(2014) 2 NIBLeJ 8

The Uneasy Case for Bankruptcy Legislation and Business Rescue

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Introduction

1 This article[1] proposes that the attempt to strengthen insolvency legislation, in terms of:

> "…promoting the ability to reorganize and rescue a company in distress"

through adaptations to European bankruptcy laws, is insufficient to save companies from bankruptcy. Moreover, new legislation in the current "corporate rescue culture" may actually have the opposite effect. The real issue in a rescue attempt is rebuilding trust amongst all parties involved. Legislation and financial restructuring are only to be considered means to reach this goal.

The Trend towards Corporate Rescue

2 Currently a "corporate rescue trend" can be spotted worldwide where each country would ideally have effective legislation in place, focused on "reorganization and rehabilitation of the debtor".[2] By adopting rehabilitation paragraphs in insolvency legislation, the aim is to reduce the amount of viable businesses that fall prey to liquidation (bankruptcy). In that line of thought, insolvency legislation ought to encourage companies to look for protection against creditors at an early stage in order to create a "stable environment" in which the company can get "back on its feet", with the appointed administrator playing a central role.

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[1] This article is an updated and revised version of J. Adriaanse *et al.*, "Faillissementswetgeving redt bedrijven niet" (2007) *Tijdschrift voor Insolventierecht* 149.

[2] See, for example, a considerable number of current IMF, World Bank, UNCITRAL, Asian Development Bank and European Union e-publications on the subject. For an overview of more historic developments regarding the subject, see, *inter alia*, J. Adriaanse, *Restructuring in the Shadow of the Law. Informal Reorganisation in the Netherlands* (Leiden University Dissertation) (2005, Kluwer, Deventer).

The Problem

3 Although I am not in principle against the aims of bankruptcy legislation reform, I cannot fail to observe a fundamental problem. Empirical evidence shows that companies in financial difficulties can only be saved when a process of active *turnaround and stakeholder management* is initiated. In this, altering bankruptcy legislation is, in the best case scenario, a positive contribution, no more than that.

4 The potential downside is, however, that new judicial debtor-friendly instruments (or one could say: creditor-unfriendly instruments) to be put in place will (further) isolate important lenders (banks, suppliers/creditors etc.). Furthermore, placing a great(er) emphasis on "forced" deals within and outside of insolvency, for example thinking about debt-discharge voting-mechanisms ("haircuts"), will further complicate reorganizations rather than provide solutions. Bankruptcy legislation, at least the reorganization paragraph thereof, ought to be viewed as an "*option of last resort*",[3] which should be treated with caution or, at least, not freely and opportunistically "applied" in case of financial difficulty by entrepreneurs and their advisors.

5 Below, these arguments are strengthened by use of several findings from a research project conducted by Leiden University between 2003-2005. Currently, researchers in Leiden are working on new projects which are partially aimed at mapping causes for financial difficulties in practice. The first results seem to underline these earlier findings.

6 The earlier research has been conducted at the so-called *Intensive Care Divisions* of four Dutch banks: ABN-Amro, Rabobank, ING and (now the former bank) Fortis, as well as by a number of consultancy firms. The size of the enterprise was made irrelevant; an average of the Dutch businesses being researched in the project. In total, 35 attempts to save companies from bankruptcy were examined, by use of intensive case-study research as well as 23 interviews and over 465 surveys being conducted (among insolvency office holders, SME-accountants, credit managers and turnaround consultants).[4] The results have also been, for the purpose of this article, tested against a number of standard works within the turnaround literature.[5]

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[3] See also V. Finch, "The Recasting of Insolvency Law" (2005) 68 *Modern Law Review* 713.

[4] For more information about the problem definition, research plan and results, see Adriaanse, above note 2.

[5] These include, but are not limited to: J. Argenti, *Corporate Collapse: The Causes and Symptoms*, (1976, McGraw-Hill, London); D. Bibeault, *Corporate Turnaround. How Managers turn Losers into Winners* (1982, McGraw-Hill, New York NY) (reprinted 1998); and S. Slatter and D. Lovett, *Corporate Turnaround, Managing Companies in Distress* (1999, Penguin Books, London).

Difficulties in a Rescue Mission

7 The current "rescue rush" by legislators seems mainly driven by the phenomenon that many formal (court-led) reorganizations in practice actually fail. From that perspective, it is vital to address the many bottlenecks and fail factors in practice. Clearly, revised legislation should be aimed at eliminating difficulties which practice (so far) has not been able to eliminate. Based on the research conducted, the following summary of difficulties can be formulated (written down in the form of a *worst practice overview*).

8 Firstly, there is often an underestimation by management concerning the necessity for quick, comprehensive and adequate reorganization of the business activities from an integral new vision and strategy. When underlying causes of financial difficulties are examined, the three most prominent categories that have been identified are:

- lack of strategic entrepreneurship;
- insufficient financial insight; and
- too high variable and fixed (overhead) costs.

9 In virtually any case of a (near-) bankrupt company, be it a local convenience store or a multinational enterprise, one can detect questions that have been insufficiently posed, such as:

- "In which markets is the company active?";
- "In which one should it be active?"; as well as
- "In which way should it be active?"

10 This also applies to questions like:

- "What are the true 'needs' of the company's customers?";
- "Who are the major (and true) competitors?"; and
- "What is truly the competitive advantage (*unique selling point*) of the company?"

11 More often than not, a discrepancy can be detected (an *assumption gap*) between the necessary market behavior and the actual behavior of the company in practice. Apart from a faulty strategy, distressed companies also appear to be insufficiently driven by parameters (*key performance indicators*) such as profit, cash-flow, solvency and liquidity.[6] There is often a weak administrative organization and insufficient cash planning, which can cause expenses to get out of hand without management noticing. In short, there are invisible inefficiencies in the primary process of the company which explains why so often action is taken (too) late.

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[6] Regarding solvency and liquidity ratios, see, for example, B. Ganguin and J. Bilardello, *Fundamentals of Corporate Credit Analysis* (2005, McGraw-Hill, New York NY), at 80-107.

12 The final factor to be addressed here, the use of an (iterative) business plan as a *management tool,* is utilized relatively rarely, even though there is an (empirically proven) positive correlation between plan-driven entrepreneurship, where a combination of acting strategically based on financial insights takes a central role, and the diminishing likelihood of bankruptcy.[7] Actually, 71% of the respondents in our survey among insolvency office holders confirmed that in court-led reorganizations a sound business turnaround plan is most of the time missing.[8] On top of that, managers are often insufficiently aware of the severity of the crisis situation in which they find themselves and are also frequently hesitant, particularly in SME-related situations, to involve specialized turnaround advisers.

13 Another recurring theme is that important financiers such as banks and large suppliers are often consciously left out of the reorganization-process. Management does not allow much or any say in the turnaround process and/or is scared of informing (read: "scaring off") these parties of their financial loss-making situation. Additionally, junior creditors are often confronted at too late a stage with (often harsh) proposals for discharge of debts.

14 On top of that, management is frequently insufficiently transparent towards involved parties concerning the reorganization process and the development of the financial situation. In this manner, parties involved do not have sufficient information to estimate the ever-changing risks involved. Finally, through a worsened situation (read: financial losses), solvency and liquidity has often greatly deteriorated. In a large number of failed rescue operations, the possibilities of addressing private equity and/or looking for take-over attempts appear to have been insufficiently researched, this in combination with the aforementioned difficulties.

Restoration of Trust

15 The research conclusively underlines that the factors that cause failure are often a result of lack of communication between involved parties, as well as their respective levels of risk perception. In fact, one could say that the potential for a successful rescue operation is mostly dependent on the question whether or not the management team can adequately *convince* its most important financers of the viability of their struggling business. In other words, the main issue is whether management is sufficiently able to create *trust*, i.e. restore trust in light of (potential) future viability of the company, as well as in its own entrepreneurial (i.e. managerial) capabilities to guide the distressed firm to that desired future state. In

[7] See, for example, S. Perry, "The Relation between Written Business Plans and the Failure of Small Businesses in the U.S." (2001) 39 *Journal of Small Business Management* 201.
[8] See Adriaanse, above note 2, at 337.

other words, the core question is whether those in charge of the company are able to manage creditors' perceptions such that they feel that:

> "…their interests will be met, for they are in good hands".

16 This is of vital importance, for when financiers (once more) support the company, room has been created for a solution because of the renewed availability of time – a basic condition – as well as credit (the latter both literally and figuratively). In other words, through engaging with creditors and providing them with ample insight into the financial situation and ultimately a sound turnaround plan, a solid basis for success is created. Also, pro-actively communicating during the reorganization about the progress, as well as embodying a clear intention not to transfer entrepreneurial risk to creditors (unless no others options are left), the chance of conflicts and unwillingness of creditors to cooperate will likely decrease tremendously, and with it the chance of bankruptcy.

17 Conversely, conflicts (with potential disastrous consequences) are significantly increased when the factors discussed above are ignored. The restoration of damaged relationships is therefore an essential part of any business rescue attempt; this being completely contradictory to judicial means that have been designed to keep creditors at bay and/or force them to discharge debts. In that case a company does not create "natural viability"; in other words, involved financiers and suppliers have to be intrinsically motivated to support the survival of the company, they should not be "blackmailed by insolvency law".

18 In this light, it is evident that by judicially forcing a company to abandon its contractual rights, what most rehabilitation procedures in fact imply, it is impossible to achieve needed trust. So, based on the points mentioned above, attempts to do so should be minimized as much as possible in order to increase success rates of business rescue. In other words, combatting the aforementioned bottlenecks with new insolvency legislation is simply fruitless, also because suppliers and financiers will probably *ex-ante* sharpen their *credit* and *risk management* systems in turn, simply in order to restore the natural balance i.e. the desired cooperation model between companies, banks and other creditors.[9]

19 As such, they will take precautionary measures at a much earlier stage than currently is the case: perfectly fair since they are the providers of *risk-averse* capital. For instance, by asking for direct upfront payments and/or denouncing (trade-) credit agreements sooner. Apart from this, one should not forget that in case of approaching insolvency, economically speaking, creditors already become part-owners. Indeed, the company is at this point mostly comprised of debt and finds itself in a situation where its future existence is for the most part in the hands

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[9] See, in the same sense, Finch, above note 3, at 713ff; D. Baird and R. Rasmussen, "The End of Bankruptcy" (2002-2003) 55 *Stanford Law Review* 751.

of creditors. The call for rights of say, supervision and insight are in this situation very well explicable and these instruments ought not to be discarded without proper consideration. On top of that, external stakeholders often have substantial market knowledge and in particular banks have in-depth knowledge concerning dealing with turnaround and restructuring challenges.

20 In that light, the involvement of creditors should most certainly be viewed as *positive*; research from, for example, Couwenberg and De Jong confirms this view, particularly concerning the role of banks.[10] Furthermore, none of the involved stakeholders will be primarily interested in forcing bankruptcy (liquidation). This “last resort” will only be addressed when the viability of the company, or at least the *perceived* viability thereof has proven to be completely lost; this, after careful consideration amongst stakeholders and often only after an extensive period of *monitoring*: could a newly appointed administrator truly make a difference in case of perceived viability lost? The answer is most likely to be negative.

Ability to Reorganize

21 In the process of value restoration and new to-be-found viability,[11] the (turnaround) vision and strategy ought to be utilized in an integrated fashion in order to tackle problems. Indeed, *durante causa durat effectus*: if the fundamental causes of decline are not eliminated, the (negative) results will continue to appear. Financial restructuring, for example, in the form of an informal or judicially forced debt-agreement with remission, as well as cutting costs, are always merely means *during* the search for renewed trust, the search for new customers, and with that the search for viability of the company in the long term. No more, no less. A reorganization of debt as such does not in any shape or form contribute to the renewed viability of the company; it merely functions as an (undesirable) “emergency brake” when there is insufficient time to address liquidity influxes.

22 Thus, a company does not revive (“phoenix-esque”) unless the involved parties: shareholders, management, suppliers, banks/creditors, customers, employees, explicitly or implicitly feel that their cooperation (“*nexus of contracts*”)[12] ought to stay intact. However, they will only agree with this sentiment in cases where it is in their best interest. A company can therefore survive solely in cases where value is

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[10] See O. Couwenberg and A. de Jong, “It takes Two to Tango: An Empirical Tale of Distressed Firms and Assisting Banks” (2006) 26 *International Review of Law and Economics* 429.

[11] See, in the same sense, N. Pandit, “Some Recommendations for Improved Research on Corporate Turnaround” (2000) 3(2) *M@n@gement* 31.

[12] See, *inter alia*, M. Jensen and W. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 *Journal of Financial Economics* 305; R. Kraakman *et al.*, *The Anatomy of Corporate Law, A Comparative and Functional Approach* (2004, Oxford University Press, Oxford), at 6-8.

created for all stakeholders involved. As long as this is the case, the tendency will be to maintain cooperation.

23 By not breaking up the (current and potential) nexus of contracts, in effect by filing for bankruptcy liquidation, the stakeholders show the perceived (going concern) value of their cooperation. In turn, when bankruptcy is indeed filed, the deciders: for instance, the company's main bank that terminates its credit, employees that file for bankruptcy, simultaneously or not with (a group of) competing junior creditors/suppliers, do not perceive the added value and with that the viability of the company: cooperation has been terminated and the end is near. Parties that want to prevent such a scenario: for instance, management and/or shareholders, thus ought not to blindly trust in a judicial reorganization procedure, and they should (remain to) show the potential economic value of the now distressed company.

24 The only way to achieve this is to, on the one hand, utilize a structured and methodical process of value recovery, by use of a turnaround vision and strategy which translates into a detailed yet pragmatic turnaround management process, and, on the other hand, by actively managing perceptions of all stakeholders involved. By use of this methodology, the chance augments that the company will once more be able to independently prosper and with that prove its (long-term) viability. The "ability to reorganize" can therefore be viewed as the equivalent of the ability to create value and the restoration of trust as such.

Conclusion

25 It is therefore a necessity that discussions regarding "insolvency rehabilitation legislation" focus more on above mentioned aspects. Otherwise, the imminent danger is that the emphasis will lie too much on, for example, more "debtor-friendly" voting quorums for compulsory settlements, as well as other ways to distance creditors, which will in fact emphasize the factors that in practice have proven to lead to failure, therefore possibly leading to the reverse of the desired result.

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