

Corporate Restructuring in Response to Performance Decline: Impact of Ownership, Governance and Lenders *

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Abstract. Firms in performance decline may choose a variety of restructuring strategies for recovery with conflicting welfare implications for different stakeholders such as shareholders, lenders and managers. Choice of recovery strategies is therefore determined by the complex interplay of ownership structure, corporate governance and lender monitoring of such firms. For a sample of 297 U.K. firms experiencing relative stock return decline during 1987–93, we examine the impact of these factors as well as other control factors on their turnaround strategies. Strategy choices during the decline year and two post-decline years are modelled with logit regressions. Our results show that turnaround strategy choices are significantly influenced by both agency and control variables. While there is agreement among stakeholders on certain strategies there is also evidence of conflict of interests among them. There is further evidence of shifting coalitions of stakeholders for or against certain strategies.

1. Introduction

Firms which have experienced substantial decline in their financial performance adopt a variety of strategies to reverse that decline. These strategies range from operational actions to rationalise production and reduce costs, changes to financial and management structure to asset sales. Some of these strategies are of a fire fighting nature with a short term cash flow increasing focus whereas others are of a longer term strategic nature with no immediate cash flow implications.

A firm faced with performance decline may choose operational restructuring to improve its efficiency and profitability, asset sales to raise cash to meet its financial commitments to, say, lenders, renegotiate its debt to relieve the immediate burden of financial commitments, issue new equity to finance its operations or reconfigure its business strategy by making strategic disposals of businesses or investing in new businesses. A precondition to firm revival may often be the removal of existing

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management. These strategies may be grouped broadly into an operational, asset, financial and managerial restructuring.

Operational, asset, financial and managerial restructuring may be motivated by the need to get the firm back on its feet. However, any restructuring strategy has different implications for different stakeholders – shareholders, lenders, managers and employees often leading to conflict of interests among them. While one stakeholder group may find its control diluted or investment eroded, another group may have its stake strengthened.

An understanding of the nature of the restructuring process – the range of restructuring choices available, the determinants of these choices and the relative effectiveness of different types of restructuring – enables firms suffering performance decline to design feasible and effective restructuring programmes to achieve turnaround. The extant literature in finance and strategy provides a fragmented perspective on the issues raised by firm performance decline and turnaround. In this study we attempt a more comprehensive and integrated analysis of corporate restructuring in response to performance decline.

We examine the restructuring strategy choices made by firms which have experienced relative performance decline in terms of stock market returns to equity holders. These choices are made by managers who are subject to a variety of pressures from different stakeholders and also to conflicts of interest. The choices made by declining firms are analysed within the agency model of the relationship among shareholders, lenders and managers. The central thesis of this paper is that these different stakeholders have preferences for different restructuring strategies. We hypothesise that choice of recovery strategies is determined by the complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in decline.

For a sample of 297 U.K. firms whose stock returns declined from being in the top 50% of all U.K. listed firms to the bottom 20% we assemble empirical evidence on the extent and variety of restructuring undertaken by declining firms. The impact of ownership, governance and lender monitoring on the restructuring strategic choices is examined for a variety of strategies.

Our results show that turnaround strategy choices are significantly influenced by both agency variables and control variables. While there is agreement among stakeholders on certain strategies there is also evidence of conflict of interests between lenders and managers and between managers and some block shareholders. Lenders' preference for cash generative action is in direct conflict with shareholders' incentive to avoid such action. Entrenched managers are less likely to restructure the firm and replace themselves. Non-institutional rather than institutional shareholders appear to be active monitors. Independent non-executive directors, however, seem to be effective in their oversight of managers as they instigate more turnaround strategies.

The paper is organised as follows. Section 2 discusses the theoretical framework for the choice of turnaround strategies by declining firms. The methodology and

data for our empirical analysis are described in Section 3. The results are presented and interpreted in Section 4. Section 5 provides a summary and the conclusions.

2. Theoretical Framework

The choice of turnaround strategies is contingent upon a number of factors. Since different strategies may have different, and often conflicting, welfare implications for managers, shareholders and lenders, the choice of any strategy can only be made as a trade off among these contending stakeholders. The restraints on any single stakeholder group such as managers maximising their own self-interest to the detriment of other stakeholders is a function of the governance structure and the mechanics of agency monitoring in a firm (Gilson, 1990). Thus, an understanding of the nature and sources of these restraints is necessary to make the appropriate turnaround strategy choices.

2.1. IMPACT OF AGENCY CONFLICTS ON TURNAROUND STRATEGY CHOICE

The restraints on managerial choice of turnaround strategies may be examined within the context of the agency conflicts among shareholders, managers and lenders. The motivations of these players also provide the impetus to the pursuit of turnaround strategies so that firm value is enhanced and its ability to meet its financial commitments is restored.

While both lenders and shareholders have a common interest in restoring firm viability and its ability to generate adequate returns to their investment in the firm, in the turnaround process either group may gain at the expense of the other. Shareholders may benefit from a transfer of wealth from creditors when managers undertake risky investments (Myers, 1977). Likewise, lenders may benefit from a wealth transfer from shareholders when sale of assets to pay off debts eliminates the option value of those assets (Lang et al., 1995). Similarly, managers may pursue turnaround strategies which least harm them while the burden of turnaround is borne by shareholders or lenders or both. Managers' pursuit of self-serving objectives may manifest itself in their choice of strategies. However, managerial discretion in choice of strategy may be tempered by the agency control mechanism in place in the firm.

Broadly, the turnaround options available to declining firms include: operational, business strategic, managerial and financial restructuring. Not all of these actions will appeal equally to shareholders, managers and lenders since they demand different degrees of sacrifice from these stakeholders during the turnaround process.

Managerial restructuring, e.g. replacement of the top managers, is obviously unlikely to be favoured by managers and where the governance structure is weak and the management is entrenched such replacement may not happen. Similarly, where financial restructuring involves additional borrowing or dilution of the covenants protecting existing lenders they are likely to resist such debt restructuring. On the

other hand, turnaround based on fresh infusion of equity is likely to be preferred by lenders but frowned upon by shareholders. Dividend cuts may be loathed by shareholders but supported by lenders.

Strategic or asset restructuring in the form of divestments may be favoured by shareholders provided the divestment proceeds are not used to pay down debt. Lenders may support divestment provided their debt is paid off. New investments of a high risk nature may be preferred by shareholders but not necessarily by lenders (Myers, 1977).

2.2. IMPACT OF LENDER MONITORING ON MANAGERIAL CHOICE

In the agency model of the firm posited by Jensen (1989a) a highly leveraged firm will react faster to poor performance than less leveraged ones due to a desire to avoid breaching debt covenants. This early response preserves the going-concern value of highly leveraged firms as compared to less-leveraged firms.

Ofek (1993) examines the role of lender monitoring within the agency paradigm in influencing the choice of restructuring strategies of poorly performing companies in the U.S.A. He finds that high gearing significantly increases the probability of financial and operational restructuring. Gilson, John and Lang (1990) find no relation between gearing and financial restructuring.¹

High leverage is also found by Storey et al. (1987) to be more positively associated with equity rights issues (i.e. financial restructuring) in failing firms than in non-failing firms. They attribute this to the monitoring pressure from bank creditors who are only willing to continue financial support conditional upon shareholders sharing a part of the burden of turnaround.

Impact of debt on managerial choice of turnaround strategies may depend on the characteristics of debt such as ownership, maturity structure and security available. Debt ownership by informed bank creditors promotes more effective monitoring than by other types of debt holders. This increased effectiveness arises from the banks' close relations with firms and their access to private information, a right established by loan covenants or through ongoing bank relationship.

Banks' reputational capital provides them with the economic incentives to monitor firm actions. Hirschey et al. (1990) find that the higher the proportion of bank debt in total debt the higher is the positive return on announcement of a sell-off to the divestor shareholders. This superior valuation is attributed to the more effective and credible monitoring by banks with a large stake.

James (1987) argues that banks provide some special service not available from other lenders. He finds evidence of a larger positive stock price reaction to new bank credit agreements than to announcement of private placements or public straight

¹ A potential explanation for this inconsistency lies in the difference in length of distress examined in the two studies. Ofek (1993) studies the short-term restructuring actions in the year of performance decline whereas Gilson et al. (1990) examine firm actions following three years of low performance.

debt offerings. In Gilson's (1989) study bank lenders frequently initiate senior management changes in financially distressed firms.

Maturity structure of debt is likely to influence the borrower firm's restructuring decisions since the greater the proportion of short term debt the greater should be the level of monitoring. The credit renewal process associated with short-term debt subjects firm managers to more frequent monitoring than long-term debt and increases the bargaining power of banks over managerial decisions such as liquidation (Diamond, 1993; Rajan, 1992; Gertner and Scharfstein, 1991) and the use of proceeds from asset sales (Brown et al., 1994). Empirically, Ofek (1993) finds that short-term leverage increases the probability of all the restructuring strategies examined by him except financial restructuring.

In addition to debt ownership and maturity structure, the security for the debt may also impact on the restructuring decision. A high proportion of unsecured debt is likely to be associated with more effective monitoring because of the unprotected nature of this debt. Lack of security may induce more intense monitoring by unsecured lenders.

The efficiency of lender monitoring is almost beyond question. Leverage may have a positive and significant relation with the incidence of all four generic turnaround strategies. The primary motivation is debt repayment. Lenders are expected to favour asset sales proceeds to be applied to debt repayment rather than retained by the firm (Slatter, 1984; Lang et al., 1995). They are likely to favour cut or omission of dividends to conserve cash or equity issues to increase liquidity (Storey et al., 1987). Lenders may expect extensive asset sales, operational cost cutting and management changes as a prerequisite for debt restructuring. Debt restructuring may be the last resort after exhausting other forms of restructuring.

2.3. IMPACT OF OWNERSHIP STRUCTURE ON MANAGERIAL CHOICE

The share ownership in the declining firm may provide an agency mechanism for controlling managerial discretion in the choice of turnaround strategy. Block shareholders may provide effective oversight leading to value maximising behaviour on the part of managers (Shleifer and Vishny, 1986). Where managers hold significant shares, their interests may be aligned to those of shareholders in general.

The role of block shareholders as agency monitors has been studied by many researchers. Large shareholders provide an efficient mechanism for resolving the agency conflict which arises in a firm owned by atomistic shareholders (Jensen and Meckling, 1976). Demsetz and Lehn (1985) argue that as the size of large shareholding increases, monitoring effectiveness also increases. Block shareholders may be institutional or non-institutional, and associated to incumbent management or independent of it. Agency monitoring effectiveness varies across these different blockholder categories.

For the U.S., Hill and Snell (1989) find a positive relation between large shareholding and firm productivity. McConnell and Servaes (1990) find a significant rela-

tion between Tobin's q and the level of institutional block shareholding. Agrawal and Mandelker (1990) provide evidence of a positive relation between institutional ownership and stockholder wealth effects of various types of anti-takeover amendments in target companies. Jarrel and Poulsen (1987) show that firms that adopt the most value-reducing forms of anti-takeover charter amendments also have lower institutional shareholding than do other firms. Brickley et al. (1988) find evidence that institutional investors who do not have business dealings with corporate management are more likely to vote against anti-takeover amendments. All these U.S.-based results are consistent with the reduction of agency costs due to large shareholders monitoring.²

The positive valuation impact of large share acquisitions has been evidenced in a number of studies. Barclay and Holderness (1991), Mikkelsen and Ruback (1985), Holderness and Sheehan (1985) and Choi (1991) report, for the U.S., that block acquisitions in excess of 5% generate significant wealth gains for target shareholders. For the U.K., Sudarsanam (1996) reports similar results.

Shivdasani (1993) emphasises the need to differentiate associated from non-associated non-institutional block holders. Shareholders associated with incumbent management, e.g. family trusts or company pension funds are less likely to provide effective monitoring of managers. Shivdasani (1993) finds evidence that unassociated shareholders increase the probability of hostile takeovers, invoking their disciplinary motives.

Bethel and Liebeskind (1993) report that block share ownership is associated with corporate restructuring. Sudarsanam (1995) finds substantial asset, financial and managerial restructuring following large block acquisitions and value increases attendant upon such acquisitions are maintained or enhanced over the following three years.

In contrast, shareholders are also known to frown upon certain strategies which are painful to themselves such as dividend cut/omission (Asquith and Mullins, 1986; DeAngelo and DeAngelo, 1990), rights issue (e.g. Schipper and Smith, 1986) and asset sales where proceeds are utilised to pay down debts (Lang et al., 1995).

2.4. IMPACT OF CORPORATE GOVERNANCE STRUCTURE

Corporate governance structure as a monitoring mechanism to reduce the agency problem between shareholders and managers has recently received much attention (Cadbury Report, 1992). Composition of the board of directors is an important part of this structure, influencing its policing effectiveness. Board composition is therefore likely to impact significantly on the choice of turnaround strategies.

² Pound (1988) provides counter-arguments for a less effective monitoring role for institutional and large shareholders due to their being passive investors or having other business dealings with the company which lead to a conflict of interest detracting from effective monitoring. Mallette and Fowler (1992) also report that high levels of institutional shareholdings are more positively associated with the adoption of anti-takeover poison pills than lower levels of institutional shareholding.

Boards of directors differ in a number of ways: the relative importance of executive versus non-executive directors; the leadership of the board by an executive or non-executive chairman and the separation of the roles of the chairman of the board and the CEO. In the context of declining firms, their performance decline may have been caused by managerial entrenchment and weak governance structure may have contributed to this entrenchment. Turnaround may, therefore, demand managerial restructuring with the top management being replaced. Whether managerial restructuring can be carried out depends upon the independence and strength of the board as well as the power of block shareholders and lenders.

According to Fama and Jensen (1983), the separation of decision management and decision control in the decision-making process can alleviate the agency problem. Whilst inside directors are responsible for decision management, decision control should be left with outside directors. Outside directors has an incentive to monitor management actions since they have staked their reputation as professional corporate referees. Consequently, the higher the proportion of non-executive to executive directors, the more effective would be the board monitoring of management.

Empirically, Weisbach (1988) finds that CEO turnover is highly correlated with proportion of outside directors to inside directors. The monitoring function of outside directors is also supported by Rosenstein and Wyatt (1990), who find positive share price reactions to the appointment of outside directors. Further, Boeker and Goodstein (1993) report that strong insider presence significantly influences CEO replacement decisions. However, Mallette and Fowler (1992) observe empirically that the proportion of outside directors has no bearing on the adoption of poison pills. Hermalin and Weisbach (1992) and Shivdasani (1993) are unable to document any systematic relation between outside directors, firm performance and the probability of hostile takeovers.³

Where one person combines the roles of board chairman and CEO his or her powers are considerable. This duality of roles can promote focused objectives and a clear line of command. On the other hand, duality may entrench the top manager to the detriment of shareholders and possibly lenders, reduce the oversight function of the board and weaken the governance structure.

The role of board Chairman is to oversee the performance of board members from an informed perspective. Therefore, if the board is chaired by a non-executive Chairman, the external and part-time nature of his position coupled with information asymmetry problems can present him with difficulty in effectively controlling the board. Consequently, a non-executive Chairman strengthens CEO control and contributes to potential managerial entrenchment. An executive Chairman, on the other hand, is likely to strengthen the board's monitoring role.

³ There are impediments to effective monitoring by non-executive directors. Baysinger and Hoskisson (1990) cite information asymmetry whereby outside directors do not possess all the information that executive directors have. Moreover, the insiders may have packed the board with outside directors who are beholden to them in some way and therefore subservient.

Mallette and Fowler (1992) find support for the entrenchment hypothesis in their empirical study with duality increasing the probability that poison pills are adopted whereas separation diminishes the probability. However, Rechner and Dalton (1989) find no significant difference in firm performance between dual and non-dual firms.

The primary focus of this study is the impact of three broad categories of agency monitoring mechanisms—ownership, leverage and board composition—on the turnaround strategies of poorly performing firms. We examine the individual as well as the combined effects of the three mechanisms.

2.5. IMPACT OF MULTIPLE AGENCY CONTROL MECHANISMS

In the choice of restructuring strategies, the influences representing ownership, board composition and lenders may often be reinforcing but at other times working at cross purposes. In other words, the monitoring role of owners, governance and lenders may be complementary, substitutory or contradictory. Lenders and outside directors may complement each other, say in forcing management changes in declining firms. However, high leverage and high lender influence on management change may also substitute for the lack of pressure from outside directors for the same action, where the proportion of outside directors in the board is low. An example of contradictory influence arises when lenders press for asset sales and rights issue to generate cash for the purpose of paying down debt. Lenders' preference, in the latter case, clearly contradicts owners' desire to avoid injecting fresh equity funds and their preference for lenders to increase or at least maintain financial support.

2.6. IMPACT OF DOMINANT STAKEHOLDERS

Our discussion so far has ignored the relative bargaining powers of the different stakeholder groups in declining firms when strategy choices are made. The choice of a strategy is likely to be decided by the relative strength and dominance of these stakeholders. We develop the concept of stakeholder dominance to take into account the complex interactions between the various stakeholders or agency monitors indicated above. Five types of stakeholder dominance are examined—lender, manager-owner, blockholder, CEO and collective board dominance.

2.6.1. *Lender Dominance*

Where a firm is highly leveraged and has suffered a severe decline, lenders⁴ are deemed dominant in influencing the firm's decision-making machinery. Recent work by Jensen (1989a,b) suggests that leverage is an important determinant of

⁴ In the U.K., secured creditors are frequently blamed for pulling the plug on firms too soon. The appointment of a receiver by secured lenders, or an administrative receiver when a floating charge is held, effectively bankrupts the distressed firm.

how decision rights are allocated among claimholders. Therefore, when a firm is severely distressed, with equity shareholders occupying a very low position in the repayment queue, lenders have the ultimate say and influence on the firm's restructuring choice.

Lenders would generally prefer cash generative strategies to facilitate debt repayment. They may frequently insist on removal of top managers and freeze in investments as a condition for continuing financial support. Removal of top managers poses a serious conflict with managers' interest, but if the firm's finance is dire, managers have little power to avoid displacement even when they hold a high equity share holding. Asset sales may pose a weak conflict of interest with block shareholders as they deem the sale of assets extinguishes the option value attached to assets sold. In the final analysis, lender dominance prevails over other stakeholders' preferences as lenders' continued support is key to the survival of the firm. Management may therefore be forced to implement cash generative actions and refrain from cash consuming asset investment and operational strategies.

2.6.2. *Manager-Owner Dominance*

If the firm's decision-making process is not dominated by lenders, and managerial and associated shareholdings are high, manager-owners are deemed to be entrenched and possess dominant influence. In the circumstance, entrenched managers are expected, in the least, to refrain from adopting managerial restructuring strategies. The literature (e.g. Maris, 1964) suggests that entrenched managers favour large size as power and compensation are related to size. Consequently, dominant managers may refrain from downsizing their operations through operational restructuring or asset divestment and prefer size increasing acquisitions or capital expenditure.

Likewise, dominant managers are likely to disfavour the 'final resort' strategy – debt restructuring – which is adopted only when all efforts to pay off (or buy out) creditors fail. In a debt restructuring exercise, lenders frequently insist on dealing with a credible management team leading to installation of a new management team. Gilson (1989, 1990), and Murphy and Zimmerman (1993) find lenders to instigate significant top management changes in distressed firms.

2.6.3. *Blockholder Dominance*

Where neither lenders nor manager-owners are dominant, and unassociated blockholding is high, blockholders may dominate. Operational restructuring, which is the least controversial of all strategies, is expected to be favoured by dominant blockholders. Extant literature (e.g., Schipper and Smith, 1986; Asquith and Mullins, 1986) indicating shareholders' dislike for equity-based strategies such as dividends cut and omission and equity issue, would mean that they are shunned by dominant blockholders. As discussed above, shareholders also shun asset sales as they

extinguish the option value attached to the assets sold. Following from dominant shareholders' dislike for cash generative actions (equity issues and asset sales), we can expect them to disfavour investments which necessitate such cash generative actions.

Dominant blockholders are expected to favour debt restructuring as lenders frequently provide additional working capital, forgive loans or interests or make other form of concessions, though reluctantly, in the hope of realising higher debt repayments when the distressed firm is eventually turned around. Similarly, dominant blockholders who possess significant influence over management are expected to initiate top management replacement.

In summary, blockholder dominance is expected to be positively associated with operational, managerial and debt restructuring but negatively associated with all other strategies.

2.6.4. CEO and Collective Board Dominance

When the firm is not lender, manager-owner or blockholder dominated, corporate control is expected to lie with the board of directors. However, where the board is chaired by a dual CEO, the dual CEO is expected to dominate the board and hence the firm's decision-making process. CEO board dominance is expected to favour strategies akin to manager-owner dominance firms, i.e. shun managerial restructuring, prefer investments, avoid operational restructuring and cash generative actions.

When the firm is not lender, manager-owner, blockholder or CEO dominated, corporate control is expected to lie 'collectively' with the board of directors. Since the collective interests of all stakeholders are in the avoidance of a crisis and recovery, collective board dominance is expected to be positively associated with all restructuring strategies.

No study to date has examined the relationships between agency monitors' motivations and restructuring strategy choice in a comprehensive manner. Although Ofek (1993) finds that different agency variables are associated with different restructuring strategies, his approach lacks a robust theoretical underpinning. More importantly, Ofek does not examine the relative dominance of stakeholders in shaping restructuring strategy choices. This research attempts to fill the empirical gap by exploring the impact of agency monitoring on specific strategy choice and the role of dominant stakeholders.

3. Methodology and Data

The first step in our empirical analysis is to devise an operational definition of performance decline. In the turnaround literature in corporate strategy and finance a range of definitions has been used, some based on change in either simple or industry adjusted accounting ratios such as return on assets and some others based

on stock returns. Given the central importance of value maximisation as an objective function within the agency model, we prefer to define performance decline in terms of stock market value changes i.e. stock returns.

Ofek (1993) defines performance decline in terms of the change in the annual stock return ranking of a firm among all the firms in the market from being in the top 67% in one year (the base year) to the bottom 10% in the following year (the distress year). This decline may range from a maximum of 100% to a minimum of 23%. This steep fall in value is regarded as sufficient to trigger various restructuring actions by the distressed firms.

We employ a definition broadly similar to Ofek's but arguably more stringent. A firm is defined as having experienced performance decline when it falls in stock return ranking of all firms on the London Stock Exchange to the bottom 20% in a year (the decline year) after having been in the top 50% in each of the two preceding years. In the decline year the maximum decline is 100% and the minimum is 30%. With this definition, in contrast to Ofek's, the fall in rank has to be much steeper for inclusion in our sample. Further, the fall is from a stable high performance. This condition avoids sampling companies whose performance decline is due to short term volatility of their share prices.⁵

Firms satisfying the above criterion of performance decline are sampled and the restructuring actions they take subsequent to decline are tracked. The agency monitoring determinants of choice of these actions by the sample firms are identified using the logit regression methodology.

3.1. DEFINITIONS OF DEPENDENT VARIABLES

The various restructuring actions declining firms choose are the dependent variables for the logit regressions. These actions fall into the four generic strategies – operational, asset, managerial and financial. Ofek (1993) distinguishes between actions resulting in short term cash inflow and those with no such cash inflow since cash generation to meet the firm's financial commitments may be necessary to alleviate financial distress and avoid default on them. Accordingly, we define combinations of restructuring strategies which generate cash and those which do not.

Operational restructuring covers cost reduction, improved financial control, and closures and integration of production and other facilities. Asset restructuring includes both asset reduction and new investment. Asset reductions comprise

⁵ The literature on stock price overreaction (De Bondt and Thaler, 1985) raises the concern that a stock return based measure of performance decline may merely represent a correction for the earlier overreaction. The condition of two consecutive years' good performance preceding the decline which we have applied in our sampling mitigates this problem. Further, anecdotal evidence suggests that stock market performance decline is not greeted with inertia and indifference by managers who smugly attribute such decline to the stock market whims such as overreaction. It appears that such performance decline causes managerial concern and triggers remedial action including corporate restructuring.

divestment, management buy-out, spin off, sale and leaseback, and other asset sales. Investment includes acquisitions and internal capital expenditures. Internal capital expenditure is measured by significant expenditure in plant and machinery, exceeding routine asset replacements. Significant expenditure is taken as that in excess of 10% of the pre-decline year total assets.⁶

Managerial restructuring covers replacement of Chairman or CEO or managing director. Financial restructuring refers to both equity- and debt-based strategies. Equity issues (excluding those issued in an acquisition-related share exchange) and dividend cuts and omission are part of an equity-based restructuring. Debt restructuring includes debt refinancing and renegotiation of the terms of existing debt. Cash generating strategies include asset sales and equity issues. Managerial and operational changes are deemed non-cash generative in the short term. The above restructuring actions are summarised in Table I. In the logit regressions each restructuring action is coded as a dummy variable.

3.2. EXPLANATORY VARIABLES

The main explanatory variables are the agency monitoring variables representing different aspects of share ownership, leverage and board composition. Leverage is book value of total debt over book values of debt and equity. The total debt is also decomposed into bank debt, short-term debt and unsecured debt (as a proportion of debt and equity). Debt comprises all interest-bearing liabilities. Equity refers to shareholders funds i.e. equity and reserves. Short-term debt is any debt that matures in less than 12 months.

Share ownership categories are proxied by directors' shareholding and block holding in excess of 5% prior to 1990 and 3% after 1990. Block holding is divided into shareholding by financial institutions and non-institutional holding. The latter is further split into associated and unassociated blocks. Associated blocks are held by families or trusts associated with the directors and company pension schemes.

Board composition is proxied by three variables: proportion of outside or non-executive directors on the board, whether the board is chaired by a non-executive director, CEO cum Chairman (CEO duality) where the two posts are held by the same person.

The empirical literature suggests that turnaround strategy choices are also dictated by non-agency monitoring factors. These additional variables are included in our regressions as control variables. Severity of decline dictates both the pace of restructuring and choice of particular actions. For example, asset investment or acquisitions may be less likely in more seriously distressed firms as they consume scarce cash resources.

Economic and industry condition also may influence choice of strategy. For example, where the industry as a whole is depressed, asset sales and divestments may not raise as much cash as otherwise (Shleifer and Vishny, 1992). Economic

⁶ Routine replacements proxied by sample firm annual depreciation charge average 6.5%.

Table I. Definition of restructuring strategies

Restructuring strategies selected by firms experiencing stock return performance decline are identified and defined. Information on strategies is from press releases to the London Stock Exchange which are documented by Extel Financial News Summary from 1987, with the exception of capital expenditure. Capital expenditure is based on annual reports and accounts. Supplementary information is also collected from Andersen Corporate Register and Hambro Company Guide, Datastream International, and Company Reports and Accounts. These alternative sources are also used for cross-checking information reported in the Extel Financial News Summary.

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

downturns may emphasise the need for operational cost cutting actions and preclude equity issues with depressed stock markets. Economic condition is measured by the Gross Domestic Product (GDP) growth rate whilst industry condition is represented by the firm's Financial Times-Actuaries (FTA) industry return. Size of the firm is a proxy for both the flexibility and internal slack available to the declining firm and the opportunities for certain strategies such as divestment. A large firm may be able to negotiate debt restructuring and may be able to avoid dividend cuts.

Where the firm's performance decline has been caused by internal, firm-specific factors such as mistaken business strategy, bad implementation of strategy or lack of financial control, any restructuring has to reverse the firm specific causes. Again, the choice of restructuring will be dictated by the existence of significant internal causes of decline.

Table II. Definition of explanatory variables

The table defines three groups of variables representing firms' agency monitoring mechanism which are expected to influence the choice of restructuring strategies by poor performing firms. Debt structure is based on accounting information provided by Datastream International and Extel Company Research. Ownership and governance data are extracted from Andersen Corporate Register, Hambro Company Guide and Annual Reports and Accounts. Block shareholding is holding of 5% or more (3% or more since 31st May 1990) as disclosed in the company annual reports. Industry is the Financial Times-Actuaries Index industry group to which the sample firm belongs.

Variable	Definition
<i>Debt structure</i>	
Leverage	Total book debt over total book debt and equity
Short term leverage	Short term debt over total book debt and equity
Bank leverage	Bank debt over total book debt and equity
Unsecured leverage	Unsecured debt over total book debt and equity
<i>Ownership structure</i>	
Managerial shareholding	Shareholding by members of the board of directors
Associated block shareholding	Shareholding by family members or trusts of members of the board and company pension plans
Institutional block shareholding	Shareholding by institutional investors
Non-institutional unassociated block shareholding	Shareholding by non-institutional blockholders unassociated with management
<i>Governance structure</i>	
Chairman cum CEO	Combined role of Chief Executive and Chairman (CEO duality)
Non-executive Chairman	Chairman in a non-executive capacity
Proportion of outside directors	Non-executive directors as a percentage of total number of directors
<i>Control variables</i>	
Economic condition	GDP growth in the restructuring year
Industry condition	FTA industry return in the restructuring year
Internal cause of decline	Reported internal problems such as project failures, bad acquisitions or poor financial control
Severity of decline	Stock returns ranking in the year of decline
Size	Log of market value of equity at the end of pre-decline year

The above explanatory variables are summarised in Table II. Chairman cum CEO, non-executive Chairman and internal cause of decline are each represented by a dummy variable.

3.3. DATA

As stated earlier, sample firms are those which experience a sharp decline in their relative stock return performance. On a ranking of annual stock returns of all London Stock Exchange listed firms, firms which fall into the bottom 20% in the decline year after having been in the top 50% in the previous two years (base years) are sampled. This sampling criterion is called the 50 : 50 : 20 rule. The sample covers the period 1985–1993, with 1985–1991 as the base years and 1987–1993 as the decline years.

Datastream International is the data source for annual stock returns. An initial sample of 415 declining firms satisfying our 50 : 50 : 20 rule is assembled from a total of 3706 firms covered by Datastream over the period 1985–1993. Sampling excludes financials, utilities and firms with a market capitalisation of less than £10m. Small firms are excluded for want of sufficient data on their restructuring.

Data on the sample firms' restructuring activities and on the explanatory variables are collected from Datastream International, company annual reports and Extel Annual News Summaries. Such data were not available for all companies defined as declining. The final sample consists of 297 poor performing firms.

3.4. SAMPLE CHARACTERISTICS

3.4.1. *Performance Decline*

Table III provides the descriptive statistics for the sample. From Panel A, the mean (median) annual log returns for the sample in the base and distress years are: 42% (36%) (base year –2), 33% (28%) (base year –1) and –51% (–38%) (decline year). The returns to the Financial Times All Share (FTALL) Index in the same years are: 16%, 15% and 16% respectively. The sample firms clearly outperform the market in the base years and under perform it in the decline year.

Moreover, the decline in performance for the sample is also very steep. This pattern of steep decline is repeated for each of the sample decline years 1987 to 1993. The sample median returns in the base years for the sample range from –6% in 1990, a recession period, to 53% in 1986. In the decline years the median return ranges from –12% in 1993 to –112% in 1990.

Panel B of Table III gives the performance statistics based on accounting variables. Both profitability and cash flows deteriorate significantly in the decline year. The median fall in the profitability measures – operating margin, earnings per share, return on equity and return on asset – ranges from 18% to 22%, all significant at 1%. Median fall in operating cash flows – profit before interest, tax and depreciation deflated by total assets – is 15%, significant at 1%. The accounting-based performance measures thus reflect the stock return decline. Our sample thus cap-

Table III. Descriptive statistics for stock returns and accounting performance

Panel A shows the sample firms' stock log returns in the two years prior to and including the year of decline. Return on the Financial Times All Share Index (FT-All), a value-weighted index based on around 800 firms covering in excess of 90% of stock market capitalisation in the London Stock Exchange, is provided for comparison. Panel B shows changes in accounting based performance in the year of decline. PBIT = profit before interest and tax. EPS = profit after tax, minority interests and preference dividends but before extraordinary items/the average number of shares in issue in the year. Return on equity = profit attributable to shareholders/share capital and reserves less intangibles. Return on assets = profit before interest and tax/total assets less current liabilities. PBITD = profit before interest and tax plus depreciation (proxy for cash flows). Total debt is the total of all interest-bearing debt, i.e. short, long and subordinated debt. Capital employed is the sum of book debt plus book equity. Beta is based on figures computed by the Risk Measurement Service of London Business School, at the beginning of the year prior to decline. Size is market capitalisation at the beginning of the year of decline. in Panel B the mean and median are tested using the *t*-test and the Mann-Whitney Wilcoxon test.

Panel A: Annual stock returns in the year of, one year prior to, and two years prior to, decline

	No.	Returns in decline year-2		Returns in decline year-1		Returns in decline year	
		Mean	Med.	Mean	Med.	Mean	Med.
Total sample	297	42.20	35.56	32.63	28.07	-51.12	-37.87
FT-All Share		16.15		14.59		16.29	
Decline year, 1987	41	40.30	33.65	50.20	41.20	-30.10	-23.97
FT-All Share		18.3		24.3		7.7	
Decline year, 1988	55	61.10	52.86	49.20	40.49	-39.70	-33.41
FT-All Share		24.3		7.7		11.0	
Decline year, 1989	54	44.10	39.46	28.70	23.61	-50.20	-41.72
FT-All Share		7.7		11		30.8	
Decline year 1990	32	38.40	35.14	32.70	25.98	-131.00	-112.31
FT-All Share		11		30.8		-10.3	
Decline year, 1991	28	23.90	20.58	-7.00	-6.19	-59.20	-54.03
FT-All Share		30.8		-10.3		18.9	
Decline year, 1992	19	1.60	2.79	36.00	24.88	-95.70	-80.53
FT-All Share		-10.3		18.9		18.7	
Decline year, 1993	68	47.20	40.51	27.10	23.06	-20.40	-11.58
FT-All Share		18.90		18.70		25.10	

Panel B: Changes in profitability and cash flows in the year of decline

	Mean (t statistics)	Median* (Z statistics)
PBIT/Sales	-19.1 (9.42) ^a	-17.6 (-10.34) ^a
Earnings per share	-25.6 (4.49) ^a	-19.6 (-7.17) ^a
Return on equity	-23.5 (7.21) ^a	-21.6 (-7.93) ^a
Return on asset	-22.4 (8.80) ^a	-20.9 (-8.85) ^a
PBITD/Capital employed	-15.3 (7.30) ^a	-14.7 (7.52) ^a
PBITD/Total debt	-27.6 (8.23) ^a	-26.8 (-8.30) ^a
Risk (beta)	0.95	0.96
	Min (0.05)	Max (1.49)

^a Indicates significance at 1%.

tures both operating performance and stock return performance decline.⁷ Excess volatility of stock returns does not appear to cause the performance decline in our sample firms. Indeed, the sample betas are not unusual (mean and median values are both less than 1) and likely to cause the stock return decline.

3.4.2. *Agency Monitoring Mechanisms*

Table IV provides descriptive statistics on the leverage, share ownership and governance structure in base year -1. The median leverage, total book debt to book debt and equity, is 27% and median short-term debt, bank debt and unsecured debt as proportions of book debt and equity are in the range 12% to 16%. The leverage variables are not entirely mutually exclusive. For example, there may be an overlap between short term and bank leverage. This implies that when all the leverage variables are included in a regression, the empirical result has to be interpreted cautiously.

Median directors' shareholding is 9.5% and associated block holding is negligible. Institutional ownership amounts to a median value of 6.9%. Non-institutional but unassociated block holding has a median of 0% (but a mean of 7%).

Comparison with the only other study by Ofek (1993) that examines the determinants of restructuring strategy choice during performance decline reveals interesting differences in agency mechanism between U.S. and U.K. firms. Ofek reports median leverage, managerial shareholding and outside (non-managerial) shareholding of 31%, 22% and 6% respectively. This compares with our sample's 27%, 9.5% and 15.7% (not shown in Table IV). U.S. firms have apparently higher levels of managerial shareholding but lower levels of outside or non-managerial shareholdings. The difference may lie in difference between sampling criteria as firms studied by Ofek are in the bottom 10% in the decline year. When we test for this difference by selecting only firms that fall to the bottom 10% ie. 50 : 50 : 10 firms the statistics are respectively 27%, 11% and 16%. Therefore, the differences between the two studies are more likely to stem from market differences than sampling criterion differences.

As regards board composition, in 44% of sample firms one person plays the dual roles of Chairman and CEO. Non-executive Chairmen preside over the board in 24% of the companies. The median proportion of outside directors in the sample boards is 22%.

3.4.3. *Frequency of Turnaround Strategies*

Panel A of Table V reports the frequencies of sample firms undertaking different turnaround strategies in the decline year and in the two post-decline years. We find

⁷ The similarity of performance decline in both stock return and accounting terms suggests that the stock return decline is no freak caused by correction of stock market overreaction in the base years unrelated to underlying operating performance.

Table IV. Descriptive statistics for agency and control variables

The table shows the descriptive statistics for the explanatory variables in the pre-decline year. For definitions of the variables see Tables I and II. Chairman cum CEO, Non-executive Chairman and internal cause of decline are dummy variables coded as 1 when these are present and 0 if otherwise. Source: Hambro Company Guide and Corporate Register, Datastream International and Company Reports and Accounts

Agency variables	Pre-decline year	
	Mean	Median
<i>Capital structure</i>		
Leverage	0.29	0.27
Short leverage	0.15	0.12
Bank leverage	0.19	0.16
Unsecured leverage	0.17	0.12
<i>Ownership structure (%)</i>		
Managerial shareholding	19.90	9.5
Associated block shareholding	0.71	0.0
Institutional block shareholding	12.2	6.9
Non-institutional unassociated block shareholding	7.1	0.0
<i>Governance structure</i>		
Chairman cum CEO	44.1%	—
Non-executive Chairman	24.2%	—
Proportion of outside directors	0.20	0.22
<i>Control variables</i>		
Internal cause of decline	0.30	—
Severity of decline	10.8	10.9
Size (£M)	344.2	54.8

	Decline year		Decline year + 1		Decline year + 2	
	Mean	Median	Mean	Median	Mean	Median
Economic condition	2.27	2.34	2.08	2.34	0.68	0.70
Industry condition	7.80	11.29	3.60	7.80	-32.75	-16.88

that the most frequent form of restructuring is operational with 59% of the sample firms undertaking it in the decline year and 47% and 52% of the firms in the two following years. This is comparable to Ofek's 53% for the decline year.

Asset sales are carried out by between 27% and 38% of the firms in those years. This is much higher than the 15% rate reported by Ofek (1993) for the decline year. Surprisingly, acquisitions do not cease when firms hit trouble and they are carried out by nearly 50% of the sample firms in the decline year and by 36% and 27% of the firms in the post-decline years. Internal capital expenditure, again surprisingly,

Table V. Descriptive statistics for restructuring strategies and frequency of restructuring strategies pursued by U.K. listed firms during 1989–1994

This table shows the distribution of corporate restructuring actions in the year of decline, one year, and two years post-decline. Frequency is the proportion of sample firms adopting the strategy. Sample size declines in post-decline years due to failure of firm, takeover or where no data is available, i.e. firms declining in 1993 (68 firms) are excluded from decline year + 2 analysis. Source: Company press releases and Company Reports and Accounts.

Panel A: Descriptive statistics for restructuring strategies in the year of, one and two years after decline

Restructuring strategy	Decline year, frequency (%)	Decline year + 1, frequency (%)	Decline year + 2, frequency (%)
<i>Operational restructuring</i>			
Cost rationalisation, closures and integration of business units	58.6	46.7	51.6
<i>Asset restructuring</i>			
Asset reduction	26.6	37.8	35.6
Acquisition	50.2	35.9	27.1
Capital expenditure	61.6	50.4	47.9
<i>Managerial restructuring</i>			
Remove top management	19.5	25.9	21.8
<i>Financial restructuring</i>			
Dividend cut or omission	23.6	27.0	34.0
Equity issue	20.2	10.4	13.3
Debt restructuring	2.4	3.3	7.4
<i>Cash generative actions</i>	40.1	44.1	43.6
Sample size	297	270	188

Panel B: Frequency of restructuring strategies pursued by U.K. listed firms during 1989–1994

Asset sales cover divestments, management buy-outs and other asset sales. Acquisitions represent full and partial acquisitions. Dividend cut/omission refers to cut/omission in dividends per share over the previous year. Rights issues encompass rights issue, rights offer, offer for sale, open offer and placing of firm shares with institutions and financial intermediaries. Source: Financial Times Extel Company Research and Company Analysis.

Average no. of firms	Asset sales %	Acquisitions %	Dividend cut/omission %	Rights issue %	Cash generative actions %
1521	19.6	34.5	20.8	15.2	31.6

does not cease but is incurred by 62% of firms in the decline year and by 50% and 48% in the following years.

Removal of top management is observed in 20% (in decline year) to 26% (in decline year + 1) of the sample firms. Again, Ofek (1993) reports a similar 21% of top management replacement in the year of decline. Debt restructuring is quite infrequent with only 2% of sample firms in the decline year and 3% and 7% in the following years respectively taking recourse to it. In contrast, Ofek (1993) finds 11% of his sample firms restructure their debt in the year of decline. Debt restructuring appears to be more common among U.S. than U.K. firms (only 4% of firms declining to the bottom 10%, i.e., 50 : 50 : 10 firms, adopt it). Equity issues are made by 20% of sample firms in the decline year but by only about 10% in the following years. The most frequently employed financial restructuring device is dividend cut or omission. The proportions of firms adopting this strategy in the three years are: 24%, 27% and 34%.

An interesting question to ask is how does the frequency of strategies followed by performance decline firms compare with that in the population of firms listed in the U.K. Do these frequencies differ from the population benchmarks and why? Panel B of Table V provides answers to these questions where population data are available. From an extensive and rigorous search of financial news reported by firms and reported by FT Extel in their Company Research CD-ROM, we compile the average number of firms in the population adopting asset sales, acquisition, dividend cut/omission, rights issue and cash generative actions, during the period 1989–1994. The period broadly coincides with the period under study, and the year 1989 is the first year covered by the Company Research CD-ROM.

Unsurprisingly, a higher proportion of our sample firms (34%) sell their assets than in the population (20%),⁸ from the year of decline to two years thereafter. In the case of acquisitions, sample firms clearly overtake the population with 50% versus 35% of firms in the population making acquisitions in the year of decline. However, with the onset of decline, sample firms reduce their rate of acquisitions to the population rate one year after decline. Two years post-decline, far fewer sample firms seek acquisitions compared to the population. A similar pattern is observed with regard to equity issue. More sample firms tap the market than the population at large, 20% in the decline year, versus 15%. However, sample firms are less likely to be successful in raising finance from equity investors subsequent to performance decline than the firm in the population. Finally, more sample firms resort to cash generative actions than the population with an annual average of 43% of sample firms taking it compared to only 32% of firms in the population. Overall, our sample of declining firms carries out various restructuring activities more intensively than the firm population at large.

⁸ The population frequency is the average for the period 1989–1994. The same benchmark population is used in the rest of this section. It should be noted that the population includes the sample firms. Hence, comparison is not between two independent groups. Managerial and operational restructuring are not examined due to lack of details in the Extel CD-ROMs.

Table VI. Stakeholder dominance and choice of restructuring strategy

The choice of restructuring strategies is determined by the relative bargaining powers of various stakeholders in the firm. The table compares the choice of strategy between stakeholder dominated and non-dominated groups of declining firms. Four stakeholder groups are identified: lenders, managers, blockholders and board of directors. Where a firm is highly leveraged (i.e. top quartile of sample firms ranked on leverage) and has suffered a severe decline (bottom 50% of sample stock ranking in year of decline), lenders are deemed dominant in influencing the type of actions the firm takes. If the firm's decision-making process is not dominated by lenders, and managerial and associated shareholding are high (i.e. top quartile of sample firms ranked on such shareholding), manager-owners are deemed to be entrenched and possess dominant influence. Where neither lenders nor manager-owners are dominant, and unassociated blockholding are high (i.e. top quartile of sample firms) relative to the total of all significant shareholders, blockholders are deemed dominant. The remaining firms, which are not lenders, manager-owners or blockholders dominated, are deemed to be controlled by the board. The board is deemed to be CEO dominated if Chairman is also the CEO and collectively dominated, otherwise. The table shows the proportion of sample firms in each group choosing the strategy. Only variables for which there is a significant difference between dominant and non-dominant groups are shown. Z is the absolute value of test statistic for the Mann-Whitney Wilcoxon test.

Strategies	Year of decline				Year of decline + 1				Year of decline + 2			
	Yes		No		Yes		No		Yes		No	
	Mean	Z	Mean	Z	Mean	Z	Mean	Z	Mean	Z	Mean	Z
Operational restructuring	0.73	0.56	0.56	1.94**	0.69	0.43	0.47	2.78***	0.47	0.53	0.53	0.59
Cash generative actions	0.49	0.39	0.39	1.27	0.69	0.40	0.53	3.13***	0.53	0.42	0.42	1.17
Capital expenditure	0.53	0.63	0.63	1.18	0.31	0.53	0.33	2.39**	0.33	0.51	0.51	1.73*
Dividend cut/omission	0.44	0.20	0.20	3.44***	0.51	0.23	0.37	3.48***	0.37	0.34	0.34	0.33
Debt restructuring	0.09	0.01	0.01	3.24***	0.17	0.01	0.10	4.87***	0.10	0.07	0.07	0.58
Sample size	43		254		35	235	30	158				

Panel A: Lender dominance

Panel B: Manager-owner dominance									
Operational restructuring	0.41	0.63	3.13***	0.36	0.49	1.80*	0.50	0.52	0.24
Capital expenditure	0.20	0.45	3.64***	0.22	0.50	3.74***	0.25	0.49	2.84***
Acquisitions	0.36	0.54	2.47**	0.22	0.39	2.42**	0.23	0.28	0.75
Managerial restructuring	0.15	0.21	1.05	0.16	0.29	2.04**	0.23	0.22	0.17
Sample size	61	236		58	212		44	144	
Panel C: Blockholder dominance									
Operational restructuring	0.55	0.51	0.59	0.33	0.50	2.34**	0.43	0.50	1.00
Capital expenditure	0.51	0.65	2.03**	0.40	0.53	1.81*	0.53	0.48	0.24
Sample size	65	232		60	210		28	160	
Panel D: CEO board dominance									
Capital expenditure	0.81	0.57	3.29***	0.67	0.46	2.58***	0.56	0.46	1.19
Managerial restructuring	0.18	0.20	0.42	0.16	0.28	1.85*	0.26	0.21	0.65
Dividend cut/omission	0.11	0.27	2.58**	0.19	0.29	1.32	0.38	0.33	0.65
Sample size	57	240		51	219		39	149	
Panel D: Non-CEO board dominance									
Operational restructuring	0.73	0.54	2.89***	0.50	0.46	0.62	0.64	0.48	1.93*
Cash generative actions	0.52	0.36	2.37**	0.53	0.42	1.68*	0.51	0.41	1.18
Acquisitions	0.61	0.47	2.00**	0.47	0.32	2.15**	0.26	0.28	0.28
Sample size	71	226		66	204		47	141	

***, **, * indicate significance at 1%, 5% and 10% respectively.

4. Results

4.1. IMPACT OF STAKEHOLDER DOMINANCE ON TURNAROUND STRATEGY CHOICE

We divide our sample into two groups – one stakeholder dominated and the other non-dominated by that stakeholder. For each stakeholder group – lenders, manager-owners, block shareholders, CEO and collective board of directors – we examine the likelihood of a given strategy being chosen. The difference in the proportions of sample firms in the dominated and non-dominated groups choosing a strategy is tested for statistical significance. Any significant difference reflects the influence of the dominant stakeholder.

Table VI shows the proportions of sample firms pursuing a given strategy in the decline and two post-decline years when the differences in these proportions between dominant and non-dominant groups are significant. Sample firms are lenders dominated when their leverage is in the top quartile of all the sample firms and they are in severe decline (bottom 50% in sample stock ranking in the year of decline). Lenders under such circumstances are likely to have high stakes in recovery and to exercise their priority rights. Sample firms are manager-owner dominated when they are not lender dominated according to the above definition and the managerial and associated shareholdings are in the top quartile of all sample firms.

Where neither lenders nor manager-owners are dominant according to the above definitions and the unassociated block shareholding is in the top quartile of all sample firms, the firms are deemed block shareholders dominated. Finally, the sample firms not dominated by lenders, manager-owners and block shareholders, they are deemed to be under the control of the board of directors. In turn, the board may be dominated by a dual CEO or collectively by the board members.

Panel A of Table VI shows the effect of lender dominance on strategy choice. To summarise, lender-dominated firms are more likely to opt for operational restructuring, cash generative actions, dividend cut/omission and debt restructuring. They are less likely to approve of cash-consuming strategy such as capital expenditure. They have little influence on management changes.

In Panel B, the effects of manager-owner dominance are shown. Manager-owner dominated firms are more likely to undertake capital expenditure and less inclined to pursue operational restructuring and acquisitions. They are also less likely to sack their top management!

When firms are dominated by blockholders, their influence is less pronounced and limited to two strategies as shown in Panel C. These shareholders make operational restructuring and capital expenditure less likely. CEO dominant board influence is also limited but stronger than with blockholder dominance. Declining firms dominated by their CEOs prefer capital expenditure but disfavour dividend cut/omission. They understandably reduce the chances of managerial restructuring. Collective board dominance again influences only three strategies. With little

conflict of interests in the board, operational restructuring, cash generative actions and acquisitions are favoured by the board collectively.

Having explored the impact of stakeholder dominance on restructuring strategy choice, we now examine the individual and joint impact of agency monitoring mechanisms on strategy choice.

4.2. IMPACT OF INDIVIDUAL AGENCY MONITORING MECHANISMS ON TURNAROUND STRATEGY CHOICE

Tables VII–IX report the model coefficients for the logistic regressions of corporate restructuring strategy choices on the agency and control variables. A separate regression is run for each strategy and for each of the following years: year of performance decline (the decline year), the year after the decline year (decline year + 1) and the second year after the decline year (decline year + 2).

We model the strategy choices in each year, rather than over a single period covering the three years, to examine whether there is a time lag in the impact of the agency and control variables. It is plausible that certain drastic strategies like top managerial change or asset reduction may be undertaken after strategies such as operational restructuring.

In the decline year, in Table VII, the logistic models are significant (based on the Chi-square statistic) in all except where managerial restructuring and debt restructuring are the dependent variables. Significance of the individual variables is tested for using the Wald statistic.⁹ The explanatory power of the models, measured by McFadden's R^2 , ranges from 4% to 24%.

It appears that in the decline year itself significant restructuring begins to take place and the impact of several agency and control variables is felt. Lenders increase the probability of cash generative and debt restructuring strategies. They, however, disfavour capital expenditure.

Associated shareholding significantly influences the choice of several strategies. It reduces the probability of the declining firm pursuing operational restructuring, cash generative actions and acquisitions. Unassociated shareholders, however, have no influence whatsoever in the year of decline.

As regards the governance structure, declining firms with CEO duality are more likely to increase capital expenditure and less likely to take cash generative actions. Non-executive Chairmen and the proportion of outside directors on the board have little influence in the choice of turnaround strategy, at least in the decline year.

The control variables have varying impact on strategy choice. Where firm decline coincides with an economic downturn, firms react with several strategies. They resort to more operational restructuring, managerial restructuring and dividend cut/omission. However, cash generative actions and investments are less likely during an economic downturn. On the other hand, if the whole of their

⁹ To simplify the tables, the Wald statistic is not reported and only its level of significance indicated when it is significant at least at the 10% level.

Table VII. Logistic regression of restructuring strategies on agency and control variables (year of decline)

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 297 declining firms over the period 1987 to 1993. The decline year refers to the year in which a firm declines to the bottom 20% ranking in stock returns, in the market, after having been in the top 50% for two previous consecutive years. Coefficients are tested for significance using the Wald test statistic.

Model: Restructuring strategy = f (Debt, ownership, governance and control variables)

Explanatory variables	Operational restructuring	Cash generation	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/omission	Debt restructuring
Leverage	0.63	2.58**	0.08	-1.76**	-0.86	0.45	4.63*
Associated shareholding	-0.02**	-0.02***	-0.02**	0.00	0.00	0.01	-0.01
Unassociated shareholding	-0.01	-0.01	-0.01	-0.01	0.01	0.01	0.01
Chairman cum CEO	-0.36	-0.58*	-0.21	-0.71**	-0.09	-0.61	0.97
Non-executive Chairman	-0.05	-0.28	-0.19	0.24	-0.19	-0.69	0.11
Proportion of outside directors	1.45	-0.21	0.21	1.78	-0.54	-0.36	0.63
Economic condition	-0.15**	0.13*	0.13**	0.22***	-0.13*	-0.50***	-0.18
Industry condition	-0.01	-0.01	0.00	-0.01**	0.00	-0.02**	-0.04*
Internal problem	1.12***	0.24	-0.01	0.38	0.02	0.44	-1.05
Severity of decline	-0.05**	0.02	0.01	0.02	-0.07**	-0.12***	-0.13*
Size	-0.10	-0.05	0.07	-0.04	0.14	-0.30**	-0.06
Constant	1.69**	-0.37	-0.09	-0.13	-0.86	2.20**	-3.92
McFadden's <i>R</i> -square	12.1%	13.0%	5.9%	12.0%	4.4%	23.9%	4.7%
Chi-square	38.2	41.2	18.0	38.1	13.3	81.2	14.2
Regression <i>p</i> -value	0.00	0.00	0.08	0.00	0.27	0.00	0.22

***, **, * indicate significance at 1%, 5% and 10% respectively.

industry suffers decline, the sample firms are more likely to increase their capital expenditure perhaps to gain a competitive advantage, cut/omit their dividends, and restructure their debts. Where decline has resulted from firm specific internal problems, operational restructuring is more likely.

The more severely declining firms (represented by low ranking on stock returns in the decline year) are more likely to go for operational restructuring, top management replacement, dividend cut/omission and debt restructuring. Finally, large companies are more likely to avoid the need to cut/omit dividends.

The strategy choices made in the second year of decline are shown in Table VIII. All logit models are significant at the 5% level or better. McFadden's R^2 ranges from 7% to 27% and for most of the models the explanatory power is much higher than of their counterparts in the decline year in Table VII. It appears that agency and control variables exercise their influence more strongly in the second year of decline suggesting delayed reaction to the onset of decline.

Unsurprisingly, lenders continue to press for cash generative actions. They are also more likely to resort to debt restructuring. Ownership continues to influence strategy choices in the second year. Associated shareholding decreases the probability of operational restructuring and cash generative actions. Thus, management-associated shareholders' resistance to these strategies in the decline year is reinforced in the second year. Interestingly, associated shareholders resist debt restructuring. Unassociated shareholding begins to influence adoption of strategies in the second year. They are negatively related to the choice of operational restructuring. CEO-duality continues to increase the chances of capital expenditure but, unsurprisingly, reduces the probability of managerial restructuring. Non-executive Chairmen make cash generative actions and debt restructuring less likely but capital expenditure more likely. More outside directors now means greater chances of cash generative actions and managerial restructuring. Outside directors' activism in the second year is in stark contrast to their passivity in the decline year.

The effects of economic downturn are equally significant in the second year. It continues to increase the probability of operational restructuring, dividend cut/omission and debt restructuring, but reduces the probability of investments both acquisitions and capital expenditure.

Industry downturn makes operational and debt restructuring less likely and dividend cut/omission more likely. Severity of decline impacts further in the second year. It continues to make operational restructuring, dividend cut/omission and debt restructuring more likely. In addition, the more severely declining firms are also less likely to undertake acquisitions. Internal cause of decline has little influence on strategy choice in the second year of decline. Finally, large firms increase the probability of investments in the form acquisitions and capital expenditure.

The logit models of strategic choices made in the third year of decline (decline year + 2) are shown in Table IX. In contrast to the model for the previous year in table 8, only five of the third year models are significant at least at the 10% level. McFadden's R^2 ranges from 5% to 27%. The third year models thus generally have

Table VIII. Logistic regression of restructuring strategies on agency and control variables (year 1 after decline)

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 270 declining firms which are neither insolvent (bankrupt) nor acquired, one year post decline, in the period 1987 to 1993. Coefficients are tested for significance using the Wald test statistic.

Model: Restructuring strategy = f (Debt, ownership, governance and control variables)

Explanatory variables	Operational restructuring	Cash generation	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/omission	Debt restructuring
Leverage	0.85	2.27***	0.81	-0.83	-0.50	1.41	10.83**
Associated shareholding	-0.02***	-0.02**	-0.01	0.01	-0.01	-0.00	-0.10**
Unassociated shareholding	-0.03***	-0.01	0.00	0.00	0.00	0.00	0.05
Chairman cum CEO	0.07	-0.49	-0.04	0.60*	-0.87**	-0.36	-1.09
Non-executive Chairman	0.24	-0.91**	0.73*	0.61	-0.48	0.47	-7.36**
Proportion of outside directors	-0.14	3.35***	0.81	0.57	2.47*	0.27	2.43
Economic condition	-0.52**	0.00	0.29***	0.31***	-0.07	-0.43***	-0.55**
Industry condition	0.02**	0.01	0.01	0.00	0.00	-0.01**	0.10**
Internal problem	0.38	0.47	-0.47	-0.21	0.02	0.05	-10.47
Severity of decline	-0.06**	0.03	0.05*	0.02	-0.03	-0.12***	-0.50**
Size	-0.11	0.03	0.22**	0.30***	-0.10	-0.08	0.84
Constant	2.60***	-0.46	-3.20***	-2.46***	-0.04	0.84	-7.86*
McFadden's R -square	26.5%	16.5%	14.0%	14.0%	6.8%	19.4%	17.7%
Chi-square	83.0	48.8	40.8	40.7	19.1	58.3	52.5
Regression p -value	0.00	0.00	0.00	0.00	0.05	0.00	0.00

***, **, * indicate significance at 1%, 5% and 10% respectively.

less explanatory power than the models for the first two decline years. It appears that the influence of the agency and control variables on strategy choices is waning. Nevertheless, some of these variables continue to exert significant impact.

Lenders continue to restrict capital expenditure. Debt restructuring is again made more likely by lenders. Associated shareholders stubbornly resist cash generative strategies. Interestingly, unassociated shareholders join associated shareholders in resisting cash generative strategies.

As regards governance structure, dual CEOs are still more likely to go for capital expenditure. Non-executive Chairmen, however, are quite inactive. With more outside directors a poorly performing firm is now more likely to undertake not only more cash generative actions but acquisitions and capital expenditure too, perhaps to expand the firm after two years of restructuring.

The impact of external environment is still important in the third year. Economic downturn still increases the probability of operational restructuring and dividend cut/omission, and reduces the probability of acquisitions and capital expenditure. If the industry is depressed in the third year, sample firms would be inclined to remove top management, cut/omit dividends and restructure their debts. Operational restructuring, however, is less likely to be needed. Sample firms are still constrained in their strategy by the existence of an internal cause of decline and severity of the initial decline. Firms with an internal cause of decline are still more likely to restructure their operations. Severe decline firms are still more likely to cut/omit their dividends. Firm size, however, ceases to have any impact in the third year.

4.3. SUMMARY OF THE IMPACT OF AGENCY AND CONTROL VARIABLES

In Table X the results of the logit models of turnaround strategy choice reported in Tables VII–IX are summarised to highlight the impact of each agency or control variable on the probability of choosing or avoiding different strategies. A striking feature of the results is that certain stakeholder groups seem to act in similar ways to reduce or increase the probability of certain restructuring actions. Associate and unassociated shareholders make operational restructuring and cash generative actions less likely. This coalition in resisting cash-generative actions stems from owners' desire to avoid option value-destroying asset sales and stump up new cash in the form of equity injections.

Similarly, Chairmen cum CEOs and non-executive Chairmen seem to prefer investments but dislike cash-generative actions. Outside directors appear to side with lenders in pressing for cash-generative actions. However, only outside directors do not disfavour any particular strategies, and favour both cash-generating and cash-consuming actions, and more importantly, instigate managerial restructuring. This lends support to the effectiveness of a governance structure characterised by a substantial independent director presence. In contrast, lenders appear to be primar-

Table IX. Logistic regression of restructuring strategies on agency and control variables (year 2 after decline)

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 188 declining firms which are neither insolvent (bankrupt) nor acquired, two years post-decline. The sample covers only firms in decline in the period 1987 to 1992, as firms declining in 1993 have only one year post-decline strategies to the end of the analysis period i.e. December 1994. Sample size is therefore reduced. Coefficients are tested for significance using the Wald test statistic.

Model: Restructuring strategy = f (Debt, ownership, governance and control variables)

Explanatory variables	Operational restructuring	Cash generation	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/omission	Debt restructuring
Leverage	-0.20	1.32	0.71	-1.96**	-0.24	1.19	3.36*
Associated shareholding	-0.01	-0.02*	0.00	0.00	0.00	0.00	-0.01
Unassociated shareholding	-0.01	-0.02*	0.00	0.00	-0.01	0.02	0.00
Chairman cum CEO	-0.54	-0.25	0.37	0.68*	0.05	-0.07	0.56
Nonexecutive Chairman	0.07	0.19	0.46	0.55	0.06	0.15	-0.18
Proportion of outside directors	0.55	2.61*	3.13**	2.55*	-0.24	0.57	-0.43
Economic condition	-0.51***	-0.02	0.22***	0.34***	-0.08	-0.31***	0.07
Industry condition	0.01*	0.00	0.00	0.00	-0.01***	-0.01***	-0.01*
Internal problem	0.81**	0.41	-0.44	-0.16	0.07	-0.66	0.06
Severity of decline	-0.04	0.03	0.02	0.04	-0.02	-0.06*	0.00
Size	0.17	0.13	0.11	0.23	0.15	-0.15	0.22
Constant	0.27	-1.48	-3.03***	-2.71	-1.86	-0.44	-4.96***
McFadden's R -square	22.2%	12.9%	9.7%	19.3%	7.0%	27.2%	5.4%
Chi-square	47.1	25.9	19.2	40.2	13.6	59.8	10.6
Regression p -value	0.00	0.00	0.05	0.00	0.25	0.00	0.47

***, **, * indicate significance at 1%, 5% and 10% respectively.

Table X. Summary of the effect of each explanatory variable on the choice of restructuring strategies

This table summarises the results in Tables VII–IX. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively/negatively related to particular strategies (i.e. increasing/decreasing the probability of those actions occurring) in the logistic regression models in Tables VII–IX, are separately listed.

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Leverage	Debt restructuring Cash generation	Capital expenditure
Associated shareholding		Acquisitions Operational restructuring Debt restructuring Cash generative actions
Unassociated shareholding		Operational restructuring Cash generative action
Chairman cum CEO	Capital expenditure	Managerial restructuring Cash generative actions
Non-executive Chairman	Acquisitions	Debt restructuring Cash generative actions
Proportion of outside directors	Cash generative actions Acquisitions Capital expenditure Managerial restructuring	
Economic downturn	Operational restructuring Dividend cut/omission Debt restructuring	Cash generative actions Acquisitions
Industry downturn	Capital expenditure Dividend cut/omission Managerial restructuring Debt restructuring	Capital expenditure Operational restructuring Debt restructuring
Internal problem Severe decline	Operational restructuring Operational restructuring Managerial restructuring Dividend cut/omission Debt restructuring	Acquisitions
Size	Acquisitions Capital expenditure	Dividend cut/omission

ily concerned with conserving or augmenting the cash position of declining firms and are neutral towards management change.

Declining firms react differently to deterioration of the business environment. Faced with an economic downturn, they resort to operational restructuring, divi-

dend cut/omission and debt restructuring. Cash generative actions, however, are also more difficult in depressed economic climates. Investments are also less likely in harsh economic conditions. In contrast, when their industry as a whole experiences a downturn, these firms pursue capital expenditure, dividend cut/omission, managerial and debt restructuring. Operational restructuring, however, is less needed during an industry downturn. Firms with an internal cause of decline are more likely to restructure their operations. The response to severe decline takes the form of operational restructuring, dividend cut/omission, debt restructuring and a reduction in acquisitions. More interestingly, management replacement is also more likely in such firms. This suggests that top managers are able to fend off attempts to replace them until the firm situation deteriorates perilously. Large firms, being more resourceful, are also less likely to resort to dividend cut/omission and are more able to afford investments.

Table XI summarises the joint impact of one or more agency or control variables on the probability of choosing or avoiding a particular strategy. It answers the questions 'which factors make a given restructuring strategy more likely and which factors make it less likely?' and 'what is the coalition of stakeholders bearing on the adoption of a given strategy?'

None of the strategies is favoured by all stakeholders. Strategies such as cash-generative actions are favoured or opposed by different coalitions of interests. While bank creditors' push for cash-generative actions, they are supported by outside directors but the coalition of associated and unassociated shareholders, Chairman cum CEO and non-executive Chairmen makes it less probable. Associated and unassociated shareholding jointly resist operational restructuring.

While capital expenditure is favoured by Chairmen cum CEO and outside directors, lenders seem opposed to the strategy. Similarly, Chairman cum CEO and outside directors' preference for acquisitions is matched by associated shareholders resistance to the same strategy. Managerial replacement is made more likely by outside directors, but it is, predictably, opposed by Chairmen cum CEOs. Our results thus reveal shifting coalitions of stakeholders vis-à-vis different turnaround strategies.

The results based on logit regression models are consistent with those discussed earlier under stakeholder dominance and thus add to the robustness of our conclusions about the impact of stakeholder dominance on restructuring strategy choice.

4.4. IMPACT OF LENDER AND OWNERSHIP TYPES ON RESTRUCTURING STRATEGY CHOICE

We know that when lenders dominate firms' decision-making process, they demand operational restructuring, cash-generative actions, dividend cuts/omissions and cut in cash-consuming capital expenditure. We also know that when manager-owners dominate firms' decision-making process, they refrain from adopting operational

Table XI. Joint impact of explanatory variables on individual restructuring strategy choice

As explanatory variables collectively influence the choice of restructuring strategies, the combined impact of explanatory variables on the choice of a specific restructuring strategy is summarised from the results reported in Tables VII–IX. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Tables VII–IX, increase/decrease the probability of that action occurring.

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Operational restructuring	Industry condition Internal problem	Associated shareholding Unassociated shareholding Economic condition Severity of decline
Acquisitions	Non-executive Chairman Proportion of outside directors Severity of decline Economic condition Size	Associated shareholding
Capital expenditure	Chairman cum CEO Proportion of outside directors Economic condition Size	Leverage Industry condition
Managerial restructuring	Proportion of outside directors	Chairman cum CEO Economic condition Industry condition Severity of decline
Dividend cut/omission		Economic condition Industry condition Severity of decline Size
Debt restructuring	Leverage Industry condition	Associated shareholding Non-executive Chairman Economic condition Industry condition Severity of decline
Cash generation	Leverage Proportion of outside directors Economic condition	Associated shareholding Unassociated shareholding Chairman cum CEO Non-executive Chairman

restructuring, acquisitions and managerial restructuring strategies, and opt instead for capital expenditure. Similarly, when blockholders dominate the firm's decision-making process, they disfavour operational restructuring and capital expenditure. The logit regression results on the effects of lender and shareholders monitoring on strategy choice broadly confirm these tendencies. The question then is which

type of lenders and owners favour which type of strategy. To test for these individual impacts we rerun all the regressions in Tables VII–IX with three types of lenders instead of one, short term lenders, bank lenders and unsecured lenders, and four types of shareholders instead of two, manager shareholders, associated block shareholders, institutional block shareholders and non-institutional unassociated block shareholders.

The results show that short term and unsecured lenders are the parties behind lenders' demand for operational restructuring.¹⁰ Bank and short term lenders jointly press for cash generative actions. However, only bank lenders have the clout to restrict firms' capital expenditure.

Manager shareholders alone resist operational restructuring, cash generative and acquisition strategies. Conversely, associated block shareholders prefer acquisitions and surprisingly, in a show of independence, managerial restructuring. Institutional block shareholders and non-institutional unassociated block shareholders jointly resist operational restructuring and cash-generative actions. However, non-institutional block shareholders also make managerial restructuring more likely. They are also supportive of declining firms, in terms of dividend cut/omission.

5. Summary and Conclusions

Firms which experience performance decline may choose a variety of alternative methods of restructuring themselves to restore their financial health. These restructuring strategies for poorly performing companies include operational, asset, financial and managerial restructuring. However, any restructuring strategy has different, and often conflicting, welfare implications for the different stakeholders in firms – shareholders, lenders and managers. Within the agency model of the firm the strategy choices made by managers may benefit one group of stakeholders at the expense of the other groups. However, managerial choices are also constrained by the agency monitoring embodied in the firms. Agency monitoring may be embodied in the rights of lenders, the power and influence of large block shareholders or in the oversight function and independence of the board of directors. The choice of recovery strategies is, therefore, determined by the complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in decline.

For a sample 297 U.K. firms which experienced stock return performance decline during the period 1987–1993, we examine the impact of agency monitoring on the turnaround strategies selected by them. Performance decline is defined as the fall into the bottom 20% of the ranking of all U.K. listed firms on annual stock market returns from being in the top 50% in the preceding two years. A number of variables proxying for different lender types, for different types of block shareholders and for the strength and independence of the board as well

¹⁰ Due to space constraints the tables are not presented in the paper. The results are available from the authors.

as control variables to allow for the external economic and industry environment, severity of decline and firm size are included as explanatory variables. The impact of these variables on turnaround strategy choices in the decline year and in the two post-decline years is modelled with logit regressions.

Our results show that turnaround strategy choices are significantly influenced by both agency variables and control variables. While there is agreement among stakeholders on certain strategies there is also evidence of conflict of interests between lenders and managers and between managers and some block shareholders. Lenders' preference for cash-generative actions are in direct conflict with shareholders' preference. Weak governance structure helps entrench managers and perpetuate their self-serving behaviour resulting in less restructuring and top management replacement. Non-institutional rather than institutional shareholders appear to be active monitors and influential in instituting top management changes. However, all types of shareholders disfavour any type of costly strategy such as operational restructuring or option value-destroying strategies such as asset sales. Boards of directors, however, seem to be effective in their oversight of managers, as they intensify adoption of generic turnaround strategies. There is evidence of shifting coalitions among lenders, managers and directors in the choice of recovery strategies. Institutional shareholders generally seem to go along with management shareholders. Response of non-executive Chairmen and CEO cum Chairman to turnaround is broadly similar.

The results also show the effects of dominance by certain stakeholder groups. Lenders' tight financial reigns through wholesale bans on investments can cause an under investment problem. Lenders may not only be depriving firms of vital resources necessary to compete and reverse decline but also side lining their long-term health by favouring short-term cash generative measures to facilitate debt repayment. It raises the question if banks are too keen to pull the plug on ailing firms which lack short-term cash generation ability in spite of their healthy long-term potential. Entrenched managers' inaction to performance decline may lead a downward spiral to failure. Blockholders have a weak influence on a limited range of turnaround strategies. Consequently, corporate failures can potentially be explained by poor management of stakeholders' interests during decline, resulting in poor selection of turnaround strategies.

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