998; Kirkman & Shapiro, 2001).

In short, such psychosocial variables influence all stages of the decision making process, including restructuring: from the identification of the problem to the elaboration of all the different possible alternatives, the assessment of each and choosing the “best” option. To sum up, the factors that modulate or come into play during the decision making process can be grouped together into two large dimensions: internal characteristics of the decision maker influences from the environment

A. Internal characteristics of the decision maker:

Restructuring decision-making is influenced by diverse factors of a psychological order, determined by the perceptions, knowledge, skills and learning of the different subjects involved (senders-receivers). Many individual differences influence the decision making process, including:

- **Perceptive-cognitive variables**: the influence of the processes of perception and categorization, such as the tendency to attribute a greater chance of occurrence in complex situations and where there are numerous events as opposed to more simple situations (Tversky and Kahneman, 1983)
- **Propensity towards risk**: a person that has little propensity towards risk will perform a different assessment of the alternatives, setting out different objectives and selecting alternatives in a different manner from a person in the same circumstances but that has an aversion to risk. Moreover, various studies have confirmed how such a tendency towards risk is subject to diverse personal variables (such as age) that have an influence on the decision making process (Hambrick & Mason, 1984).
- **Cognitive discord**: in a restructuring situation, after making a decision, there is usually a certain degree of anxiety or anguish arising from doubts that the decision maker may have concerning the selection that he or she has made (cognitive discord). We tend to reduce such anxiety by means of an *a posteriori* shift in our beliefs, ignoring or undervaluing the other alternatives and believing that the chosen option was the correct one (Akerlof & Dickens, 1982).
- **Previous experiences**: one of the most important aspects has been the role played by previous or similar experiences. When facing highly uncertain situations where we are being pressed to make quick decisions, we usually explore common traits between the current situation and our past experiences in order to make successful decisions. This strategy is employed by senior professionals to a far greater extent than by the inexperienced (Klein, 1998). Yet such a procedure is illogical since both situations will have different components and, hence, different consequences. It is also possible that the manager...
has not had any previous experience on restructuring.

- **Attributional processes:** generally speaking, managers have a greater tendency to make external attributions towards financial situations of crisis and failure (requiring restructuring), and internal attributions towards situations of success and growth (Barker & Barr, 2002). Logically, such attributions will influence the final decision. The tendency towards the external attribution of failure has been extensively studied by other areas of Psychology (Zuckermann, 1979) and we must consider its effect on restructuring decision-making.

**B. Influences from the environment:**

As well as the decision maker’s internal characteristics, we should consider other variables from our immediate environment, such as:

- **The group:** it is one of the main influential variables; From the classic study by Kogan & Wallach (1967) to more recent studies (Duflo & Saez, 2002), they have highlighted group influence in decision making processes of conformity, whereby people tend to change their opinions based on the majority (or social) consensus and the importance attributed to social rules. Moreover, the social standing of the person who puts forward the proposal is another important factor. This explains why the same person makes different decisions, in different companies, or environment over a period of time according to the position and responsibility that he or she holds at that particular moment. The importance of social influence on restructuring process is bigger, since companies are social and political arenas.

- **Cultural factors:** an important aspect when considering decision making on restructuring is the influence of cultural variables and, especially, subjective rules (i.e. the subjective evaluation that members of a particular culture make of a specific conduct), which violate the assumptions of universality of the rational theory (Schwartz, 2000). Numerous studies have pointed out the importance of culture in psychological and perceptive processes in particular (Hofstede, 1998; Kirkman & Shapiro, 2001). So, probably, the same problem, in different countries has generated different restructuring strategies.

- **Physical environment:** a relationship exists between various emotional states and the taking of economical and non-economical decisions. Thus, for instance, Rind (1996) found a relationship between choosing alternatives and the weather.

To summarise, the decision-maker of the restructuring decision has internal and external influences operating on him, just as the firm, which is the object of restructuring, has its own internal and external influences in process. The restructuring strategy selected therefore has to find a fit between all the different influences.

**VI. Conclusion**

In this paper, we have formalized a descriptive framework of determining restructuring applicable to sick enterprises. Specifically, the selection of a restructuring strategy is influenced not only by general restructuring criteria (firm-specific factors, the environment and characteristics of different restructuring methods) but also by the decline or distress (the fact of decline, the level of distress, the causes of distress). These objective criteria are then processed by a decision-maker whose personal attitudes and cultural specificities influence the decision. Where possible, we have presented the findings of other researchers and have indicated where it would fit in this framework.

This paper is a literature survey within the fields of restructuring and decision-making. A conceptual framework has been developed. Being a theoretical framework, it suffers from all the limitations of such exercises.

Future research will continue to document what is unknown about the black box in the mind of the decision-maker: influences of personality, social and cultural factors, including for example the influence of different group values and norms. Another area of research is sociological and group dynamics inside the enterprise which could influence the restructuring selected.

Moreover, the precise relationship between the different antecedents of the restructuring decision may one day be the focus of empirical research through more in-depth case-studies.

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