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"DISTRESS INVESTING UNDER THE ITALIAN BANKRUPTCY LAW:
A COMPREHENSIVE CASE"

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Introduction

The corporate distress is a complex issue which recently is even more important for a global economy characterized by a material number of companies which enter a distress scenario. Dealing with distressed companies is even more difficult when approaching a private company (or SME), either because the information available to prepare the proper due diligence cannot be sufficient or because a material part of the SMEs is owned by families who often are not willing to give up the control of the company they have founded. In particular, in Italy the 76% of the companies are SMEs (Banca IFIS, 2018) and inside those companies the 68% of them (100.790 in absolute terms) are owned by a family (Cerved, 2018/A). Thus, in Italy the issue is significantly important, not only because of the reluctancy of the family-owners, but also because often the SMEs entrepreneurs must be educated financially in order to not make the same mistakes in the future. For those reasons, who deals with the Italian distressed SME niche faces a very complex world; thus, it is important to analyze the issue in detail in order to increase the possibility to find the right way to rescue those small companies that represent the “driving force” of the Italian economy.

Obviously, the main reason which recently led the Italian small companies to distress is related to the 2008 global financial crisis, but the reasons that lead a company to distress – and in the most serious cases to bankruptcy – can be multiple and different. Indeed, a company can suffer either because of a change of the external environment or because of internal cost or capital structure inefficiencies. Similarly, a company can have operative or financial troubles, impacting directly the income statement or the balance sheet, respectively. Again, the reasons for distress can be related to a mix of all the causes mentioned so far. Accordingly, to understand the path which have led the company to distress requires a thorough analysis of the whole context, from the market and industry composition to the financial statement analysis.

Moreover, it is critical to detect the distress status sufficiently soon. For this reason, the researchers have provided – and still provide – a high number of studies aimed at discovering how to identify in advance a distress scenario inside a company, in order to be in a position to take the necessary countermeasures when it is still possible to revert the company performance.

In combination with those studies, other researchers have tried to adjust the most common valuation techniques including the distress component¹.

In addition to those issues, it is also important to know perfectly how to manage a procedure aimed at dealing with a distressed company; depending on the severity of the crisis, the procedure can be addressed to liquidate the company assets or to continue the company operations. According to Cerved (2018/B), in the first trimester of the 2018 both the types of procedures are decreasing, signaling a recovery from the negative performance of the post-crisis period; however, the number of procedures is not trivial, accounting for 2.945 liquidation procedures (- 6% than the 2017 first trimester) and 370 non-bankruptcy procedures (- 16% than the 2017 first trimester).

A particular attention shall be given to the procedures aimed at continuing the company operations, given the fact that the recent reforms on the Italian bankruptcy law are focused in encouraging the parties to give priority to continue the company operations instead of liquidating the assets. In practice, if the new reform will be approved, in the future the liquidation legal tools will be used only when there are no other possibilities which guarantee a better solution for the creditors.

A significant role in a procedure aimed at continuing the company operations is often performed by the distress investor, i.e. a fund specialized in investing in distressed companies in order to obtain a positive return. In Italy the presence of those funds is not pervasive yet, so it is important – at this point in time – to provide an analysis of those players in order to see how they may operate in order to revert the Italian distressed companies' performance. Accordingly, an analysis of those investors is important in order to see the way in which they can behave, given the fact that those entities shall have an advanced knowledge in all the issues which entail the investment in a distressed company, i.e. business, financial, valuation and legal expertise.

The final aim of this dissertation is to contribute to describe and analyse which are the most important aspects that regard the activity of the distress investors and the way in which those entities contribute in recovering the performance of a distressed company. In order to do this, it is necessary to examine all the business and legal issues that such players should know in detail. Then, those bases will be used by such investors in order to select the right strategy for both the distressed company and the distress investor itself.

¹ See Damodaran (2010).

For this purpose, the first Chapter will try to clarify and organize the main definitions of “distress” that the literature has provided so far. In particular, a final definition will be provided, and the principal distress stage models will be presented. Moreover, the reasons for distress are classified in various ways and a different approach will be presented. Finally, the concept of “turnover” will be discussed, since it represents the logical consequence of a distress period in the case where there is the necessity to continue the company operations.

Then, the Italian bankruptcy law will be explained, in order to define the perimeter inside which the parties involved are included. In this section, the legal tools provided by the law will be presented; the instruments will be divided into in-court procedures and out-of-court procedures². Moreover, the new Italian bankruptcy reform (not in force yet) will be described in order to provide an idea about the future of the Italian bankruptcy law system.

The third Chapter will include a focus on the procedures aimed at continuing the company operations, performing a comparison among them and finding the main drivers which lead a distressed investor (or an advisory company) to prefer one procedure instead of the other ones. Moreover, the main actors of those procedures will be described, in order to have a clear framework about who usually participates during the negotiation process when trying to rescue a distressed company and which are the main conflicts of interest among the stakeholders of the procedure.

Chapter 5 will include a description of the distress investors, a classification of their main strategies and an analysis of the way in which they work in order to decide the target company in which to invest. Those funds can invest in different items of the distressed company (i.e. assets, debt or equity) and may have either a speculative behaviour or a strategic one. Clearly, for the purposes of this paper, the strategic behaviour will be analysed more in detail.

Finally, the case study is presented. The Distressed Company³ object of the case was an Italian medium company specialized in the footwear design industry. After a couple of decades of significant growth, because of a mix of different reasons – both internal and external – it entered a distress scenario. As a consequence, the Distressed Company managers decided to perform different activities in order to try recovering the company performance. After some failed attempts, a distress investor entered the procedure. Thus, after the presentation of the Distressed

² In reality, the out-of-court procedures may involve a minimal involvement of the court; however, the presence of the court in those cases is not pervasive.

³ For disclosure reasons, the name of the distressed company and the parties that have been involved will not be disclosed.

Company and its reasons for distress, the events occurred in order to turn the company around will be described and analysed. Finally, the strategy implemented by the distress investor will be analysed in detail.

Chapter 1: Corporate distress

1.1 Definitions

Finding a final and exhaustive definition of corporate distress is difficult, if not impossible. The researchers typically use a lot of creativity to find definitions which represent the same aim, i.e. to describe the fact that a company is definitely in troubles and what had happened before the moment in which the distressed company management had to decide whether to reorganize the firm or liquidate it. In practice, there is one definition for each author. This may not be surprising if we think that usually a definition is “built” basing on the purposes of the study and the dataset used.

To make the issue more complicated, the researchers tend to treat other terms such as corporate crisis, decline and failure as synonym, making the issue even more complex⁴. For example, Müller (1985) uses the term ‘corporate crisis’ to define “un unwanted event which always seriously threatens the continued existence of the firm” (Müller, 1985). Similarly, Outecheva (2007) employs the word “‘corporate distress’ synonymly with ‘corporate failure’ as an overall term for the determination of single stages of the decline period and in order to reproduce them as a dynamic process” (Outecheva, 2007). A different perspective is given by the Anglo-Saxon literature, which adds a probabilistic element into the definition of what they call ‘organizational crisis’ (Pearson and Clair, 1998)⁵; in particular, the authors seem to adopt a broader definition underlining that in general a crisis is a low-probability event. The latter fact illustrates clearly that each researcher creates a definition which is tailor made for the research he is making⁶.

In general, two of the most used terms are ‘decline’ and ‘failure’. However, it is not clear in the literature whether those two terms are used in a static way or in a dynamic way. In this case, static means that a definition indicates a particular point in time, while dynamic is linked to an

⁴ For example, Pretorius (2009) states that “As the research progressed and while probing the different databases, it was found that failure is associated with bankruptcy, liquidation, insolvency, crisis, decline in performance, [...], collapse, crashing, accounting practices, project failure, distress, trouble, systems failure, franchise failure, being non-successful, and more”.

⁵ “An organizational crisis is a low probability, high-impact event that threatens the viability of the organization and is characterized by ambiguity of cause, effect, and means of resolution, as well as by a belief that decisions must be made swiftly” (Pearson and Clair, 1998).

⁶ In the specific case, the authors want to adopt a multidisciplinary approach to crisis management research, using psychological and social-political points of view. Accordingly, it seems reasonable such a broad definition.

interval of time during which the word takes significance. Watson & Everett (1999) have found that some studies report divergent results simply because of a different definition of ‘failure’.

On one side, ‘*decline*’ is seen as a dynamic notion in most works, with some exceptions. For example, Chowdhury and Lang (1993) say that “Decline and crisis are the low and high extremes of the rate of performance deterioration”: in their work, the authors both analyze the gradual component of the decline (the dynamic way) and calculate a decline rate to see whether a company is in decline or not for one point in time (more close to the static way). However, as precised above, the greatest part of decline definitions include only the dynamic component. For example, Lorange & Nelson (1987) define ‘decline’ as “Degeneration of organizational performance in sales, profitability, market share and technological leadership”, indicating a dynamic path of decrease of a performance. Similarly, D’Aveni (1989) talks about “...decreasing internal resource munificence over time with respect to two critical resources: financial and human (managerial) resources”, focusing on the interval of time characterized by a loss of potentially critical resources which could lead to solvency problems.

On the other side, ‘*failure*’ is adopted by the researchers in many ways. Sometimes it is used dynamically: for example Richardson, Nwankwo & Richardson (1994) say that “Business failing organisations are those that will become insolvent unless appropriate management actions are taken to effect a turnaround in financial performance”, suggesting that there could be a period in which a company can be in a failure stage, period that the management must use to recover from the bad performance. Alternatively, – and this is the prevalent use of the term – most of the authors see ‘failure’ as a static issue strictly linked to bankruptcy. Many authors match the term ‘failure’ with strong terms such as default, zero⁷, closure, going out of business, dissolution, to shut down, insolvency, bankruptcy and in one case the term death⁸ has been used. Moreover, special versions of ‘failure’ exist: for instance, Lussier & Pfeifer (2001) give a rule to determine whether a firm is in failure by setting a three years period of negative profits, while Sudarsanam & Lai (2001) suggest that an organization is failing when there is a sufficiently large deviation from a “superior performance”. Cannon & Edmonson (2005) define ‘failure’ simply as a “deviation from expected and desired results” (Cannon & Edmonson, 2005).

⁷ “Failure occurs when the level of organisation capital reaches zero. It is no longer able to meet its financial obligations to debt holders, employees, or suppliers and resorts to or is forced into bankruptcy or liquidation” (Levinthal, 1991).

⁸ “Failures refer to deaths of entire firms and industry exits by multiple business companies” (Henderson, 1999).

A solution about the lack of clarity of those two terms is provided by Sheppard & Chowdhury (2005), which give a sequential order when defining ‘decline’ and ‘failure’. In particular, they argue that “Organisation failure is the end result of a decline” (Sheppard & Chowdhury, 2005); thus, describing ‘decline’ in a dynamic way and ‘failure’ as a final consequence (a point in time) of the decline period, i.e. in a static way. This view is confirmed by Schmitt (2009), who specifies two main points:

- Following Altman (1968) and Altman & Hotchkiss (2006), ‘failure’ could be defined in several ways but related to a point in time event:
 - i. Economically, i.e. “[...] the realized rate of return on invested capital [...] is significantly and continually lower than prevailing rates on similar investments” (Altman & Hotchkiss, 2006);
 - ii. Legally, i.e. when a corporation is not able to respect the terms agreed with its creditors anymore;
 - iii. In business terms, i.e. when a company ceases its operations because of a bankruptcy proceed;
- ‘Decline’ is related to a specific period of time, and it describes a process which might, but not for sure, end in corporate failure.

In sum, the failure event can happen only after a period of decline. This seems to be the interpretation given by the greatest part of the researchers.

After having classified the most critical criteria for each of the terms, Pretorius (2009) has been able to summarize the two definitions in order to arrive at a middle way between all the definitions provided in the literature:

- Decline: “*A venture is in decline when its performance worsens (decreasing resource slack) over consecutive periods and it experiences distress in continuing operations. Decline is a natural precursor in the process to failure*”;
- Failure: “*A venture fails when it involuntarily becomes unable to attract new debt or equity funding to reverse decline; consequently, it cannot continue to operate under the current ownership and management. Failure is the endpoint at discontinuance (bankruptcy) and when it is reached, operations cease and judicial proceedings take effect*” (Pretorius, 2009).

Moving on the term ‘distress’, even though it is included inside the definition of decline provided by Pretorius (2009), it could be juxtaposed somewhere between the two expressions above.

Indeed, on one side, ‘distress’ can be viewed as a term indicating the degree of severity of the strategic, operative and financial condition of a company, a meaning very close to the ‘failure’ one. For example, Sudarsanam & Lai (2001) define distress as a percentage measuring the bankruptcy risk of a company, linking directly the distress concept to the bankruptcy one. On the other side, the word ‘distress’ is used to indicate a path covering a period of time during which the strategic, operative and financial performance of a corporation decreases, a sense very similar to the ‘decline’ one. For instance, Schweizer & Nienhaus (2017) do not define directly the term ‘distress’ but it seems clear in their work that ‘distress’ is used to describe a multi stage period characterized by a continuative decline of the firm performance.

To make the things more complex, it would be enough to recall the definition of ‘corporate distress’ used by Outecheva (2007), who combines the latter term with ‘corporate failure’ to indicate the dynamic process that leads a company from a healthy situation to a problematic one. This circumstance demonstrates that the real meaning of ‘distress’ is between the two most important words present in the literature.

Finally, coupling the definitions of ‘decline’ and ‘failure’, ‘distress’ could be defined as a *scenario in which a company is continuously decreasing its performance – from a strategic, operative and/or financial perspective – until it reaches the point in time in which the management must decide whether to restructure the company or file for bankruptcy.*

For a temporal point of view, the distress period starts immediately after the symptoms (even invisible) of the decline start and ends when the managers must decide about the future of their corporation⁹. It follows that during this time interval (which length is not easy to specify since it is firm-specific) there could be – and it is usually the case – different degrees of decline.

1.2 Corporate distress as a stage process

A simple general definition of distress is not adequate to understand exhaustively the concept. In particular, there is the need of analyzing in detail the time interval considered, since the extent of

⁹ Some authors use the term “turnaround process” when defining a similar notion (Chowdhury, 2002; Grinyer et al., 1988; Hoffman, 1989). However, sometimes they include also the turnaround strategy inside the time interval.

the decline is not stable during this period. The literature has provided different models which help to find some common characteristics of the distress periods, often assuming different perspectives as expected.

To analyze the corporate distress at this level is important for at least five aspects, which cover the most central issues about a business environment:

- *Legally*, an analysis of the intensity of the corporate distress is essential, among other purposes, for separating the solvency scenario and the insolvency one. For example, an unexpected negative event or wrong behavior of the management may let slide immediately a company into insolvency because the enterprise value falls straight away;
- Strictly linked to the legal aspect there is the *accounting* one: the transition of a company from a solvency state to an insolvency one implicates a change of the accounting framework which directly affects the financial statements;
- From a *corporate governance* perspective, it is critical to determine when a company is in several distress in order to define the “vicinity of insolvency” status. This status is important since it may imply a change of the managers’ fiduciary duties that they owe to their shareholders. Indeed, in case of corporate distress, it may be in the shareholders’ interest to take risky decisions because the downside risk has become low (i.e. in the most extreme cases, the value of equity is close to zero); but on the other side, the creditors’ interest is the opposite one (i.e. too risky strategies would diminish further the probability to be paid). In other words, under distress the equity holders would like that the managers “gamble for resurrection”, while the lenders would prefer a package of conservative measures that preserve the (remaining part of the) enterprise value. The debate is about “whether directors in the vicinity of insolvency are primarily obliged to act as trustees for the debt capital providers” (Bachmann et al., 2014). Irrespective of the outcome of the debate, if there are any changes (positive or negative) of the fiduciary duties that the management must guarantee to the lenders, it is important to detect the precise moment in which the former have the right or are obliged to behave differently (to be more conservative or to “gamble”, respectively);
- From a *financial* point of view, it is important to detect the exact moment in which the degree of distress severity is high. For example, a bank may want to know when it has to take more precautions on its contract with a company, as for example setting tighter covenants or asking for more collateral for its term loan contracts. On the other side of the

banking contract, a company may be interested in knowing when the distress has become dangerous, so that it can communicate to the bank the situation in a transparent way and respecting the proper timing¹⁰;

- Finally, there is the *business* perspective. For a manager, it is important to select the most appropriate moment to take the right decisions. Moreover, a CEO is interested in predicting the distress, since it is for sure that he will not want to enter a similar scenario. For this purpose, the literature has provided a very high number of studies aimed at forecasting the corporate distress years before when it really happens; on average, the best models are able to detect the start of a crisis period two years before it effectively occurs.

1.2.1 Interval models

An important theoretical model which regards the timing of the distress severity is provided by D'Aveni (1989). The author considers the distress time interval as a whole, without dividing it into stages. He differentiates three types of patterns:

- *Sudden decline*: characterized by a very rapid decrease of the performance followed by an immediate filing for bankruptcy;
- *Gradual decline*: identified with a slow, marginally incremental reduction in the enterprise value; as soon as the decline reaches an irreversible stage, the managers have to file for bankruptcy;
- *Lingering*: in this case, the firm declines rapidly at the beginning of the distress period but remains in a sort of deadlock scenario, so that differently from the sudden decline the company stays alive after the quick decline.

¹⁰ Otherwise, if the company does not communicate properly with the bank there would be a reputational problem. The bank may think that the company is hiding a bad situation: this fact may be dangerous for the company because the bank may decide to not finance the company anymore.

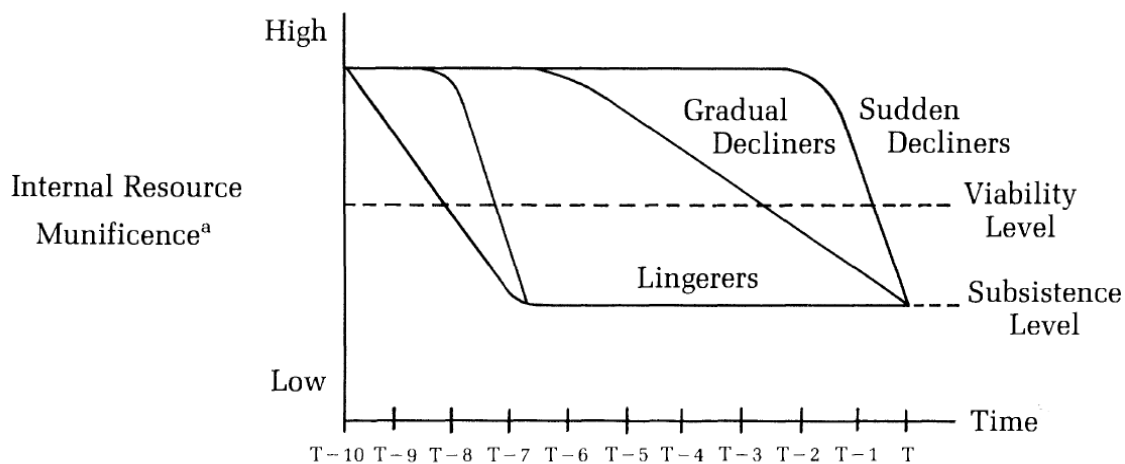


Figure 1.1: Proposed patterns of declining resources preceding bankruptcy. Source: D’Aveni (1989)

The author suggests that during the distress period the company is in a state of “strategic paralysis”, indicating that there are differences between the managers’ decisions in healthy periods and in case of distress. He links this dissimilarity of behaviors to the notion of resource scarcity: the higher the distress severity, the lower the resources¹¹ available as the distress period goes on. Further, this erosion procedure is alimeted by the need to maintain a positive cash position by selling some assets in order to finance the turnaround strategy.

To support the theory provided, the author finds that on one side, five years before the bankruptcy, there were differences on the consequences of decline between lingering and gradual declining companies¹²; on the other side, two years before bankruptcy, no dissimilarities have been found between the two types of declining firms. This supports the fact that there exist different paths of corporate distress. Accordingly, the management shall thoroughly analyze the type of distress pattern their company is having. In particular, when making this analysis, they shall focus also on the characteristics of the industry in which they are operative, since the study shows that a fast-growing industry favors a lingering-type pattern, delaying bankruptcy. A sudden decline would be a signal that a decision – whether to reorganize the corporation or to liquidate it – must be taken soon, while a lingering or gradual decline gives more time to think about the best strategy to implement in order to maximize the payoff in such dangerous situation.

¹¹ D’Aveni (1989) focalizes on two main types of resources: financial (i.e. decrease in liquidity and profitability) and human (i.e. forced layoffs and employees’ escape).

¹² “[...] the consequences of decline include managerial imbalances, actions concerned with efficiency, centralization effects, and strategic paralysis, all reflecting threat-rigidity responses” (D’Aveni, 1989).

The D'Aveni (1989) model has been integrated by Francis & Desai (2005), which analyze three drivers of decline that influence the way in which the managers can operate to recover the company: severity, suddenness and urgency.

The *severity* of a distress implicates that the higher it is, the lower is the range of actions that the managers may adopt. Moreover, the higher the degree of severity, the more likely is the implementation of drastic measures (for example assets disposal, operational or financial restructuring and repositioning), since the situation would be more deteriorated.

The concept of *suddenness* present in this model is the one introduced by D'Aveni (1989) and indicates how gradually a company is deteriorating. In particular, the higher the degree of suddenness (i.e. the more rapid a decline is), the more difficult is to recover a company.

The third factor analyzed is *urgency*; the authors define urgency as a mix of severity and suddenness. Even in this case, the higher it is, the more difficult is to have a successful turnaround.

1.2.2 Sub-interval models

After having analyzed the distress period on a macro perspective, it is useful now to focus on the attempts made by the researchers in order to find some characteristics of the distress which can be clustered into a sub-time interval included in the total period of distress. The following models are very important in particular for a manager perspective, since they serve as a guideline to select the right strategy to reorganize the company successfully. Indeed, in a business life-time cycle perspective, a distress situation is an extraordinary and often unexpected scenario; accordingly, the risk that the management finds itself unprepared is very high. The direct consequence could be the selection of the wrong turnaround policy because of either a bad timing analysis (i.e. the managers believe not to have enough time to prepare an appropriate and rational countermeasure for reverting the negative trend, so that they believe to be in a hurry) or a lack of skills and capabilities to manage the dangerous condition properly (for example, the managers could decide to sell drastically a high amount of assets in order to stabilize the cash position, when in reality the secondary effect is a huge loss of the company long term enterprise value)¹³.

¹³ “[...] under conditions of collapse, managerial behavior becomes reactionary or experimental, since the imminent dissolution of the organization is a very real possibility. Because there are serious time constraints, little planning is done, and less than efficient decisions are accepted” (Weitzel & Jonsson, 1989).

In a chronological order, the first important work which has tried to create a temporal classification of the corporate distress pattern has been performed by Müller (1985). The author suggests a ‘narrative’ way of explaining the corporate distress pattern, by dividing it into four subsequent categories: strategic crisis, performance crisis, liquidity crisis and bankruptcy.

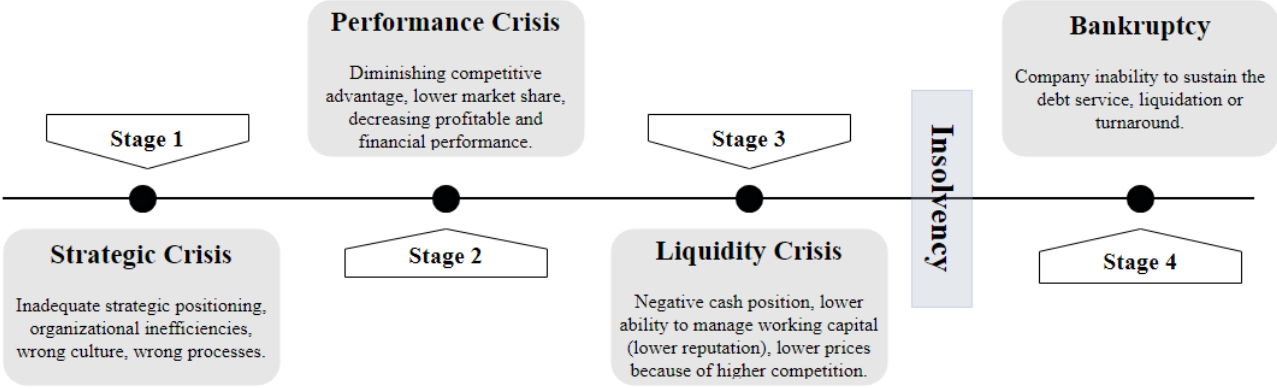


Figure 1.2: The Müller four stages model. Own elaboration.

Following the model, a healthy company begins to have its first signals of distress because of a *strategic crisis*. It means that the organization is not able anymore to maintain its unique and inimitable sources of competitive advantage, for example related to cost efficiency, differentiation, working capital, intangibles or resource exclusivity. The competitive advantage of the company is not sustainable to any further extent, and as a direct consequence the distress reaches the second stage, the *performance crisis*. Relatively to the distressed firm, the competitors are more powerful now, and the main ratios (both profitable and financial) show an alarming decline. In other words, the distressed company is not able anymore to meet the planned targets in terms of both revenues and operative margin. Consequently, the financial performance of the firm becomes very negative, reaching the *liquidity crisis*. Often the distressed company is obliged to decrease its sales prices in order to deal with the increased competition. Moreover, it may be forced to offer improving conditions to the creditors (for example decreasing the days in payables) in order to reduce the risk of losing them because of the lower reputation. In this stage the threat of insolvency increases, and if the managers do not take the necessary actions, the only outcome is represented by the final stage, *insolvency and firm dissolution*.

A common concern found also in the D'Aveni (1989) model is that it is important for the managers to well understand where they are, because the later the moment in which they recognize to be in several distress, the narrower the range of actions they can implement. Further, those remaining possibilities are very likely to be the less efficient ones. For instance, if the crisis has been found at the beginning of the corporate distress period, the distressed company has the necessary time and reputation for asking for a renegotiation of the covenant with the banks, obtaining a debt standstill or organizing an efficient auction which let the firm sell its non-core assets at a higher price; on the other side, if the management discovers the distress too late, the solutions are more inefficient, such as a less convenient asset disposal or a debt-equity swap.

This model is not valid for every distressed firms. Of course, the way in which one company gets distressed is unique, so that a classification such that might not be suitable for all the distressed corporations. A company may skip the strategic crisis stage by suffering directly a performance problem, for example when for some organizational reasons (such as the opening of an inefficient new core plant which substitutes the old one) the company finds itself unable to offer its products at the same competitive prices, with a negative consequence on the revenues. Alternatively, external market forces (such as an unexpected change of the consumers' tastes) could lead the company out of the market because its offer has become obsolete.

Moreover, the distress period can be interrupted in every moment. In fact, a good CEO may recognize in advance the strategic problems: in this case, its company may enter the distress period but only for the time required to implement the set of actions which permit the firm to solve the deficiency. Similarly, a performance problem could be solved by the appointment of a new Chief Operating Officer which improves the firm efficiency or R&D department.

A second well-known model has been proposed by Weitzel & Jonsson (1989). The authors' goal is to give a more comprehensive and homogeneous definition of decline, since they recognize that various researchers have focused singularly on different components of the decline, namely the following:

- i. "A reduction in some organizational size measure (e.g., workforce, market share, assets, etc.);
- ii. A stage in the organization's life cycle;
- iii. Internal stagnation, or inefficiency;
- iv. A failure to recognize warning signals (internal or external) about changes needed to remain competitive;

- v. A failure to adapt or change to fit external environmental demands” (Weitzel & Jonsson, 1989).

Accordingly, they summarize all those factors in a definition which includes all of them¹⁴.

Even in this case, the authors have stressed the point that it is important for the management to detect the distress condition as soon as possible: further, their model includes a stage which is characterized by the inability of the managers to identify the reasons of the decline, as will be analyzed later.

Going into the details of the model, the authors theorize five stages: blinded, inaction, faulty action, crisis and dissolution.

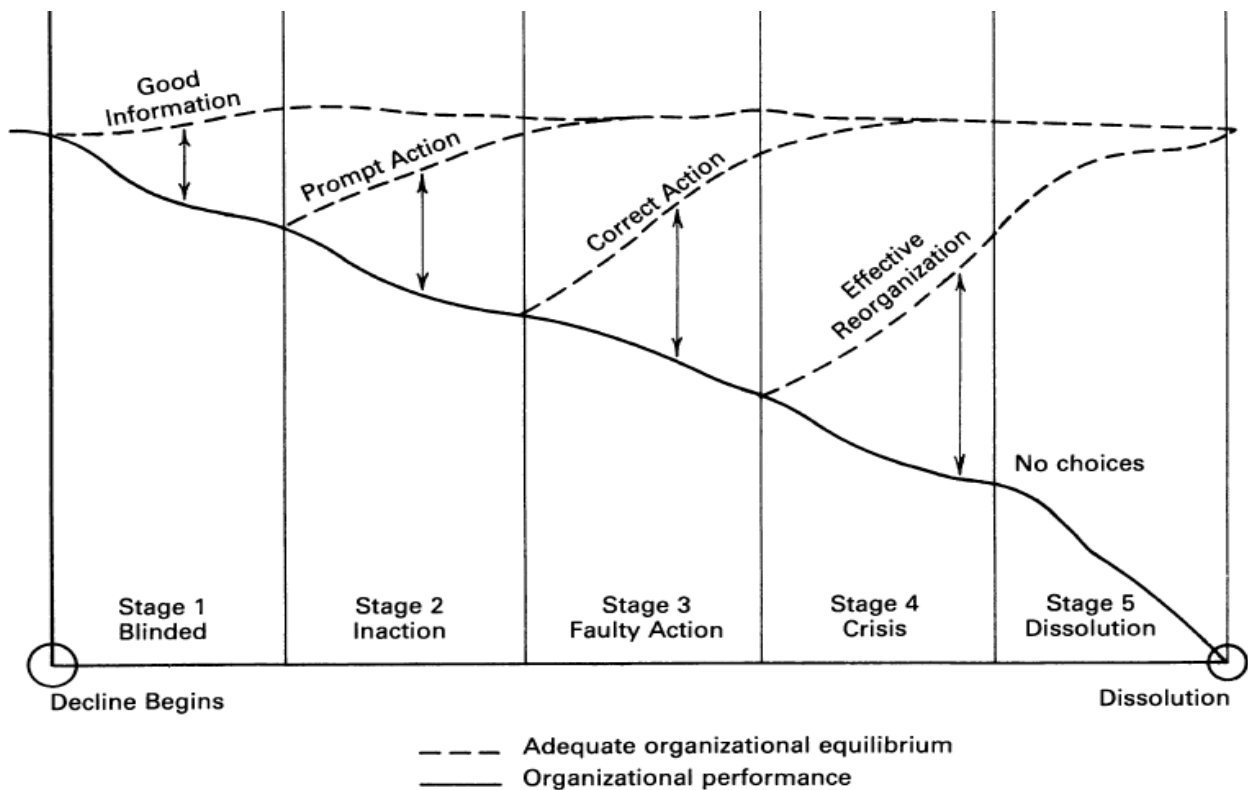


Figure 1.3: The Weitzel & Jonsson model. Source: Weitzel & Jonsson (1989)

¹⁴ “Organizations enter the state of decline when they fail to anticipate, recognize, avoid, neutralize, or adapt to external or internal pressures that threaten the organization’s long-term survival. Decline begins when an organization fails to anticipate or recognize and effectively respond to any deterioration of organizational performance that threatens long-term survival. [...] Decline can also begin if the organization fails to respond to an opportunity to improve organizational performance” (Weitzel & Jonsson, 1989).

The *blinded stage* is characterized by a lack of recognition of the distress symptoms. Those symptoms sometimes are already existent but impossible to detect (for example, the lack of clarity about the communication to the employees of the corporate philosophy and mission in a period in which the industry is growing fast and without excess of demand), while other times the problems are evident but the management (or the middle and low-level employees) do not possess the right skills, capabilities and motivations to detect them. Accordingly, by definition there is a “grey area” of blindness in every company: the dimension of this area depends largely on the organizational structure and the corporate culture. It is reasonable to assume that when the company is in a healthy state for decades, the culture tends to be far away from a proactive behavior towards distress prevention; in specific, when things are going well for many years, the business environment creates automatically an inertia status which congeals the company. For this reason, in general “in the first stage of decline, organizations have insufficient methods of internal surveillance” (Weitzel & Jonsson, 1989). Simply, the company is not used to perform activities such as employees’ monitoring and quality control. Particularly important is to control the employees’ motivation, since a worker perfectly aligned with the company mission and focused on maximizing the enterprise value is the first step toward an early detection of the deficiencies. Moreover, it is important for a business to have the right organizational structure, in order to ease the probability to identify the flaws “from the top”. Finally, the firm shall train its employees in order to give them the right skills to find the mistakes, even for low-level workers; the latter are often better able to detect any early signal.

The second phase of the model is the *inaction stage*: it is characterized by the absence of any activity by the management while the effects of the distress are evident and not hidden anymore. Obviously, the best thing to do immediately after the existence of a decline state has been discovered would be to take some remedial actions, but for some reasons the company stays in an impasse. In the meantime, the performance of the company is decreasing. If in the first stage the direct responsibilities are both of the managers and the lower-level employees (together with the external environment in case of impossible-to-detect symptoms), now the responsibilities of this misconduct are all on the managers. Sometimes it could happen that the lower-level employees have detected correctly the mistakes which may cause corporate distress, but the managers are not willing or able to take the necessary countermeasures. The reason is about the presence of some biases between the real severity of the condition and its managers’ perception. Weitzel and Jonsson (1989) find two types of biases: the first is time-related (i.e. the managers believe that the

threat is only temporary, so the best thing to do is to “wait and see”), while the second is cost saving-related (i.e. the administration is not willing to spend money for a reason it believes unjustified or value-destructive). A third reason is related to the inertia factor described above: the managers may decide not to change any operation because in the past the same set of activities have been successful. A final reason is associated to the psychological reaction of the managers as soon as they recognize that they could be responsible for the decreasing performance; the managers may be subjected to the so called “failure paranoia”, where “managers frequently refuse to admit that their organization is in trouble” (Whetten, 1980). The consequence of this behavior is usually a more centralized and narrow-based vision.

The decrease of the performance goes on, reaching a sort of “point of no return” where the managers must take some actions. That is the *faulty action stage*, characterized by bad quality management’s choices. In this phase, the managers face a reality they have never dealt with, so it includes confusion and divergences about which direction to undertake to recover from the bad performance. Thus, most of the activities carried out in this time sub-interval are ineffective in correcting the problems. The internal environment becomes more nervous, the managers increasingly feel the pressure to make the right things quickly, while at the same time they have lost part of their credibility; tensions arise not only between managers and employees (the leadership of the formers is questioned) but also between the members of the administration function. As said before, the managers are forced to take quick and efficient decisions, entering a new field since they cannot defend anymore either the old strategy driven by the past good performances or the “wait and see” strategy of waiting for an automatic return to the good times. Due to this bad internal environment, the organizational structure goes towards a centralization of the decision-making process and a decrease of the communications between the different levels of the business structure. The problem is that usually the middle and low-level employees are the ones who know better how to improve the situation, so the company enters a virtuous cycle where the likelihood to take bad decisions is higher. Often, in this phase a change of the top management occurs, in order to signal the willingness to revert the negative pattern and to leave the company in better hands.

Once a company has not been able to implement the right strategy which reverts the negative trend in performance, it enters the *crisis stage*. Most of the cases, this phase is characterized by confusion, procrastination and conflicts; as precised before, the company is not used to be in a scenario such that and the fact that the company is declining (despite the strong commitment of

the managers) leads to an environment full of irritability and frustration. However, this is the exact moment in which the company must take strong actions in order to recover the performance: hesitation is not a key word anymore. The literature calls the mentioned set of strong actions to be implemented in such situation turnaround¹⁵. “Now, revolutionary changes in structure, strategy, personnel, and ideology are necessary” (Weitzel & Jonsson, 1989), and usually it is necessary the help of external users such as creditors, banks, distress investors and consulting companies. In this stage, the principal problems are about scarcity of resources, in particular human (since there is a higher probability that some key employees abandon the firm) and financial (due the material decrease in performance).

Finally, the last stage of distress is *dissolution*. This phase is irreversible, since the company is in a too serious troubles because of the irreparable fall of market share, reputation, human capital and financial leverage. The only important thing here is to liquidate the company in the best way possible, without losing more value.

A similar model has been provided by Slatter & Lovett (1999). The authors divide the distress process into four stages:

- *Crisis denial*: a company enters in distress because it has ignored or underestimated the early signals of decline. For example, the managers may know that there are some deficits in the communication process between the different levels of the organizational structure, but they simply treat them as non-material for the business model implementation. This stage is quite similar to the Weitzel & Jonsson (1989)’s blinded stage;
- *Hidden crisis*: the managers believe that the distress is temporary or due to external causes, so that it makes no sense to deviate from the strategy that has been successful so far. This phase is close to the inaction stage found in the model above;
- *Disintegration*: now the managers have realized the severity of the distress, so they try to implement some corrective actions. However, as described in the Weitzel and Jonsson (1989) model, the likelihood of carrying out ineffective or disruptive activities is high. The above faulty action stage is very close to this one;
- *Organizational collapse*: as in Weitzel and Jonsson (1989), the final outcome of the distress time interval, if not corrected, is characterized by employees escape, insolvency and liquidation.

¹⁵ A complete definition of turnaround is presented later in this chapter.

1.2.3 Other models

The literature provides also models of crisis which are related to views very different from the economic ones. In this paragraph follows a description of a psychological model and a social-psychological model which see the distress analysis from a different perspective.

Other models focus on the psychological characteristics of the human being and seek to find the ways in which the individuals react under situations of high pressure or where unexpected events occur. A very important point of departure for those models is that “the crisis cannot be evaluated from the view of an individual who is experiencing it” (Mikušová & Horváthová, 2011), an assumption which suggests that a management turnover under distress periods is a preferable alternative. Moreover, as a basis for those models there is the assumption that a corporate crisis is an event which is emotional by definition, and that the likelihood to take wrong decisions is material.

The most important model existent in the literature is the Caplan (1961) one¹⁶. The model focuses on the reaction of a single individual when a crisis occurs; however, the model can easily find application in the business context since we are talking about corporate decisions taken by one or few individuals¹⁷. The model divides the (individual) distress period into four stages: *treat*, *consequence*, *appropriate response* and *disruption*. In the first phase (*treat*), the individual is elaborating the fact that a trigger event has occurred so that the current situation is potentially critical; thus, the user starts to feel stressed, under pressure and with a new mood where he moves from a ‘quite’ status to a one in which he may take important decisions. Then starts the *consequence* stage where the “inability to cope with anxiety would begin to appear as well as stress, tears or a feeling of being guilty” (Mikušová & Horváthová, 2011); accordingly, the individual performance is likely to be disturbed by those mental biases. Alternatively, the user may feel incapable to act, of course a state which does not solve any problem. In the third phase (*appropriate response*), the person enters in an active mood, where he decides to react concretely in order to find a solution to the problem. To solve the crisis, the individual may use old techniques – not the best solution for a corporate decline, as seen in Weitzel & Jonsson (1989) – or he may ask to external experts for help. A third way is to resign from its task. Finally, if no

¹⁶ This model is a pure psychological one. Apart from this paper, the input of this model in an economic framework is present in Mikušová & Horváthová (2011).

¹⁷ For this last purpose, probably a good starting point for further research could be to complicate the model applying it also for analyzing the way in which a group of people (i.e. the management) react when a crisis occurs.

solution has been found the person's stress increases further until it reaches a state of mental disorder, where the individual risks of losing control of itself. This is the final stage of *disruption*. Shifting to the business application of this model, it is important to analyze the corporate distress time interval also from the point of view of the psychological reaction of the managers. Indeed, a corporate distress phase could be seen as a period where the people involved into the decision-making process is disturbed by both evident and hidden biases. An analysis of the main cognitive problems the managers may have when under pressure can be decisive for developing the right strategy to either eliminate any risk of distress or to interrupt the distress period adopting the right choices.

An alternative social-psychological model is provided by Arnold¹⁸, which focuses on the individual behavior in relation with the group in which he is working. In practice, he considers that in some cases a crisis scenario is managed by a certain amount of people, so it is useful to include also groups of people in this type of analyses. In its model, the author defines four stages:

- *Shock*: as it seems usual, as soon as a trigger event linked to a crisis occurs the individual (or group of individuals) feel shocked. A shock can be manifested in different ways such as anxiety, panic, conflicts between members and confusion;
- *Denial*: the first instinctive action is to try to return to the ordinariness, to the routine. It could be view either as a crisis refusal – as already reported in the Weitzel & Jonsson (1989)'s blinded stage and the Slatter & Lovett (1999) crisis denial stage – or as a psychological defensive tactic (i.e. to gain some confidence by making all the activities one is used to make);
- *Admitting*: the individual (or group) accepts to be in a crisis scenario, and changes his attitude about the whole situation;
- *Adjusting/Adaptation*: after the crisis has been accepted, the individual (or group) tries to solve the problems.

¹⁸ For an analysis of the model, see Sherman (1992).

1.3 Financial distress

If on one side the greatest part of the authors analyzes the corporate distress as a whole, other researchers' studies deal with the 'financial distress'. Accordingly, it seems useful to give a brief explanation also of this concept.

As precised by Schmuck (2013), "financial distress is one specific distress situation" (Schmuck, 2013), so it can be viewed either as a singular stage of decline¹⁹ or as the dynamic outcome of a company distress from the financial performance perspective. In particular, the concept of financial distress is linked directly to the firm capital structure, i.e. the debt position and its incidence on the total liabilities. According to Lin et al. (2008), "Financial distress refers to a condition when a firm incurs more debt than its firm size, profitability, and asset composition can sustain" (Lin et al., 2008). From this definition, it follows directly that the levers which drive the degree of financial distress are four:

- *Debt*: a company may fall in financial distress simply because the managers have obtained too much finance from the lenders²⁰. Thus, the company becomes too much leveraged directly;
- *Size*: generally, the smaller the company, the lower the amount of debt it can sustain; in other words, if a firm size is trivial, it has to get a very strong expected increase in performance to justify huge investments financed with debt;
- *Profitability*: if a firm has a low EBITDA margin (i.e. low profitability), a given amount of debt is more difficult to sustain. Accordingly, a corporation could enter a scenario of financial distress because of a material fall in profitability (due either of a strong fall in revenues or an increase of the unitary costs);
- *Asset composition*: the way in which the management allocates the assets through the investment of the cash raised influences the riskiness of a company. Therefore, a bad investment or a bad asset composition may be a reason for financial distress.

Since the financial distress is seen as a sort of ultimate stage of distress – where the effects of the crisis start to be tangible – the final consequence is a state of insolvency, where the company is not able anymore to generate enough cash to bear the debt service. Under financial distress, the banks will try to tighten the covenants and the other credit terms, while the trade creditors will

¹⁹ For example, Schmuck (2013) positions the financial distress "at the onset of a liquidity crisis" (Schmuck, 2013).

²⁰ And the lenders have allowed the company to raise so much debt, which is more problematic.

make some attempts to reduce their days in receivables related to the financial distressed company. Thus, the situation is severe, but has not reached a point of no return; a recovery is still possible.

Outecheva (2007) provides a classification of the main definitions of financial distress existent in the literature; she separates the definitions into three categories: event-oriented, process-oriented and technical definitions.

Under the *event-oriented* definitions class, the term financial distress is used analogously to ‘decline’, ‘failure’, and ‘bankruptcy’. Those types of definitions want to precise that a company is in distress when it is unable to sustain the debt service and are related to the occurrence of an event such as bankruptcy filing, bond default or decision to write off a part of the total debt. Andrade & Kaplan (1997) find three events as indicators that a company is in financial distress: “[1] the first year that a firm has EBITDA less than interest expense, [2] attempts to restructure its debt and [3] default” (Andrade & Kaplan, 1997).

Process-oriented definitions treat the financial distress as a stage of a bigger process which includes failure and restructuring²¹. Other researchers see the financial distress as a stage between solvency and insolvency, assuming that a company could be distressed financially without being bankrupt. Other authors see the financial distress as a sequential dynamic composed by stages divided each other from trigger points such as negative cash flow, dividend reduction, technical default and bankruptcy filing²².

Finally, the *technical* definitions deal with the use of financial indicators, ratios or other measures to define the financial distress. Those definitions are at the same time the most criticized – since the use of financial ratio are seen as a backward-looking way to define the financial distress – and the most used ones. Further, for this type of definitions the heterogeneity is very high, since the authors use different measures for determining the financial distress. For example, Andrade & Kaplan (1997) use the interest coverage ratio (i.e. EBITDA / Interest), while others compare the debt service with the operative cash flow (if the latter is lower than the debt service, the company is in financial distress), look at covenant breaches, observe the EBITDA (for example, if the EBITDA is negative for at least three consecutive years, the firm is in financial distress) or analyze the trend of the company market value.

²¹ “Failure and reorganization are preceded by financial distress” (Gordon, 1971).

²² See (Turetsky & MacEwen, 2001).

Similarly to the corporate distress case, there exist some stage models which try to fragment the financial distress period into several phases, divided each other through a trigger point as in the Turetsky & MacEwen (2001) model mentioned before or through an analysis of the different characteristics that distinguish each stage.

One of the second type models has been provided by Outecheva (2007). The model is based on the fact that there are different degrees of financial crisis severity – not an innovative precondition since it is present in the corporate distress stage models as well. Accordingly, under each stage (except bankruptcy, of course) the company has the possibility to recover adopting the correct strategy. The entire financial distress period starts at the “first sign of slight deterioration in performance [and ends at] the deepest point and subsequent recovery” (Outecheva, 2007). By the way, the difficulty in identifying the first early signals of financial distress implies the use of a prediction model²³. The model divides the financial distress into three stages: early impairment, financial distress and “death struggle”.

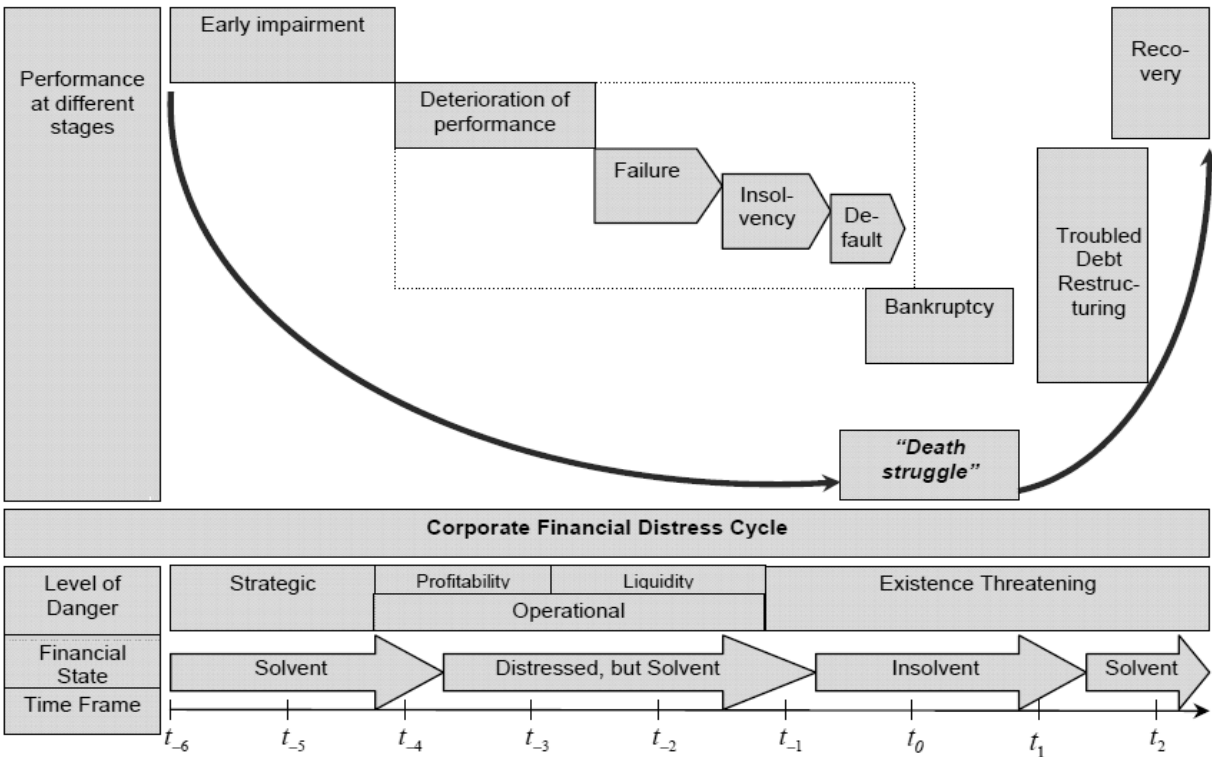


Figure 1.4: the Outecheva model. Source: Outecheva (2007)

²³ A detailed analysis of the distress prediction models is outside the purposes of this work. Generally, those models are aimed at finding some common behavior or performances analyzing a sample of companies – either bankrupt (or under reorganization plan) or health – using different statistical approaches. For a summary of the most famous models, see Pozzoli & Paolone (2017).

The *early impairment* stage provides very weak signals about the worsening of the financial performance of a firm. In particular, those warnings are not captured at all by the external third parties since they are very immaterial, but they could be detectable by a good manager. Indeed, the cash flow is still positive, and it would be necessary a thorough internal analysis to find those signals. Thus, usually in this phase no correcting actions are undertaken.

The second phase, *financial distress*, is in turn divided into four sub-stages:

- *Deterioration of performance*: the operative and financial ratios of the company decrease continuously, usually at an exponential pace. A decrease in performance could be due either to a material drop in the revenues or to an increase of the per-unit costs. Usually, for listed companies this phase is accompanied by a decrease of the stock price. Moreover, some qualitative issues arise, such as customers complaints, management anxiety and lower firm reputation;
- *Failure*²⁴: this sub-stage confirms the performance deterioration, suggesting that now the company is permanently decreasing its value. In this phase, the cash flow becomes negative, and the company passes definitively from a solvency status to a distress one. The troubles present in the previous sub-stage develop in negative: the employees abandon the firm, the shareholders do not trust the managers anymore and the liquidity situation worsen. The management is obliged to take some remedial actions, such as dividend cuts and assets restructuring;
- *Insolvency*: at this point, the value of equity is very small if not negative (it means that the value of debt is higher than it); moreover, the cash flow generated by the company is not enough to pay the debt service. The net income worsens, and the managers are forced to take some remedial action to collect enough cash to stay operative;
- *Default*: it means that the company is definitely unable to cover the debt service at maturity; it violates the agreement with the creditors and may be forced to file for bankruptcy (liquidation or reorganization) in order to avoid being sued by the creditors. Basically, the main difference between ‘default’ and ‘insolvency’ is that the default occurs at the maturity date (Outecheva, 2007).

²⁴ In this model the Altman & Hotchkiss (2006) definition of failure has been used, i.e. “[...] the realized rate of return on invested capital [...] is significantly and continually lower than prevailing rates on similar investments” (Altman & Hotchkiss, 2006).

Finally, the author finds a deeper negative point than the default one, which is called “*death struggle*”. In this phase, the only aim of the managers is to take actions that let the company survive. At this point, financial distress not only represents a very low enterprise value, but also a several weakening of the organizational structure (i.e. almost no one would like to remain as employee in the company) and a irremediable relationship with the most important stakeholder (i.e. trade creditors, lenders, shareholders, etc.).

1.4 Reasons for distress

Once an idea of what are the principal definitions of distress (both corporate and financial) have been provided, it is important to shift the attention on the reasons which may lead to this scenario. To find a common framework is almost impossible and also not useful. On one side, each research focuses on the key points related to the study itself; on the other side, the reasons for a distress are so wide that an exhaustive work is practically impossible. Moreover, the causes for distress are firm-specific, so that each company follows its original pattern that will be for sure different from every other firm crisis path. Therefore, this section provides the main classifications existent in the literature and creates some basic frameworks to give an idea about how different the reasons for distress can be.

Almost all the researchers agree to the fact that the main reason which leads a company to corporate distress is bad management. Saying it with Balgobin & Pandit (2001), “the primary or root cause of severe income declines must be poor management”; similarly, Schendel et al. (1976) suggest as a main cause of distress the “...interaction of poor managerial decisions coupled with or in response to unfavorable environmental events” (Schendel et al., 1976).

At the same time, Andrade & Kaplan (1997) analyzing highly leveraged transactions arrive at the conclusion that the main reason of distress is the leverage. Probably, they arrive at that conclusion because their main focus was on high leveraged transactions; thus, it seems too forced to conclude that they don’t agree with the general view that poor managerial decisions leads to distress primarily²⁵.

²⁵ Moreover, the Andrade & Kaplan (1997) findings seem difficult to generalize, since for example Denis & Denis (1995) find that the main cause for financial distress under high leveraged recapitalizations is related to industry-wide issues.

1.4.1 Internal vs External reasons

The most used classification of the reasons for corporate and financial distress involves two classes: external reasons and internal ones²⁶. Indeed, “downturns in performance were a result of unfavorable environmental shifts combined with organizational inefficiency or inappropriate competitive strategies” (Francis & Desai, 2005).

Internal causes are not only a matter of ability to be efficient internally, but also deal with a population ecology perspective, where the survival of the corporations depends on their capacity to align their resources with the external environment. If not, those company will exit the market. For this purpose, an inertial behavior by the management may be one first factor which may lead a company to distress²⁷. More generally, bad management²⁸ – either related to an incapacity of adaptation to the external environment or a failure to produce a product (or provide a service) in an effective and efficient way – is the primary source of distress. For example, some of the principal errors that a CEO may make – so that he increases the risk of distress – are related to: (i) a too autocratic behavior, (ii) the absence of clarity on the segregation of duties between the CEO and the chairman, (iii) the presence of unskilled managers and (iv) greed or egoistic behaviors. If it appears easy to think about examples of bad management, it may be useful to describe some extreme cases which are not immediate to think about. Interesting is the point of view of Miller (1992) which has found four behaviors that paradoxically (he called them “Icarus Paradox”) may lead to distress, since they are related to something that the company is very good at doing:

- *Focusing*: the company has a success product and concentrates all the attention in getting that product perfect. However, this perfection is not fully perceived by the customers, that may be satisfied even with a less perfect product. Thus, a company may enter a distress period because of a bad capital allocation;

²⁶ Some researchers, such as Chowdhury (2002), use the term “*K-extinction*” to indicate the external reasons and “*R-extinction*” when defining the fact that “decline is a property of the organization” (Chowdhury, 2002).

²⁷ For this purpose, a good example has been provided by Maheswari (2000), with the case of Indian Telephone Industries Ltd. “Indian Telephone Industries Ltd. (ITI) remained prosperous in the protected environment as the Department of Telecommunication (DoT) ensured the purchase of its products. The organization developed inertia due to this protected environment and failed to develop in-house technological capability. In the post-liberalization scenario, the arrival of foreign giants like AT&T and Ericsson into the country brought new products. [...]. ITI found it hard to respond to these changes in the environment and started declining” (Maheswari, 2000).

²⁸ Bad management is not related to any type of lack of action or inertia only, but also to the undertaking of too much initiatives. For example, a frequent change and revision of the medium-term business plan could be a source of distress because of the increase of the confusion inside the company.

- *Venturing*: the managers tend to continuously look for new profitable opportunities without having the necessary capabilities to enter new industries. Accordingly, those firms may become distressed because of bad investments and failures to compete successfully with the new competitors;
- *Inventing*: those organizations operate in innovation-related industries, and risk to fall in distress since a bad management of the intrinsic complexities may lead to organizational chaos and wrong missions. For example, those companies could decide – erroneously – to invest in a too futuristic technology, without performing a market analysis to see whether the investment is justifiable also in the short-middle term;
- *Decoupling*: in this case, a business focuses too much on its marketing department. The consequence is that the company concentrates the efforts only in finding new ways of selling the old products without looking at the efficiency issue. This behavior may lead to distress.

Another important internal cause of distress is related to bad acquisitions. This is one of the most frequent reasons why a company enters into distress²⁹. One of the most critical phases of a company which wants to grow externally, indeed, is the valuation and the form of payment of a subsidiary; sometimes, deciding to pay the whole transaction by cash could lead to a very negative cash position, as well as raising too much debt for financing a transaction. Thus, it is very important for a company – in particular a Small Medium Enterprise (SME) – to be assisted by the right people when deciding to purchase another firm.

Balgobin, Pandit (2001)	Gopal (1991)	Schmitt (2009)	Grinyer (1990)
<ul style="list-style-type: none"> - Poor management - Inadequate financial control/policy - High cost structure 	<ul style="list-style-type: none"> - Poor quality of top management - A weak board - Conservatism in management - Excessive complacency - Premature corporate expansions - Weak financial management policies - Unacceptable market prices and costs 	<ul style="list-style-type: none"> - Poor management - Mismanagement of big projects - Bad acquisitions - Cost disadvantages - Poor financial control - Inadequate marketing - A weak financial policy - Autocratic leadership - An excessive success culture 	<ul style="list-style-type: none"> - Poor management - Lack of marketing efforts - Inadequate financial control - High cost structure - Poor quality - Bad acquisitions - Big projects that fail

Table 1.1: Selection of the main internal reasons for distress present in the literature. Own elaboration.

²⁹ For example, recently one of the most important Italian case has been the Favini Group srl one, that at the end of the last decade went into distress (among other factors) because of having overpaid some M&A transactions.

External reasons are related to the external environment; some of them are controllable by a good manager able to adapt the company to the dynamic external environment (this means that the line which separates internal reasons and external ones sometimes is very blurred), while others are difficult to eliminate even if predicted, such as a global economic crisis, or a controversial decision of a policymaker. The external causes are usually segmented into five sub-sections: market, industry, customers, legal and nature.

The external reasons are related to the *market* when they deal with events such as market price volatility, changes in the offer for raw material and macroeconomic changes. For a financial institution, for example, an increase of the speculative activity may lead to a revaluation (in negative) of all the assets measured at fair value; similarly, a financial crisis usually leads to a several distress scenario the banks and as a consequence also all the local companies. For those manufacturing companies with a high need of commodities as raw material (for example oil), a change of the suppliers' decision, such as a restriction of the quantity produced, may affect the company in a very negative way; in that case, the firm may fix the purchasing price using future or forward contracts, but that solution is not always feasible or available. Macroeconomic changes, such as an interest rate cut or rise, may be positive for some companies but negative for others, since it affects the financial performance of both manufacturing companies and financial institutions.

An *industry* is a dynamic group of companies, which might compete each other in order to get more market share or might collude to become bigger and be able to fix higher prices. However, the behavior of one or more companies inside an industry can damage the performance of the other ones. For example, if the two most important companies collude each other in order to monopolize the market, the other firms will enter a several distress scenario if they are not able to find a profitable niche. Alternatively, a company can use a too conservative strategy by avoiding huge investments in R&D but doing so it risks suffering from the technological developments of its competitors. In this sense, it is important also to know the field in which a company is playing: if a sector is characterized by a very short product life cycle, it is likely that the technological environment changes rapidly, and the company shall invest in R&D in order to avoid remaining left behind. Finally, the herding effect is also important, in particular in the financial sector; a company crisis may decrease the reputation also of the distressed company's competitors.

As for *customers variations*, if not detected through a thorough market analysis, a company risks losing customers, falling into distress. Thus, it is important to analyze precisely the customers'

needs and their future developments both in terms of general trend and in terms of changes in behaviors, needs, tastes and psychographic characteristics. For example, if a demand for a certain product is in decline, to avoid distress a company shall reinvent itself by looking for a new market niche where its resources and capabilities may be valuable at least as before. A different type of strategic change is necessary if a material variation in the consumers' tastes occurs; indeed, the company shall reinvent its product in order to follow the demand properly.

The *legal* factor is usually industry-specific, since some industries are more regulated than others. For example, in the US the Airline Deregulation Act of 1978 facilitated the entry of new airline companies: the corporations that were operating before the reform have been damaged from the new legislation for sure, and the ones which have not been able to take the necessary countermeasures have increased their risk to become distressed. A similar reasoning could be made for the broadcasting industry, as well as the petroleum one. By contrast, other industries are freer to act; for those companies the legal factor is less important.

Finally, a factor which must be taken into consideration is *nature*. Generally, it includes natural catastrophes and other unpredictable events such as tough weather conditions and accidents. In this case, the only thing a company can do is to sign an insurance contract.

Balgobin, Pandit (2001)	Gopal (1991)	Schmitt (2009)	Grinyer (1990)
<ul style="list-style-type: none"> - Decrease in demand - Increase in competition - Increase of input costs 	<ul style="list-style-type: none"> - Postponement or cancellation of major projects - Decrease in market demand - Changes in government rules and regulations - Increased competition - Increased input costs - Non-availability or shortage of raw materials - Inadequate insurance cover 	<ul style="list-style-type: none"> - Economic changes - Catastrophes - Competitive changes - Social changes - Technological changes - Governmental constraints responsible for organizational decline 	<ul style="list-style-type: none"> - Adverse changes in total market demand - Failing revenues due to more intense competition

Table 1.2: Selection of the main external reasons for distress present in the literature. Own elaboration.

It is discussed whether the internal reasons or the external ones are more decisive for causing a corporate or financial distress. The debate is still open, but difficult to solve because of three main aspects. Firstly, since all the authors agree on the fact that the primary cause for distress is

poor managerial performance, the works may be prejudiced in favor of this solution. This may be true, in particular if we think that a material number of studies are based on surveys which are biased by definition³⁰. Secondly, as the years pass the older studies are becoming less reliable, since the economic conditions change. Think about all the regulatory change that occurred in the last decades, or about the financial engineering that started some decades ago. For example, Outecheva (2007) suggests that “the evolutionary development of corporate enterprises as well as a change to more service-oriented economies and an increasing role of governmental regulation provoke a shift from endogenous to exogenous causes of corporate failure” (Outecheva, 2007). Thirdly, every distressed company is such because of a mix of internal and external reasons. Moreover, sometimes it is not possible to divide a cause as internal or external, since some reasons are themselves a mix of the two.

1.4.2 Operational vs Strategic and other reasons provided by the literature

Another classification that has been used frequently in the literature relates to the distinction between operational and strategic reasons. This taxonomy usually is parallel with the internal vs external classification³¹, but it may offer a different view in analyzing the sources of distress.

Basically, the *operational* reasons are related to a negative managerial performance, so very close to the internal causes present in the last paragraph. In reality, there is not a real definition of operative causes. The difference may be that operational reasons are more connected with efficiency problems, so not related with the external environment at all. By contrast, the internal causes include, for example, the inability of the management to adapt to receipt correctly the external signals. Thus, an example of operative reason – which in turn is also internal – may be the inability of the management to hire a medium-level director able to optimize the operations.

On the other side, following Furrer et al. (2007), the *strategic* reasons may be compared to the external causes. However, a strategic cause of distress may be an inability of the managers to reposition the company as soon as the demand changes – a reason closer to the internal reason in the previous classification.

³⁰ In reality, in those surveys there is a tendency by the sample company managers to blame the external environment rather than analyzing critically their themselves behavior, as evident in Grinyer (1990). Therefore, the factor “poor managerial performance” may be underestimated.

³¹ As precised by Furrer et al. (2007).

A material insight provided by this new classification is its relationship with time. Operative reasons may deal with the short-term, such as the lack of production process optimization; on the other side, strategic reasons could be more medium or long-term related, such as the incapacity to increase the marketing effort to rebrand the company when necessary.

Other authors do not provide a classification, but simply list some reasons of distress.

Lorange & Nelson (1987), for example, provide some qualitative and managerial oriented reasons for distress, based on bad management conducts. They find the following reasons: (i) decline, entrapment and self-deception (i.e. the belief that the most important thing to do is to base the strategy on the outdated view of the business which has worked in the past); (ii) hierarchy orientation; (iii) cultural rigidity; (iv) desire for acceptance, conformity (i.e. no suggestions from the bottom will be heard because of the management aversion to change or criticism); (v) too much consensus and compromise (i.e. when the organizational structure becomes too complex, the company may lose too much time in planning the activities).

Other authors provide different classifications: the following table provides the lists of Schendel et al. (1976) and Pearson & Clair (1998).

Schendel et al. (1976)	Pearson & Clair (1998)³²	
<ul style="list-style-type: none"> - Higher costs: - Wages and other costs - Extraordinary costs - Inefficient production - Unanticipated start-up costs - Anti-trust defense - Demand decline - Lower revenues - Lower prices - Excess industry capacity - Product obsolescence - Strikes - Increased competitive pressure - Management problems - Marketing problems 	<ul style="list-style-type: none"> - Extortion - Hostile takeover - Product tampering - Vehicular fatality - Copyright infringement - Environmental spill - Computer tampering - Security breach - Executive kidnapping - Work-related homicide - Natural disasters - Malicious rumor 	<ul style="list-style-type: none"> - Bribery - Information sabotage - Workplace bombing - Terrorist attack - Plant explosion - Sexual harassment - Escape of hazardous material - Personnel assault - Product recall - Counterfeiting - Product/service boycott

Table 1.3: Selection of other distress reasons present in the literature. Own elaboration.

³² As it is possible to observe, they focus more on external events than variables such as poor managerial performance, indicating that a company management shall be ware also on this type of (sometimes illegal) third parties' behavior.

1.4.3 A SWOT – financial statement approach

In order to have a clear framework to use when analyzing the company troubles, the most comfortable way is to connect as much as possible the reasons for distress with the most used models and with the financial statements – i.e. the frameworks that a normal manager uses very often. For this purpose, this paragraph tries to connect the well-known SWOT analysis with the causes for distress. Subsequently, the reasons are connected with the financial statements, in order to see whether the reasons are a balance sheet problem or an income statement problem³³.

As all the business experts know, a SWOT analysis involves the classification of the main characteristics of a company into four classes: Strengths (i.e. which are the factors that explain the firm competitive advantage), Weaknesses (i.e. the aspects where the company is less effective or inefficient than the competitors), Opportunities (i.e. the external factors that the company may use to take advantage to increase its performance and market share) and Threats (i.e. the external factors which may erode the firm competitive advantage). The aim of the model is to serve as a basis when deciding which strategy to implement.

The aim here is to build the “negative” of a classic SWOT, where all the problems that potentially can lead a company into distress are linked with the company Strengths, Weaknesses, Opportunities and Threats. Obviously, the most used sections will be the Weaknesses and Threats ones (which roughly can be considered similar to the internal and external reasons for distress, respectively), but as seen before there exist some paradoxes where a company may enter into distress because of an overconfidence on the abilities. Table 1.4 presents the “negative” SWOT, the negative aspects are presented between brackets.

³³ As already precised, it is impossible to create an exhaustive model which includes all the possible reasons for distress. However, this approach may be useful as a framework from which one can start its firm-specific analysis.

Strengths	Weaknesses³⁴
<ul style="list-style-type: none"> - Good past performance (<i>inertia</i>) - Good past acquisitions (<i>confidence</i>) - Successive culture (<i>inertia</i>) - Focusing, Venturing, Inventing and Decoupling (<i>too high specialization</i>) 	<ul style="list-style-type: none"> - Poor management performance - Inadequate financial control - High cost structure - Bad acquisitions - Autocratic leadership
Opportunities	Threats
<ul style="list-style-type: none"> - Changes in government rules (<i>worse reaction than the competitors</i>) - Economic changes (<i>worse reaction than the competitors</i>) - Social changes (<i>worse reaction than the competitors</i>) 	<ul style="list-style-type: none"> - Decrease in demand (<i>no adaptation</i>) - Increase in competition (<i>no retaliation</i>) - Increase of input costs or shortage of input (<i>no hedging policy</i>) - Change in government rules (<i>no adaptation</i>) - Economic changes (<i>no adaptation</i>) - Catastrophes (<i>no insurance</i>) - Social changes (<i>no adaptation</i>)

Table 1.4: The “negative” SWOT. Own elaboration.

The table must be seen in the following way: every element in the list represents a reason which potentially can lead to distress, while the words in italic represent the behavior which can lead to distress. For example, ‘good past performance’ is a positive aspect in the normal SWOT, but if the managers react to this Strength adopting an inertial behavior (i.e. by continuing with the same strategy simply because it has been successful in the past), the company may enter a distress situation. Similarly, since a ‘decrease in demand’ is a Threat in a classic SWOT, the “best solution” to enter a distress scenario is to avoid any adaptation to the changing environment.

Once an easier framework has been created, the reasons listed in the modified SWOT can be analyzed singularly and linked to the main financial statement line items, in order to make a more precise analysis aimed at defining concretely the real sources of potential distress. Some of them are out-of-financial statements items (such as the inertia behavior of the management), while others have an impact on the financial statements. Doing in this way, it is possible to see whether a company has a *balance sheet problem*, an *income statement problem* or a *managerial problem*. One example is about a well performing company which is growing externally (i.e. through M&As). The primary risks in this case are two: the management inertial behavior and the too

³⁴ The Weaknesses are reasons for distress by definition, so the only negative reaction related to them is to not correct them. In order to not complicate the table, the reactions have not been written there.

high confidence when performing acquisitions. The first risk is a managerial problem, so it doesn't have any direct impact on the financial statements; the second risk is a balance sheet problem, since the monetary risk is to pay too much for a subsidiary, deteriorating the capital structure.

A second example regards a company with cost inefficiencies operating in a highly regulated industry. Even in this case, the main risks are two: to continue with the bad cost management and to avoid any adaptation to the change in regulations. The first risk is an income statement problem, since the EBITDA would be better with an improved cost management; the second risk may be either balance sheet related or income statement related.

1.5 Turnaround

1.5.1 Turnaround definitions

Once having defined in detail the concept of distress, it is useful to analyze what should a manager do after the distress has been detected. As described in the previous sections of this chapter, in all the stage models presented the distress period starts with the appearance of the first signals of distress (hidden or not) and ends with dissolution, collapse or bankruptcy. However, before entering the last stage, the managers have the possibility to implement some strategies aimed at rescuing the company. The set of activities selected by the managers in order to recover from a distress situation is usually called *turnaround*³⁵.

Before describing the main definitions and characteristics of a turnaround process, two clarifications are necessary. First, it is important that, before implementing a turnaround strategy, the managers analyze whether it makes sense its execution; it could be that the liquidation value of a firm is higher than the company going-concern one, so that it would be better to file for bankruptcy. Secondly, if the managers decide to implement a turnaround strategy, they must consider that the time to apply is usually very short; as precised by Hofer (1980), "In most turnaround strategies, regardless of the performance area affected, the time criticality of the firm situation is quite severe. There is some imminent danger to survival" (Hofer, 1980).

³⁵ Inside the distress literature, after the distress prediction segment the turnaround segment is the biggest one.

Similarly to the distress case, the literature offers different definitions of turnaround³⁶. In general, the turnaround concept is seen as the reversal of the distress one; a turnaround is considered successful if the business performance returns to or becomes higher than the pre-distress level. A basic definition is present in Pandit (2000), who describes turnaround as the “recovery of a firm’s economic performance following an existence-threatening decline” (Pandit, 2000). Similarly, Chowdhury (2002) describes the “process of turnaround [as] how firms move away from crippling deterioration in performance to enduring success or eventual death”, adding to the former definition the idea that a turnaround strategy may fail; a successful turnaround occurs when a company “ends the threat with a combination of strategies, systems, skills, and capabilities [,] and achieves sustainable performance recovery” (Chowdhury, 2002).

A turnaround strategy usually involves four types of restructuring strategies, depending on the type of distress reason (i.e. balance sheet problem, income statement problem or managerial problem): operational, asset, managerial and financial. To provide critical examples of turnaround strategies is outside the purpose of this work; however, there is a flourishing literature which analyzes case studies (the so called “anecdotal studies) in order to provide practical ways of implementing a turnaround strategy³⁷. A general truth is that “a precondition for almost all the successful turnarounds is the replacement of the current top management of the business in question” (Hofer, 1980). Indeed, the ability of implementing a strategy for growing a company is materially different from a restructuring strategy; thus, it would be necessary to hire a new person, more expert in corporate restructuring, who substitutes (totally or partially) the old managers.

However, the most accepted classification present in the literature is about operating turnarounds and strategic turnarounds³⁸. As summarized by Hoffman (1989), “Operating turnarounds focus on improving the way the firm currently conducts business. Strategic turnarounds focus on changing or adjusting the type of business conducted by the firm” (Hoffman, 1989). In other words, operating turnaround strategies deal with the implementation of activities aimed at increasing revenues, decreasing the unitary cost or refining the asset composition; the focus is on maximizing the resources that the company already has, i.e. to increase the performance.

³⁶ Some authors use the term turnaround to describe a process composed by two stages: a downturn one (coincident with the distress phase) and an upturn one. For the sake of simplicity, this particular has been avoided in this work.

³⁷ See Pandit (2000).

³⁸ See Hofer (1980) and Chowdhury (2002).

Differently, strategic turnaround strategies consist in changing the firm positioning in the market they are already operative or entering a new market niche; the main aim here is to increase the market share by working in the product/market matrix. The greatest part of the literature agrees that on average both strategies are important to turnaround successfully a company.

Other researchers limit their work in listing the turnaround strategies they retain are most used. Probably the first author who has classified the turnaround strategies has been Hofer (1980). If on one side he has classified the turnaround strategies into operative or strategic, on the other side the author has listed four types of turnaround strategies: revenue-increasing (for example, the selection of the product lines to maintain and the ones to dismiss), cost-cutting, asset reduction (i.e. the disposal of the less useful assets) and a combination of them. According to him, the decision about which strategy to choose depends on how far the company is from its break-even point: an asset reduction strategy is the most effective if a firm is very far from the break-even, while if the company is very close to the break-even, a cost cutting strategy is preferable.

Alternatively, Hoffman (1989) differentiates the possible strategies into three main stages: preparatory stage, short-term fix stage and growth stage. The *preparatory stage* includes the strategy of “restructuring leadership and organisation/culture”: in this phase a change in leadership occurs in order to either motivate the employees and the external stakeholders to not abandon the company or simply to leave the company in better hands. The *short-term fix stage* comprises the strategies of cost reduction (both variable and fixed), asset redeployment (i.e. the disposal of plants and equipment in order to increase the productivity) and selective product/market strategy (for example, marketing policies adopted in order to increase revenues). Finally, the *growth stage* includes repositioning strategies (i.e. to choose the market segment in which to operate, also through acquisitions or strategic alliances).

Another useful classification has been provided by Balgobin & Pandit (2001), who list four events which characterize successful turnaround plans: situation analysis, gaining control, managing stakeholders and improving motivation. *Situation analysis* means that who performs the turnaround strategy (usually the new management) has to collect information about the current situation, in particular the distress reasons. *Gaining control* is divided into financial (i.e. to obtain the control of the financial situation by improving the capital structure equilibrium) and managerial (i.e. to be able to influence the employees’ attitude). *Managing stakeholders* means that the new managers must start and maintain good relationships in particular with banks, trade

creditors, employees and customers. Finally, *improving motivation* is related to the fact that the leadership must be such that incentivizes the entire internal environment.

1.5.2 Turnaround as a stage process

As in the distress case, also the turnaround can be divided into several stages, in order to determine in a more detailed way which is the best strategy for every case. As a precondition, it is important to recall that the “turnaround golden rule” is that the higher the time available, the wider the range of strategies from which a manager can select the best one.

As described in one of the last paragraphs, Müller (1985) has provided a model which divides the distress period into four phases (i.e. strategic crisis, performance crisis, liquidity crisis and bankruptcy). Furthermore, he has linked each stage with another one that includes the main ways to manage the crisis. In particular, each solution shall be connected with the characteristics of the distress: for example, a strategic crisis shall be solved adopting a turnaround strategy aimed at solving a strategic crisis. Thus, the model presents four stages of turnaround, that are specular to the distress stages: *strategic crisis management* (i.e. to operate on the product/market matrix in order to eliminate the business segments with low potential), *operating crisis management* (i.e. to increase efficiency), *financial crisis management* (i.e. activities such as securing new credit lines and improving the working capital) and *crisis management during insolvency* (for example, to create a restructuring plan).

Finally, the most accepted turnaround stage classification consists in dividing the turnaround into retrenchment and return to growth, (Balgobin Pandit, 2001).

The *retrenchment* (or stabilization) phase is characterized by a focus on the firm survival; therefore, the activities performed under this stage are aimed at generating cash flow. To do this, usually the firm has to sell some assets and reduce costs. “The basic idea is to take one step backwards so that two steps forward may be taken in the future” (Balgobin & Pandit, 2001). The final outcome of a successful retrenchment stage is to stabilize the cash flow and to prepare the field for the subsequent stage.

The second stage is *return to growth*. During this stage, the objective is to recover the pre-distress performance and to implement strategies that will increase the long-term profitability of the

company. Those strategies are usually revenues-related and may also include mergers and acquisitions.

This model is not a rule. Sometimes, a retrenchment strategy may affect positively the enterprise value, in a certain sense including the return to growth stage; alternatively, in order to stabilize the cash flow, it is necessary to take some aggressive measures that in the model are included into the return to growth stage, incorporating the retrenchment phase into the other one. Furthermore, other times it is not possible to take a single strategy alone but is essential to adopt both the stages-strategies at the same time. For example, during the 1999-2002 Nissan turnaround it has been important to implement both the stages-strategies at the same time: “Turning around a company in Nissan’s state is a bit like Formula One racing. To take the highest-speed trajectory, you have to brake and accelerate, brake and accelerate all the time. [...] We couldn’t say, ‘There will be a time for cost reduction and then a time for growth’ – we had to do both at once.” (Ghosn, 2002).

Chapter 2: the Italian bankruptcy law

After having analyzed in detail the concept of distress – and the moment in which a company can be defined as distressed, at different levels –, it is important to describe the tools which are available when dealing with a company in troubles. In every country, some of those tools are regulated by the bankruptcy law, while others are completely private, as for example a consultancy service provided by a specialized firm³⁹.

The first main classification – which is valid for all the countries' bankruptcy law systems – is related to the severity of the corporate distress: some tools are more appropriate for a seriously damaged company, while other ones are suitable for recovering a distressed company at its early stage of distress (i.e. when the crisis is still manageable). Accordingly, a first separation is between *liquidation tools* and *recovering tools*, where the former is appropriate for a bankrupt firm (where the principal aim is to preserve the remaining enterprise value and to liquidate the assets in favor of the creditors) while the latter are useful for turning around an early-distress-stage company.

Another classification could be made considering the *reasons for distress*. As seen in the previous chapter, the reasons for distress are so various that it is possible to conclude that each firm has made its own specific set of mistakes before entering a distress scenario. Therefore, under this approach a clear classification of the tools mentioned before is difficult to create. However, in some cases it may be useful to consider the type of distress, when selecting the right way to recover from a crisis: for example, recently the Italian bankruptcy law has provided the two institutions of *accordi di ristrutturazione con intermediari finanziari* and *convenzione di moratoria*, which could be used when a distressed company has a predominant indebtedness towards the financial institutions⁴⁰, suggesting an unbalance of capital structure as main reason for distress. By contrast, if the principal causes for distress are far from a too high dependence on the financial institutions, those two instruments are not applicable at all; thus, depending on the severity of the crisis, other tools are available to deal with the negative situation created.

³⁹ Currently, there are different types of tools provided by the countries. However, a comparative analysis of the different countries' approaches about the balance between regulated agreements and private ones is out of the scope of this paper.

⁴⁰ In particular, the *art. 182 septies* of the Italian bankruptcy law (Royal Decree of 16 March 1942, no.267) states that those two institutions are applicable when at least one half of the total debt has been made with the financial institutions.

For the purposes of this paper, only the Italian bankruptcy law will be considered. Accordingly, the following sections of this chapter will present the Italian legal framework and will include an analysis of all the available tools which can be used to conclude a distress scenario – either in a positive way through a turnaround strategy or negatively using liquidation tools.

2.1 The Italian bankruptcy law framework

The main legal source about the Italian bankruptcy law is the *Royal Decree of 16 March 1942, no.267* (hereinafter *Legge Fallimentare – l.f.*). This law has been modified several times, especially from the 2005; an improvement of the original law has been considered necessary because of the obsolescence of the latter as the years were passing. In particular, the “vision” of the legislator at that time was too punitive, in the sense that the main purpose was to detect the bankrupt companies and to liquidate them, and at the same time to label the entrepreneur (or the management body) as “failed”⁴¹. Recently, on the contrary, a new way of thinking has been established, where the bankruptcy is not seen as an extraordinary event but as an ordinary phase of the company life cycle. In other words: to fail is possible, and not necessarily it must be a shameful event and not necessarily the fault is on the entrepreneur (or the corporate management)⁴². Moreover, under this new approach the focus has been shifted towards procedures aimed at supporting the continuation of the company operations rather than liquidating them. To do that, the legislator should take measures directed to let the economic agents prefer private out-of-court agreements rather than in-court liquidation procedures, and to limit the application of the liquidation tools only when necessary. In short, the objective of this new attitude is to increase both the probability of continuing the operations of the distressed company and the likelihood that the creditors will receive the full amount of their claims.

A first initiative towards this new approach has been taken with the Prodi law of 3 April 1979, no.95⁴³, that introduced the legal tool of the extraordinary liquidation for big companies (*amministrazione straordinaria delle grandi imprese in crisi*), a special procedure created to deal

⁴¹ Under the first version of the Royal Decree, the bankrupt individuals could not maintain the right to vote for five years after the negative event. Moreover, their name was published in the “Public Register of Bankrupts”, labeling them as a negative individual forever.

⁴² Of course, the problem of this approach is the risk of giving second opportunities to who does not deserve it, but apparently the importance of giving a further chance to who, notwithstanding the crisis, is behaving well is higher.

⁴³ Reformed and substituted by the Legislative Decree of 8 July 1999, no.270.

with big corporations of national or systemic importance. This legal tool is characterized by a completely new purpose, i.e. the continuation of the distressed company operations⁴⁴. Indeed, the law has been created in a period where a material number of Italian big corporations were in a very critical scenario; using the old legislation, the only result would have been a long chain of liquidations which could have negatively affected the Italian economic environment.

More important changes occurred in the first decade of the new century, firstly with the Law Decree of 14 March 2005, no.35⁴⁵, known as Competitive Decree (*Decreto Competitività*). This law on one side provided some changes for the composition with creditors (*concordato preventivo*) and the clawback action (*revocatoria fallimentare*), while on the other side introduced the procedure of the agreements for debt restructuring (*accordi di ristrutturazione dei debiti*). The last aspect is very important, since this law has opened the field towards a more complete reform in favor of private out-of-court agreements. Furthermore, the Law of 14 May 2005, no.80 – the result of the conversion of the Law Decree mentioned before – included a mandate to the Government to reform organically the in-court procedures discipline. The result was the Legislative Decree of 9 January 2006, no.5, which rewrote part of the Legge Fallimentare following the directives of the precedent Law Decree. In the same period, the Law Decree of 30 December 2005, no.373 modified slightly the regulation of the composition with creditors by adding the insolvency state, together with the crisis state, as a prerequisite for the admission to the procedure.

At this point, even though the legislator has tried to change some rules in order to convince the economic agents to prefer the private tools, the latter continued to use them very rarely. The main problem was that the private procedures have not been regulated completely, so that the uncertainty about their use were still high. The Corrective Decree of 15 June 2007, no.169 tried to include new measures in favor of the private procedures – for example establishing that the restructuring agreement can be done even in case of corporate crisis and increasing the protection on the assets of the entrepreneur who files for a restructuring agreement⁴⁶ –, but the reluctance of the economic agents continued. In order to further increase the incentives, with the Law Decree of 31 May 2010, no.78, the legislator extended the protection of the entrepreneur's assets even

⁴⁴ By the way, the name of the procedure – extraordinary liquidation for big companies – shall not create confusion, since the aim is not to liquidate the company. That was a very innovative approach at that time.

⁴⁵ Converted in Law of 14 May 2005, no.80.

⁴⁶ In particular, the creditors' direct actions towards the entrepreneur's assets are suspended for the 60 days that follow the start of the private agreement procedure.

during the negotiations with the creditors; moreover, the Law Decree of 22 June 2012, no.83⁴⁷ was aimed at facilitating the access on the private procedures and disciplining the assessment of feasibility performed by the expert, under some prerequisites precised by the law.

At this point, the situation of the Italian bankruptcy law is characterized by a lot of confusion and a certain degree of obsolescence. On one side, there is the need of new rules that incentivize the economic agents to select private out-of-court agreements rather than liquidating the company without considering softer alternatives; on the other side, the high number of updates of the Legge Fallimentare text has led the operators to a scenario of confusion and difficulty on selecting the right legal tool when dealing with distressed firms. In particular, currently inside the same Legge Fallimentare text there is a combination of old-written articles and reformed ones, and for this fact sometimes there is a lack of clarity due to the different purposes of two articles. Moreover, as member state of the European Union, when legislating the Italian policymaker has to comply (or at least align) with the EU guidelines; in particular, the Recommendation no. 2014/135/EU specifies the principle of helping the companies in troubles – but still healthy – to restructure themselves at an early stage, avoiding an insolvency procedure that could happen some years later.

All those necessities have pushed the Italian legislator to think about making a complete reform of the Legge Fallimentare, in order to:

- increase the incentives for the economic agents (entrepreneurs, creditors and other parties) to select private out-of-court agreements when dealing with a distressed scenario: this will imply the definition of a condition which occurs before the insolvency, as will be better described later in this chapter;
- create a new and more homogeneous Legge Fallimentare text, where all the articles are written under the same “vision”, avoiding as much as possible the uncertainties when adopting and interpreting the law;
- adopt the most recent guidelines provided by the European Union, in particular the Recommendation no. 2014/135/EU mentioned before.

For all those purposes, following the work performed by the Rordorf Commission, in the 2017 the Italian Parliament approved the Law of 19 October 2017, no.155 which empowers the

⁴⁷ Converted in Law of 7 August 2012, no.134.

Government to reform the Italian bankruptcy law, following the directives that will be discussed later in this chapter.

Finally, it is important to specify that some rules about the bankruptcy issue are present also in the Italian Civil Code and other codes (for example, *legge cambiaria*, *legge sull'assegno bancario* and *codice della navigazione*).

Apart from its dynamics, currently the Italian bankruptcy law includes different procedures, which can be roughly divided into two ways, as presented in Table 2.1:

- in-court procedures and out-of-court ones;
- liquidation tools or going concern ones.

		Liquidation	Liquidation or going concern	Going concern
In court	Bankruptcy (<i>fallimento</i>)	X		
	Administrative compulsory winding up (<i>liquidazione coatta amministrativa</i>)		X	
	Extraordinary liquidation for big companies (<i>amministrazione straordinaria delle grandi imprese in crisi</i>)		X	
	Extraordinary special liquidation (<i>amministrazione straordinaria speciale</i>)		X	
	Composition with creditors (<i>concordato preventivo</i>)		X	
Out of court	Settlement of over-indebtedness crisis (<i>composizione delle crisi da sovraindebitamento</i>)		X	
	Agreements for debt restructuring (<i>accordi di ristrutturazione dei debiti</i>)			X
	Certificate plan (<i>piano attestato di risanamento</i>)			X

Table 2.1: Legal tools provided by the Italian bankruptcy law.

2.2 In-court procedures

As it is possible to see in Table 2.1, the greatest part of the procedures regulated by the Legge Fallimentare establishes the presence of the court, at different extents depending on the type of procedure. This section will describe the most important aspects of every in-court procedure.

2.2.1 Bankruptcy (*fallimento*)

The bankruptcy is the most regulated institution in the Legge Fallimentare, and not surprisingly is also the legal option the most used by the economic users. The aim of the bankruptcy is to liquidate the company assets in order to satisfy in the best way possible the creditors which claims have not been settled yet or have a property right on a debtor asset. Thus, the procedure does not encourage the continuation of the debtor activities, but simply “takes note” of the insolvency status of the debtor and establishes a procedure aimed at liquidating the firm⁴⁸, in the best interest of the creditors.

This legal tool is addressed to all “the entrepreneurs⁴⁹ who practice a commercial activity, except the public corporations” (*art. 1, l.f.*). As for the company size, there is a limitation: indeed, the firms considered small by the law cannot apply the bankruptcy procedure⁵⁰. Moreover, the procedure is not allowed also for the entrepreneur-farmers and the start-ups⁵¹; however, on the other side those two agents can apply for other tools (such as the settlement of over-indebtedness crisis) which permit them to take advantage of the protections assured by the law as happens for the entities which can file for bankruptcy.

⁴⁸ The (temporary) continuation of the activities is applied only when the alternative (i.e. the immediate liquidation of the assets) is less convenient for the creditors. For example, it is in the interest of the creditors to continue the company operations in case of a major project which is going to conclude by the end of the year. Thus, it has nothing to do with the aim of supporting the continuation of the company activities as a priority.

⁴⁹ Currently, the law defines the debtor as an individual, and applies using the *analogia legis* technique the same rules for the companies managed by an administrative body or with more than one partner, with some variations in certain cases (for example, the extension of the bankruptcy to the general partners of a firm *ex art. 147 l.f.* and the fact that after a bankruptcy declaration the company bodies are not eliminated).

⁵⁰ On the basis of the second paragraph of the *art. 1 l.f.*, a firm is considered small if has: *a*) in the three years before the start of the bankruptcy procedure, “active assets” (*attivo patrimoniale*) lower than €300.000; *b*) in the three years before the start of the bankruptcy procedure, gross revenues lower than €200.000; *c*) total debts lower than €500.000. However, those entities can use the tool of the settlement of over-indebtedness crisis for dealing with an insolvency scenario.

⁵¹ For the start-ups, the aim is to protect them from a too early bankruptcy procedure. Indeed, the first years of those companies are characterized by important investments in R&D and low (if not negative) profits, and consequently negative cash flows.

As precised before, the bankruptcy procedure starts with the identification of an insolvency status. The *art. 5 l.f.* precises that “the entrepreneur that finds himself in an insolvency status is declared failed. The insolvency status shows itself with non-fulfillments or other exterior acts which demonstrate that the debtor is not able to regularly fulfill its own obligations anymore”. From this article, two definitions are clearly separated. On one side, the ‘non-fulfillment’ is related to a single obligation, while on the other side the ‘insolvency’ is linked to the whole indebtedness of the company⁵². Accordingly, not necessarily a non-fulfilled obligation means that a company is insolvent. Moreover, is insolvent not only who is not able to pay its debt at all, but also who pays only a portion of its debt when it falls due; similarly, is insolvent who, in order to collect cash to pay the creditors, is forced to sell part of its assets at a material discount, signaling a strong difficulty of finding enough cash to pay them. Finally, another insolvent company characteristic is the *persistence*⁵³ of the inability of paying the creditors; as precised before, the non-fulfillment of a single obligation does not imply an insolvency status. In short, a company could be defined as insolvent when it is not able to generate enough cash (either through its operations or through the financing channel⁵⁴) to pay the creditors (including the debt service).

The bankruptcy procedure starts with the bankruptcy declaration. Ex *art. 6 l.f.*, “The bankruptcy is declared on complaint by the debtor, one or more creditors or the prosecutor”⁵⁵. The complaint must be done to a court, and the procedure is almost the same in all the three cases. The law provides that immediately after the bankruptcy declaration has been made, the court must call the debtor in order to give to it the right of defense. Subsequently, the court must verify the existence of all the preconditions for a bankruptcy declaration (i.e. the corporate size of the debtor and an analysis of the insolvency status); if there are all the requirements, the court will declare the bankruptcy through sentence. Alternatively, it can reject the declaration, precising the reasons.

If the court declares the bankruptcy, the sentence must:

- elect the main bankruptcy bodies (the official receiver and the bankruptcy judge);

⁵² However, the Legge Fallimentare does not provide a clear definition of ‘insolvency’.

⁵³ Fiale (2018), when describing the moment in which the insolvency status exteriorizes itself, talks about ‘repeated non-fulfillments’ (*reiterati inadempimenti*) to state the importance of the persistence when defining an insolvency status.

⁵⁴ For example, a company with a persistent negative operating margin but with a strong reputation so that it is able to be financed regularly from the financial institutions may be considered as solvent, since it is effectively continuing its activities without any cash flow problems. Furthermore, in order not to be considered as insolvent, a company can obtain from the creditors the so called *pactum de non petendo*, i.e. an agreement where the creditors commit to not ask for the debt service for a certain period of time.

⁵⁵ Before the recent reforms, it was possible also for the court to declare the bankruptcy. Now it is not possible anymore.

- ask to the debtor to deposit, in three days, the book entries, the financial statements and the list of creditors;
- fix the place and date of the first hearing for verifying the credits. Before the fixed date, the creditors must ask for taking part of the procedure.

At this point, the bankruptcy bodies are elected or appointed. The system is made in a way that gives the right powers to each body, without favoring only one them, under a sort of ‘checks and balances’ system. The bodies established by the Legge Fallimentare are:

- *bankruptcy court (tribunale fallimentare)*: as seen before, it is the jurisdictional body which is in charge of declaring the bankruptcy (*art. 9 l.f.*). Moreover, the bankruptcy court has a general assignment of control of the whole bankruptcy procedure. The bankruptcy court most important tasks are:
 - to appoint (and revoke and substitute if necessary) the others bankruptcy bodies;
 - to hear in the council chamber the official receiver, the debtor and the creditors committee;
 - to decide about all the disputes that are not under the authority of the bankruptcy judge and to decide about the disputes that involve the bankruptcy judge;
 - to ask for clarifications and explanations to the others bodies;
- *bankruptcy judge (giudice delegato)*: it exercises a role of “control, surveillance on the regularity of the procedure” (*art. 25 l.f.*). Its main tasks are:
 - to communicate to the court about every issue which competence is on the court itself;
 - to take the necessary compelling measures in order to protect the debtor assets;
 - to appoint the creditors committee;
 - to call the official receiver and the creditors committee when necessary and when established by the law;
 - to decide about the complaints on the official receiver and creditors committee activities;
 - to authorize the provisional budget or the rent of the company;
 - to organize the final allotment;
- *official receiver (curatore fallimentare)*: it is the body aimed at managing the debtor assets. In particular, it has to identify, preserve and liquidate the debtor assets, once it is sure to have included in the inventory all the debtor assets. Its goal is to liquidate the

assets satisfying in the best way possible the creditors' claims. The official receiver is appointed by the court during the same sentence that declares the bankruptcy. To be elected, an official receiver must be a lawyer, an accountant or a person considered expert because has conducted successfully a public company; also a firm can be an official receiver (for example a professional firm). On the other side, it is important that the official receiver has not been declared bankrupt in the past and has not any limitation to its capacity to act; moreover, it has not to be connected with the debtor (for example, it is not possible to appoint as official receiver the spouse of the debtor, or a debtor's creditor).

The other most important tasks of the official receiver are:

- to prepare the debtor assets inventory;
- to prepare a first report on the reasons for distress and every six months to prepare, and to send it to the bankruptcy judge, a report on the activities performed during the period;
- if necessary, to prepare or integrate the debtor financial statements;
- to examine the declarations of claim (*domande di insinuazione al passivo*) and to participate at the hearing where all the claims are discussed;
- to require to the court to not perform any verification of the claims because of a too low value of liquidated assets, so that there will not be enough cash to perform the final allotment;
- to prepare a final report on the activities performed and to promote the bankruptcy closure.

As precised before, the main task of the official receiver is to manage the debtor assets. Thus, it may perform all the actions it retains necessary to preserve their value; if this is true for all the ordinary operations, for the extraordinary ones it must obtain the consent of the creditors committee. Moreover, it can propose to the bankruptcy judge the rent of the company or the start of a provisional budget (*esercizio provvisorio*) period.

Every dispute related to the official receiver activity is managed by the bankruptcy judge. Moreover, the bankruptcy court can revoke the official receiver in every moment if there is a right justification, on its own initiative or after a proposal made by the bankruptcy judge or the creditors committee;

- *creditors committee (comitato dei creditori)*: it is formed by three or five members chosen among the creditors and has the power to address and control the whole procedure. The body is appointed by the bankruptcy judge. Its main functions are:
 - to authorize all the extraordinary acts that the official receiver wants to perform;
 - to authorize the official receiver to enter the pending contracts on behalf of the debtor;
 - to approve the liquidation plan produced by the official receiver;
 - to formulate a legal opinion where required by the law⁵⁶. Those opinions could be compulsory or discretionary; moreover, some of them are binding, some of them are not;
 - to inspect the financial statements and ask for information about the debtor and the procedure.

The bankruptcy, as all the legal procedures, takes effect on all the participants of the procedure but also on third parties.

As for the debtor, he is subjected to some personal effects. First of all, it has to cooperate with the bankruptcy bodies during the whole procedure, by making itself available for every explanation or clarification the other bodies need⁵⁷. Secondly, the bankruptcy declaration sentence reduces some civil rights of the debtor⁵⁸ protected by the Italian Constitution, such as the right of freedom and confidentiality of its own correspondence and the right of reside and travel freely. But the most important effect of the bankruptcy declaration sentence on the debtor is the dispossession of its assets in favor of the official receiver that will manage the assets on its behalf in order to

⁵⁶ For example, the legal opinion of the creditors committee is required in case of temporary continuation of the debtor company operations (*art. 104 l.f.*), company rent (*art. 104bis l.f.*), official receiver revoke (*art. 37 l.f.*) and for asking for a bankruptcy discharge (*esdebitazione*) for the debtor (*art. 143 l.f.*).

⁵⁷ If the debtor does not cooperate in such a way, it risks to eliminate every probability to take part to the institution of the bankruptcy discharge, where it would not be liable anymore for the debts not completely paid during the bankruptcy.

⁵⁸ Either as a person or as a company; in the latter case, there are some slight differences, but the essence does not change.

liquidate them⁵⁹. A final effect sustained by the debtor is the ineffectiveness of all the acts completed by it⁶⁰.

Obviously, also the creditors get some effects after a bankruptcy declaration sentence. Firstly, they have the right to participate to the distribution of the sum collected after the official receiver has liquidated all the debtor assets, following the ranking structured by the law. The ranking gives the highest priority to some types of claims defined by the law and to the claims arose during the bankruptcy procedure (*crediti prededucibili*). Once those claims have been satisfied, the following level is composed by the secured claims (*creditori privilegiati*). Finally, only after the secured claims have been paid, the remaining part of the money collected are divided on a pro quota basis (the so-called *par condicio creditorum*) to the unsecured claims (*creditori chirografari*). The second effect of the procedure on the creditors is the ban of initiating or continuing individual executive or protective actions towards the debtor assets; in the American bankruptcy law this injunction is known as *automatic stay* and is one of the most important pillars of the US insolvency law which has been used as inspiration by many of the civil law countries. Therefore, the creditors can only participate in the bankruptcy by applying for the declaration of claim.

The bankruptcy declaration sentence takes effects also for some third parties which take not directly part of the procedure. This happens in particular because of the use of the so called clawback action (*azione di revocatoria fallimentare*)⁶¹. The aim of the action is to reconstruct the assets of the debtor, returning to the moment in which the insolvency status began; in practice, the action is oriented to respect the principle of the *par condicio creditorum*, which permits to treat all the creditors (except the '*prededucibili*' and privileged ones) in the same way. Indeed, with the clawback action the official receiver scrutinizes all the transactions occurred in the so called 'suspect period', and/or with a third party that was aware of the bad conditions of the debtor. For the bankruptcy purposes, a period is considered suspect when it is close to the bankruptcy procedure start: the law sets a period equal to one year or six months before the

⁵⁹ It is important to precise that also the profits derived from the use or possession of the assets are included into the total assets of the debtor. Moreover, also the assets arrived to the debtor during the bankruptcy procedure take part of the procedure itself. By contrast, some assets cannot be part of the total assets subjected to the bankruptcy (for example, personal items, salaries, maintenance payments, pensions and other assets not subjected to foreclosure as precised by the law).

⁶⁰ However, the debtor can intervene legally in the disputes regarding a declaration of bankruptcy pending on it, or when it is allowed by the law.

⁶¹ The action is regulated by the *art. 67 l.f.*

opening of the procedure. As for the second prerequisite, for the ‘normal transactions’⁶² the official receiver has to prove that the third party was aware of the debtor insolvency; if the transaction is abnormal, the official receiver does not have to prove anything but just to execute the clawback action⁶³. If the prerequisites are present, the assets related to that transaction return to take part of the total debtor assets which can be used by the official receiver⁶⁴.

The bankruptcy takes effects also on the pending contracts. Since it is out of the purposes of this paper a focus on what happens for all the different types of contracts, it is sufficient here to mention the general rule. In general, the *art. 72 l.f.* establishes that the execution of the contract remains suspended until the moment in which the official receiver decides whether to replace the debtor in the contract or to exit from it.

Finally, the bankruptcy may have also penal implications. The most frequent criminal violations are called ‘simple bankruptcy’ and ‘fraudulent bankruptcy’. The debtor could be accused of fraudulent bankruptcy when has:

- hidden, concealed or destroyed its assets (*fraudulent bankruptcy strictly speaking*);
- stolen, destroyed or counterfeited the journal entries (*documentary fraudulent bankruptcy*), before or during the bankruptcy;
- executed payments in favor of certain creditors (*preferential fraudulent bankruptcy*).

The debtor could be accused of simple bankruptcy when has:

- made too high personal expenses, in relation to its financial situation;
- invested too much in high risky operations;
- delayed the procedures on purpose;
- not maintained the journal entries in the last three years (*documentary simple bankruptcy*).

Apart from those two cases, other criminal violations are the abusive loan financing (i.e. a debtor continues to ask for a financing when it knows to be already insolvent), the omission of declaration of some assets when the official receiver is preparing the inventory and other illegal acts performed by the other bodies of the procedure.

⁶² A transaction is abnormal when the price paid is completely out of the market or the payment method is abnormal (as for example a payment in kind not described in the contract). Moreover, the anticipated payments and the free-of-charge acts (*atti a titolo gratuito*) are abnormal by definition. All the other acts are considered normal, and the official receiver must prove that the third party was aware of the debtor’s bad conditions.

⁶³ However, the third party can demonstrate that it was not aware that the debtor was in troubles.

⁶⁴ The clawback action cannot be asked for certain assets, such as the payments performed in order to favor the continuation of the debtor activities, the transactions planned by a certificate plan or a composition with creditors and the payments made in favor of the debtor employees.

The bankruptcy procedure is composed by four phases:

- *preservation and management of the debtor assets*: in this phase, after having placed temporarily the seals on the assets, the official receiver creates the inventory. With this activity, the official receiver takes the control and all the responsibilities on each item listed in the inventory. Together with the inventory, the official receiver must prepare also a detailed list including all the creditors and everyone that has a real right on a debtor asset. Once this operation is concluded, the official receiver must manage the assets, taking both ordinary operations and extraordinary ones (obtaining the consent of the other bodies as described before)⁶⁵;
- *liabilities scrutiny*: the purpose of this phase is to determine the creditors admitted to the procedure (i.e. both the ones which have a credit with the debtor and the ones which have a real right on a debtor asset). It is important to precise that this is the only moment in which the creditors can enter the procedure; if they do not apply to the declaration of claims or do not defend themselves in case of rejection from the official receiver⁶⁶, they cannot participate to the final allotment;
- *assets scrutiny and liquidation*: as explained before, the total assets to liquidate are composed by all the debtor assets at the bankruptcy declaration time plus the assets returned to the debtor because of the clawback action. Those assets are liquidated, i.e. transformed in cash. In this phase, the official receiver prepares a liquidation plan which must be approved by the creditors committee and authorized by the bankruptcy judge. The plan must include all the details about the creditors and the way in which the liquidation of each asset occurs⁶⁷, together with other information about the necessity of having a provisional budget and the existence (if any) of some proposals of composition with creditors. The law gives also the possibility of selling the company as a whole, but

⁶⁵ Among the possibilities, it is possible to continue the debtor activities under the consent of the creditors committee and to rent the company.

⁶⁶ Indeed, the official receiver must prepare a project in order to give to the creditors not admitted the possibility to contest the decision.

⁶⁷ The recent reforms have given more freedom to act about the way in which an asset can be sold during a bankruptcy procedure. Thus, currently it is possible to sell an asset also using a purchase agreement (*contratto di compravendita*). The only prerequisite that the Legge Fallimentare provides is that the sale must be done adopting competitive procedures. However, the bankruptcy judge has the power of suspending the assets sale (if there are justified reasons and on request of the debtor, the creditors committee and everybody which is interested in the issue, *ex art. 108 l.f.*) and to block a transaction if the offered price is materially below the right one inferred by the market trend.

only if the sale of each asset singularly would have produces a smaller amount of cash to distribute to the creditors (*art. 105 l.f.*);

- *final allotment*: during this phase, the cash obtained from the assets liquidation is distributed to the creditors accepted during the liabilities scrutiny stage, following the ranking described before (*prededucibili*, secured and unsecured creditors). It is important to precise that this phase is not mandatory; indeed, it may happen that the bankruptcy procedure can finish because of a too low amount of cash obtained through the liquidation process. Before the final allotment occurs, the official receiver must present to the bankruptcy judge a report which includes all the transactions performed during the procedure, including also the related journal entries. Once the bankruptcy judge has approved the report and liquidated the official receiver compensation, he orders the final allotment.

As a consequence, the bankruptcy procedure can end in several ways, *ex art. 118 l.f.*:

- when the creditors do not apply to the declaration of claims process (i.e. when no one applies for entering the bankruptcy procedure);
- when all the liabilities have been liquidated⁶⁸;
- when all the cash generated from the liquidation of the debtor assets has been distributed to the creditors. Differently than the previous case, under this circumstance the creditors are not fully satisfied;
- when during the procedure the official receiver verifies that there are no possibilities for satisfying, even partially, the creditors.

If one of those cases occur, the bankruptcy court declares the closing of the procedure, on request of the official receiver, the debtor or by its own initiative (*art. 119 l.f.*). Immediately after the bankruptcy is definitely closed, all the related bodies cease to exist, while the debtor returns *in bonis*, i.e. it can restart to manage its (remaining) assets as it could do before the procedure inception. As for the creditors, they can execute individual legal actions on the remaining assets of the debtor, except the case of debtor bankruptcy discharge⁶⁹.

⁶⁸ This case may mean that not all the cash raised from the liquidation of the debtor assets have been distributed. In this case, all the creditors have been satisfied.

⁶⁹ The debtor bankruptcy discharge (*esdebitazione del fallito*) is an institution aimed at favoring the reintegration of the debtor in the economy, by eliminating his post-bankruptcy remaining debt. The goal is to give to it the possibility to restart a new commercial activity without supporting the burden of the liabilities related to its past bankruptcy. In order to get this advantage, the debtor must satisfy some prerequisites:

2.2.2 Bankruptcy buy-out (*concordato fallimentare*)

The Legge Fallimentare provides for a further way to conclude a bankruptcy procedure: the bankruptcy buy-out (*concordato fallimentare*). It consists of the creation of an agreement between the debtor and the creditors aimed at satisfying the claims of the latter. Generally, the principal advantage of this legal tool is that it is a quicker way to exit an insolvency status; thus, rather than waiting for the closure of the bankruptcy procedure, on one side the creditors are satisfied earlier, while on the other side the debtor has the possibility to restart the (or a new) commercial activity sooner. Moreover, the second advantage of this tool is that the debtor is released completely from the liabilities that it has not paid to the creditors under the bankruptcy buy-out. Thus, with the bankruptcy buy-out the creditors may agree to be satisfied only partially and commit to not execute any individual action towards the debtor assets after the agreement has been approved by the court. The bankruptcy buy-out can be proposed either by the debtor (but only after one year from the bankruptcy declaration) or by one or more creditors or a third party (*art. 124 l.f.*). The proposal may include the subdivision of the creditors in different classes, a different treatment for each class and must contain the detailed description of the liquidation plan. The bankruptcy buy-out plan must be presented to the bankruptcy judge; after the consent of the creditors committee, the bankruptcy judge orders that the plan is communicated to all the creditors. The creditors must vote adopting the majority rule⁷⁰; if the majority of the creditors gives the consent to the plan, the court homologates it⁷¹. The bankruptcy buy-out on one side binds the debtor to execute what described into the plan; on the other side is valid for all the creditors, also the ones which have not voted positively. Moreover, as precised before, the debtor is free from every liability connected with the bankruptcy procedure; thus, the creditors cannot take individual actions on the debtor assets related to the remaining part of the debt.

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- i. during the bankruptcy procedure, the debtor must have satisfied partially the creditors;
 - ii. the debtor has cooperated with the bankruptcy bodies during the procedure, without delaying voluntarily the procedure;
 - iii. the debtor has not obtained another bankruptcy discharge in the last ten years;
 - iv. the debtor has not made fraudulent activities (such as having hidden, concealed or destroyed its assets and obtained illegal financing).

⁷⁰ Recently (Decision no. 17186 of 28 June 2018), the United Chambers (*Sezioni Unite*) of the Italian Supreme Court established that the plan cannot be voted by the subject which has filed for the plan, since there would be a clear conflict of interest. Indeed, on one side the objective of the party which files for the plan is to minimize payments to the other creditors, while on the other side the goal of the creditors is to receive the highest amount of cash possible.

⁷¹ There is the possibility that more proposals are presented during the procedure. If this is the case, the creditors must vote on each procedure, and wins the procedure which has obtained the highest amount of votes (in case of equality of votes between two plans, wins the one which have been presented first or the one presented by the debtor).

One of the most critical aspects of this legal tool is that the procedure could start also when the list of creditors created by the official receiver is still temporary (*artt. 124-127 l.f.*). Indeed, the proposal can be made by every creditor or third party also before the production of the decree that gives execution of the list of creditors, if the official receiver has been able to create a temporary list of creditors. If we combine this aspect with the fact that every change of the creditors admitted to the procedure occurred after the inception of the buy-out are irrelevant for the computation of the majority (*art. 128 l.f.*), the risk to obtain a solution which disadvantages some creditors could be very material.

2.2.3 Administrative compulsory winding up (*liquidazione coatta amministrativa*)

The Legge Fallimentare includes a special procedure addressed to those companies which insolvency has important implications for the whole country, for different reasons. For example, a corporation may be owned by the public authority, or it may be important for public reasons because if it goes bankrupt the financial credibility of the country will fall dangerously⁷². The administrative compulsory winding up is a special procedure through which, in order to protect the public interest, the authority decides to cancel that particular company. As a consequence, not necessarily a company subjected to this procedure is insolvent; a corporation may enter this procedure also in case of legal violations and other public interest reasons. However, the law has explicitly considered the possibility of verifying the insolvency of the company, when insolvency is not the reason why the procedure has been applied. In such a way, it is possible to satisfy the creditors as happens under the bankruptcy procedure⁷³.

The procedure determines the substitution of the entrepreneur (or the board of directors) with an administrative body which acts on behalf of him (or them). The initiative for starting the procedure is taken by the Public Administration (i.e. the company industry's competent ministry). The bodies which take part of the procedure are:

- *liquidator (commissario liquidatore)*: its prerequisites and tasks are very similar to the official receiver ones;

⁷² For example, are among those companies: the insurance companies, the financial institutions, the cooperatives, the investment funds and the auditing firms.

⁷³ However, the verification is not possible for the public authorities (*enti pubblici*) and for the companies which can be subjected to both the bankruptcy and the administrative compulsory winding up procedures.

- *supervisory authority (autorità di vigilanza)*: its activities are comparable to the one performed by the bankruptcy judge under a bankruptcy procedure;
- *supervisory committee (comitato di sorveglianza)*: it is composed by three or five members. In practice, they advise the other bodies when required.

As a result of the procedure, the activity of the company bodies are suspended. Moreover, as in the bankruptcy case, the individual legal actions are banned. As for the creditors, the effects of the administrative compulsory winding up are similar to the bankruptcy ones, except the fact that there is not any declaration of claims; in this procedure, the list of creditors is prepared by the liquidator, which has to communicate to each creditor the amount of its claim as specified in the journal entries. Each creditor can complain if it retains that the amount identified by the liquidator is wrong or it has not been included in the list of creditors. Once all the complaints have been solved, the liquidation starts. Finally, after the supervisory authority has approved the liquidation plan provided by the liquidator, the final allotment can be performed.

The procedure can close in two ways: with the final allotment and with an agreement which is very similar to the bankruptcy buy-out.

2.2.4 Extraordinary liquidation for big companies (amministrazione straordinaria delle grandi imprese in crisi) and Extraordinary special liquidation (amministrazione straordinaria speciale)

As already precised before, the first push towards the new approach to the whole Italian bankruptcy law content has been provided by the Prodi law of 3 April 1979, no.95; this act introduced the institute of the *extraordinary liquidation for big companies*, aimed at recovering an insolvent big company instead of liquidating it. The mentioned law has been abrogated by the Legislative Decree of 8 July 1999, no.270, which has confirmed the institution adding up new rules in order to regulate better the issue.

The procedure is similar to the one for the administrative compulsory winding up, but its main aim is to preserve the know-how and the commercial, technical and occupational values of those big companies. Indeed, a simple dissolution of those corporations could implicate severe problems for a material number of users, from the employees to the society.

To participate in this procedure, a company must be considered big; the *art. 2* of the Legislative Decree of 8 July 1999, no.270 sets the quantitative threshold. A company is admitted to this procedure, when:

- for at least one year, it has more than 200 employees;
- it has an amount of debt at least equal to the $\frac{2}{3}$ of both the total assets and the total revenues;
- it shows a concrete possibility to recover the economic equilibrium.

The procedure inception occurs in two phases: (i) the verification of the quantitative prerequisites and the insolvency declaration; (ii) the analysis of the company recovering. Thus, when a company is considered ‘big’, it cannot be declared bankrupt immediately, but must be subjected to the analysis of its recovering. Only when the court have declared that it is not possible to recover the company, the latter could be declared bankrupt⁷⁴.

Accordingly, the court can declare the bankruptcy or reject the complaint if it concludes that the company is not insolvent⁷⁵. With the sentence which declares the insolvency status, the court appoints the bankruptcy judge, elects the judicial commissioners (*commissario giudiziale*)⁷⁶, asks to the debtor the journal entries and the financial statements, sets a term for the declaration of claims and decides up to whether the company is run by the existing managers or by the judicial commissioner(s) under this period.

Once the court has concluded that the company is sufficiently big and insolvent, the second phase starts, i.e. the analysis of the company recovering. The aforementioned recovery can be obtained in different ways, namely by selling the company assets or restructuring the company operations and capital structure. For this purpose, the judicial commissioner must prepare a report including the reasons for distress and the possibility of recovering the company. Consequently, the court decides whether to start the procedure of extraordinary liquidation or to declare the bankruptcy.

Once the procedure is opened, the Minister of Economic Development appoints one or three extraordinary commissioners (*commissari straordinari*), depending on the complexity of the

⁷⁴ However, before declaring the bankruptcy of a big company, the court must hear the interested parties (i.e. the debtor, the claimant and the Minister of Economic Development).

⁷⁵ There is a third way, i.e. when the court rejects the complaint only because the quantitative prerequisites are not reached. In this case, since the company is insolvent but not big, the court will declare the bankruptcy.

⁷⁶ One or three, depending on the complexity of the case.

case. The extraordinary commissioner manages the company⁷⁷, and every six months has to prepare a report about the activities performed to deliver to the Minister.

Furthermore, the Minister has to elect the surveillance committee (*comitato di sorveglianza*) composed by three or five members⁷⁸; the committee's aim is to give opinions about the decisions taken by the extraordinary commissioner. Moreover, it has control powers, since it can control the journal entries and ask clarifications to the extraordinary commissioner.

As for the effects of the procedure, as happens in the bankruptcy procedure, the debtor cannot manage the company anymore; furthermore, it cannot start any dispute related to its company and the corporate bodies are suspended. Moreover, after the procedure has started, it is not possible to start or continue individual legal actions on the company assets. However, only if the turnaround plan is about the liquidation of some assets, it is possible to perform clawback actions.

By sixty days from the inception of the procedure, the extraordinary commissioner must prepare and present to the Minister a plan, which must include all the details about the procedure to perform and the specification up to whether the plan regards the liquidation of the assets or the restructuring of the company operations and capital structure. The plan must be approved by the Minister of Economic Development, after having heard the surveillance committee.

After the plan has been approved, the extraordinary commissioner can execute it; if the plan includes a liquidation procedure, after the assets have been liquidated it is possible to distribute the cash obtained to the creditors, as stated into the plan.

Ex art. 74 Legislative Decree of 8 July 1999, no.270, the procedure closes:

- if there are no creditors that has applied for the declaration of claims;
- if the insolvent debtor has recovered from its indebtedness;
- when the sentence which approves the agreement between debtor and creditors (*concordato*) is definitive.

Moreover, if the plan consists of the liquidation of some debtor assets, the procedure closes when the final allotment has been performed or when the creditors have been satisfied fully.

⁷⁷ When managing the company, the extraordinary commissioner has more power than the official receiver of the bankruptcy procedure. Indeed, the Minister of Economic Development has the power of authorization of only two acts, namely the rent of the company and the rent of the buildings (and similar rights) of material value. However, the Minister has the power of revoking the extraordinary commissioner if there is a fair reason, on the request of the surveillance committee or on its own initiative.

⁷⁸ One or two of them (respectively, in case of committee composed by three or five members) are chosen among the unsecured creditors, while the other members are selected among the individuals considered expert in the field.

A legal tool very similar to the extraordinary liquidation for big companies is the *extraordinary special liquidation*. The procedure has been introduced with the Law of the 18 February 2004, no. 39⁷⁹, and is addressed to bigger companies than the one subjected to the extraordinary liquidation for big companies. To apply for this procedure, the prerequisites are:

- the company must have no less than 500 employees;
- the corporation must have an amount of debt of at least €300 million.

The aim of this procedure is to accelerate the procedure presented above in this paragraph; in particular, in order to limit the time necessary to perform the procedure, the powers of the Minister and the extraordinary commissioner have been reinforced. It is up to the insolvent debtor to decide which procedure to follow. If the debtor follows the special procedure, the Minister (if agrees with the decision) immediately starts the procedure by appointing the extraordinary commissioner and dispossessing the debtor in its own favor. As for the remaining part of the procedure, it is similar to the one described for the extraordinary liquidation for big companies, with the difference that every task shall be performed quicker. As stated for the ordinary tool, also the special one may conclude through a declaration of bankruptcy or an agreement between the debtor and the creditors.

Finally, the Law of 27 October 2008, no. 166 has updated the Marzano Decree by extending the power to open the procedure also for the Prime Minister, but only for the companies which operate in the “essential public services” industry.

2.2.5 *Composition with creditors (concordato preventivo)*

Generally, the composition with creditors is an agreement between the debtor and the majority of the creditors aimed at solving the distress situation through the satisfaction, even partially, of the creditors.

To be admitted to the procedure, the debtor must be a commercial entrepreneur and in a distress status. Moreover, the debtor must produce a recovery plan (*piano di risanamento*) which includes the restructuring of the debt, the satisfaction of the creditors, the transfer of the activities to a

⁷⁹ Which has converted in law the Marzano decree (Law Decree of 23 December 2003, no. 347).

contractor (*assuntore*)⁸⁰, the subdivision of the creditors in different classes and a different treatment given to each class of creditors.

The procedure bodies are:

- *bankruptcy court (tribunale fallimentare)*: differently than the bankruptcy case, its functions are not general but predetermined. In particular, the bankruptcy court has to admit the debtor to the procedure, to declare the bankruptcy if the composition with creditors is not feasible, to homologate (or cancel) the plan and to decide on the disputes related to the bankruptcy judge and the judicial commissioner;
- *bankruptcy judge (giudice delegato)*: its duties are slightly different from the bankruptcy case. Indeed, it has to solve the disputes arisen during the procedure, to authorize the extraordinary operations performed by the judicial commissioner and to promote the eventual bankruptcy declaration;
- *judicial commissioner (commissario giudiziale)*: this body must verify the list of creditors presented by the debtor, monitor the debtor activities (since the debtor can manage the company also after the inception of the procedure), prepare the necessary reports about the distress reasons and monitor the way in which the plan is going to be performed;
- *public prosecutor (pubblico ministero)*: its main task is to receive the information from the judicial commissioner about potential criminal investigations to perform, in case the judicial commissioner finds some material facts when performing the report about the reasons for distress.

Moreover, in case of composition with creditors regarding the liquidation of the debtor assets, the court has to appoint one or more *liquidators* (with the same tasks and power of the official receiver under the bankruptcy procedure) and the *creditors committee*, as in the bankruptcy case (*art. 182 l.f.*).

The composition with creditors procedure starts with the application for the admission to the procedure itself. To do that, the debtor has to complain to the court, present several documents (i.e. the updated financial statements, the list of creditors and all the entities which have real rights on a debtor asset) and present a plan containing the detailed proposal⁸¹. The debtor can also present the complaint without proposing a plan at the same moment, in order to take advantage of

⁸⁰ Also a creditor can be a contractor.

⁸¹ The law establishes that, to protect the creditors, the plan must be accompanied by a report where an expert confirms the veracity of the data and the feasibility of the plan itself.

the protections guaranteed by the law from the very beginning; however, the debtor has no more than 120 days to present the complete plan (this institute is called *concordato in bianco*)⁸². Apart from this particular case, once there is a plan, the bankruptcy court can approve or reject it; if the court rejects it, the court may give to the debtor a period of time during which it could complete the plan. If the court approves the plan, it admits the debtor to the procedure of the composition with creditors, nominating the bankruptcy judge, electing the judicial commissioner and ordering the convocation of the creditors for the approval of the plan⁸³. In this phase, the judicial commissioner has to verify the list of creditors provided by the debtor; indeed, differently than the bankruptcy case, under the composition with creditors rules there is not any verification of the claims. Subsequently, the judicial commissioner prepares the inventory and a report about the reasons for distress, as mentioned above.

After this stage, the creditors have to approve the plan. The proposal is approved if it obtains the vote of the majority of the creditors admitted to the vote⁸⁴. If the proposal has not been approved by the creditors, the bankruptcy court must revoke the composition with creditors and – if the company is insolvent – declare the bankruptcy, but only on request by the creditors or the public prosecutor.

Once the plan has been approved, to be effective it must be homologated by the bankruptcy court, after the judicial commissioner has presented a justified opinion where it confirms the feasibility of the plan. The court can homologate the plan also when a percentage of creditors up to the 20% of the total creditors admitted to the vote is against it, but only if the court believes that the composition with creditors plan is more convenient for the creditors than the other alternatives.

After the homologation of the plan, the composition with creditors procedure is closed.

⁸² This possibility is strictly regulated, in order to avoid fraudulent purposes by the debtor. In particular, when presenting the complaint, the debtor must provide information about the creditors and the last three years financial statements; moreover, the bankruptcy court can appoint the judicial commissioner at this moment, in order to control the debtor operations and behavior also from this pre-composition with creditor phase.

⁸³ From the 2015, it is possible for the creditors to provide a *competitive proposal*, in order to prevent the presentation of illogical plans by the debtor. Thus, the law states that it is possible to present a competitive proposal if the plan presented by the debtor does not include a satisfaction of the claims greater than the 40% of the total claims (30% in case of composition with creditors with continuation of the company operations).

⁸⁴ If there are different classes of creditors, the plan is approved when:

- i. the proposal obtains the majority of the creditors admitted to the vote;
- ii. the majority of the creditors classes has voted positively.

If there are multiple plans, wins the plan which has obtained the highest majority. In case of equality of votes among two or more competitive proposals, wins the proposal presented earlier. If among the proposals with the same vote composition there is the plan presented by the debtor, the latter proposal wins.

As regards the effects of the composition with creditors, differently than the bankruptcy case, the debtor management bodies (or the entrepreneur) continues to manage the company; in other words, the dispossession of its assets in favor of a third party does not occur⁸⁵. As for the effects of the procedure on the creditors, they are similar to the bankruptcy case; in particular, the creditors cannot take any individual legal action on the debtor assets after the procedure has begun. However, only for this procedure the Law Decree of 31 May 2010, no. 78 sets a list of claims considered as *prededucibili*, namely the financing provided by the financial institutions aimed at starting the procedure and executing the plan and the financing provided by the shareholders when executing the plan. Moreover, from the 2012⁸⁶ there is a new discipline on the pending contracts⁸⁷; in particular, the debtor can ask to the court to dissolve some ‘oppressive’ contracts in exchange of a fair compensation in favor of the third party⁸⁸.

After the procedure has been closed with the homologation by the bankruptcy court, the debtor regains the full availability of its assets, and the creditors can continue to adopt legal actions on the debtor assets (respecting the guidelines of the agreement).

A particular type of this procedure is the *composition with creditors with continuation of the company operations (concordato preventivo con continuità aziendale)*, introduced by the Law Decree of 22 June 2012, no. 83⁸⁹ and regulated by the *art. 186bis l.f.*. The article defines ‘continuation of the company operations’ as the continuation of the activities by the debtor, the conferment of the company in another one or the sale of the company. The aim of this recent legal tool is to create an agreement aimed at continuing the company activities, without incurring in illogical liquidations. In practice, the continuation of the operations is guaranteed by the future expected cash flow of the company; thus, it is necessary that the debtor proposes a business plan which proves that the firm will restart to be profitable in the near future. The procedure is the same described before for the ordinary composition with creditors.

The composition with creditors, of every type, can be dissolved when the debtor does not perform the activities defined into the plan. Moreover, it can be cancelled, on request by the

⁸⁵ However, the activities of the debtor are monitored by the judicial commissioner (*art. 167 l.f.*). Moreover, for the extraordinary operations it is necessary the authorization of the bankruptcy judge.

⁸⁶ Law of 7 August 2012, no. 134.

⁸⁷ In fact, one of the most common reasons for the crisis is the presence of some oppressive contracts. Thus, the Legge Fallimentare wants to give a chance for the debtor to exit from those contracts, simplifying the recovering from the distress scenario.

⁸⁸ This compensation enters the procedure as a *prededucibili* claim, together with the other ones listed above.

⁸⁹ Converted in Law of 7 August 2012, no. 134.

judicial commissioner or every creditor, when the debtor has voluntarily exaggerated the assets value or concealed part of the liabilities. Thus, the main difference between dissolution and cancellation is that the latter must have a malicious component.

2.3 Out-of-court procedures

The Legge Fallimentare includes also some out-of-court procedures, i.e. legal tools that are regulated but do not require (or minimize) the intervention of any jurisdictional body. In practice, the aim of those legal instruments is to favor the creation of private agreements between the debtor and the creditors, without incurring the legal costs and being bound to the time of the bureaucracy (often too long for having an efficient result). Moreover, the increase of the out-of-court agreements helps to decrease the work for the courts, allowing them to be more focused on the most critical cases.

2.3.1 Agreements for debt restructuring (*accordi di ristrutturazione dei debiti*)

The Law Decree of 14 March 2005, no. 35⁹⁰ introduced the possibility to create an arrangement between the debtor and the creditors aimed at reaching an agreement with the majority of the creditors about the restructuring of the capital structure (*art. 182bis l.f.*). Thus, the final purpose is to support the continuation of the company activities, without looking for useless liquidations. Once an agreement has been reached, the court has to homologate it: this is the only phase in which a judicial body enters the procedure. The main procedure is accompanied by two similar ones – the *accordi di ristrutturazione con intermediari finanziari* and the *convenzione di moratoria* – that work as the main procedure but have different purposes.

The agreement must be approved by at least the 60% of the creditors which represent the total liabilities of the debtor and must provide for the full payment of the claims of the creditors that have not approved the plan. The main disadvantage of this rule is that the procedure is continuously subjected to the so-called *free ride problem*, i.e. that situation where, since the creditors that do not agree with the plan will obtain for sure a full payment, all the creditors have the incentive of rejecting the plan. In other words, those creditors will take advantage of the fact

⁹⁰ Converted in Law of 14 May 2005, no. 80.

that there are some creditors that are willing to be paid less than the full amount of their claims because they are directly interested in the continuation of the debtor operations. Similarly, the procedure could be subjected to the *holdout problem* as well, i.e. that scenario where some creditors are encouraged to reject a plan because there are more convenient (only for them) alternatives⁹¹.

The company that applies for this procedure must be in a distress condition; thus, it may not be insolvent, but at an earlier stage of distress. If a company is in distress, it can ask for the homologation of the agreement after having provided the documentation *ex art. 161 l.f.* (the updated financial statements, the list of the creditors and the specification of the plan) and a report prepared by an expert about the feasibility of the plan itself and the veracity of the data included on it. Then, the court can decide up to whether to approve or reject the agreement, explaining the reasons.

Recently, one of the most critical points of this legal tool was the precautions that the law guarantees to the companies that apply for the procedure. In order to support the creation of out-of-court agreements, the Legislative Decree of 12 September 2007, no. 169 established a period of 60 days – subsequent the publication of the agreement in the Registry of Businesses – where for the creditors it is not possible anymore to take individual legal actions on the company assets. In the 2010⁹², the ban has been extended also during the negotiations related to the conclusion of the agreements. Finally, to further increase the incentive to use this tool, the Law of 7 August 2012, no. 134 established that the ban is valid also for the achievement of the guarantees (such as pledge, lien or other special privileges).

Another important aspect of the procedure is the possibility to obtain a financing during the procedure⁹³. Indeed, the Law of 30 July 2010, no. 122 introduced in the Legge Fallimentare text the *art. 182 quater* which gives the possibility, for the parties interested in doing this, to finance a company without being afraid of getting involved in a bankruptcy procedure in the near future. Indeed, the claims related to the financing obtained under this framework are classified as

⁹¹ However, it is important to note that the Italian law encourages procedures such as the agreements for debt restructuring only when there are not any more convenient alternatives.

⁹² Law of 30 July 2010, no. 122.

⁹³ In the American insolvency law, this type of help provided to the debtor in state of crisis (or insolvency) is summarized with the Debtor-In-Possession (DIP) financing institution, where it is possible to provide financing to the debtor also during those tough moments.

prededucibili claims in case of bankruptcy⁹⁴. The aim is to guarantee the continuation of the company operations: indeed, in order to continue the activities, it is important for a company to be able to pay the creditors (such as the trade creditors) during the procedure. To do that, the law provides for this type of ‘preferential financing’.

Moreover, from the 2015⁹⁵ it is possible for the court to authorize the debtor to obtain preferential financing during the phase in which the debtor asks for the agreement without presenting the plan yet (i.e. the *concordato in bianco*). In other words, the law provides for the possibility to collect some cash in terms of risk capital before the very beginning of the procedure. However, this is possible only when the debtor demonstrates that it is not able to collect money in other ways; further, it has to specify how those money will be used and prove that without that financing the company would enter a more severe distress scenario.

As illustrated before, the main procedure is accompanied by two other procedures – introduced by the Law of 6 August 2015, no. 132 –, that work in a similar way but have been created for different purposes:

- *accordo di ristrutturazione con intermediari finanziari*: it is possible to adopt this legal tool only when the distress is accompanied with a strong dependence on the financial institutions. In particular, it is necessary that a distressed company has at least the 50% of the total debt related to the financial institutions. The agreement is valid if the 75% of the financial creditors subscribe the plan; moreover, all the non-financial creditors must be paid in full. If those conditions are respected, the court will homologate the agreement;
- *convenzione di moratoria*: this agreement permits a debtor to delay the payment terms of the debt service with the financial institutions. Also for this institution are required the preconditions for the previous tool.

2.3.2 Certificate plan (*piano attestato di risanamento*)

The certificate plan is a tool aimed at turning around a company performance, characterized by the completely absence of any jurisdictional body and any publication. The first advantage of the absence of a jurisdictional body is that the debtor saves all the legal costs; however, differently

⁹⁴ Together with the other types of financing identified for the composition with creditors discipline and the fee for the expert which prepares the report aforementioned.

⁹⁵ Law of 6 August 2015, no. 132.

than the other out-of-court procedures, there are no protections guaranteed by the law during the execution of the plan. Thus, this instrument is completely in the hands of the distressed company, that can use it to recover the profitability without any legal limitation. The institute has been introduced in the 2005 (Law Decree of 14 March 2005, no. 35) and has been reinforced with the Law Decree of 22 June 2012, no. 83, implementing the *art. 67 l.f.* regarding the clawback action. The article, at the *letter d*), establishes that all the acts related to the debtor assets in execution of a plan suitable for recovering the company indebtedness and improving the equilibrium of the performance – where the plan is certified by an independent expert –, are exempt from any clawback action. Thus, one of the most important aspects of this tool is that the activities performed in execution of such plan are safe, in the sense that if the plan does not succeed, the third parties that have given confidence in the plan are not damaged by a potential clawback action during the bankruptcy procedure.

To get the protection guaranteed by the law, the plan must have two conditions:

- to permit the turnaround of the company: it can be obtained by reducing the amount of debt, renegotiating the deadlines of the payments or renegotiating the conditions of the loan (for example, decreasing the interest rate or with a debt write out)⁹⁶;
- to be certificated by an independent expert appointed by the debtor.

Moreover, it is sufficient that a company is in distress and not insolvent, as happens for the agreements for debt restructuring.

The plan can be prepared by all the entities that can file for bankruptcy and every private entrepreneur considered “not small” by the *art. 1 l.f.*.

Since this tool is not explicitly regulated by the law, it is object of some critics. In particular, the certificate plan is a unilateral act, in the sense that the consent of the majority of the creditors is not mandatory. Indeed, it seems possible to affirm that the real aim of the certificate plan is not to satisfy the creditors’ claims (or at least not indirectly), but to reorder the company capital structure (Burigo, 2016). Following this perspective, it would not be necessary to include into the plan agreements with the creditors⁹⁷.

⁹⁶ It is important to precise that the plan is not suitable to solve an operational crisis (for example, a loss of market share, or the obsolescence of the machineries), while it is more appropriate for restructuring the company capital structure.

⁹⁷ Obviously, the plan may include agreements with creditors, and it usually happens.

Another critical point about the certificate plan is the absence of any type of publication of the plan. Currently, the law gives to the debtor the possibility (but not the obligation) to publish the plan. Thus, in some cases the third parties could be damaged from a non-published plan. Moreover, a problem could arise when, during the bankruptcy procedure which follows a failed certificate plan, the official receiver wants to control the certificate plan in order to verify its feasibility; in particular, if the plan has not been written on paper, it could be difficult to prove the non-feasibility of the plan.

2.3.3 Settlement of over-indebtedness crisis (*composizione delle crisi da sovraindebitamento*)

From the 2012⁹⁸, the Italian law provides also for other legal tools addressed to all the entities which cannot apply for all the other procedures aforementioned, i.e. small firms and consumers. If under the other procedures the main ‘protagonist’ is the debtor, under this framework the entity which is subjected to those procedures can be called *over-indebted*. An over-indebted is an entity (or an individual) that has taken obligations for other purposes than the execution of an entrepreneurial or professional activity; this entity must not have the requisites to be declared as bankrupt or to take part of a composition with creditors⁹⁹. Logically, an over-indebted must be in an over-indebtedness status, i.e. a situation of persistent disequilibrium between the level of debt and the assets; the consequence of this condition is a serious difficulty of fulfilling the obligations.

The law provides for three procedures:

- *debtor agreement (accordo del debitore)*: it regards a plan aimed at the reorganization of the debt and the satisfaction of the creditors, which have to approve the plan. The proposal is prepared by the over-indebted (with the help of a specific agency¹⁰⁰); the plan must include all the details about the execution of the plan itself (for example, the way in which the creditors will be paid, the technique of liquidation of the assets and the new fiscal position of the over-indebted). The plan must be presented in the court, together

⁹⁸ Law of 37 January 2012, no. 3.

⁹⁹ A recent Court of Cassation sentence (1/2/2016, no. 1869) affirmed that can apply for the procedure also the professional or entrepreneur – which does not have the prerequisites for the bankruptcy or composition with creditors procedure – which assumed debts for purposes not related to the professional or entrepreneurial activity.

¹⁰⁰ The specific agency (*organismo di composizione della crisi*) is an agency registered in a specific register provided by the Minister of Justice which participates in all the settlement of over-indebtedness crisis procedures. Their aim is to help the over-indebted to prepare the plan and executing the most complex parts of the procedure.

with the list of creditors, the journal entries if the over-indebted is an entrepreneur and the report produced by an expert where it certifies the feasibility of the plan. The plan is homologated by the court after at least the 60% of the creditors have approved the proposal;

- *consumer plan (piano del consumatore)*: if the over-indebted is also a consumer¹⁰¹, he can choose whether to prepare a plan aimed at balancing the over-indebtedness status, without looking for the consent of the creditors. The characteristics of the plan are the same of the debtor agreement's one; the only (but important) difference is that the decision on whether to approve the plan is on the court, without the necessity of the creditors approval;
- *assets liquidation (liquidazione dei beni)*: the Law Decree of 18 October 2012, no. 179¹⁰² introduced the possibility for the over-indebted to liquidate the assets in alternative of the other two procedures aforementioned. The liquidation may include all the assets with some exception (for example the assets that cannot be subjected to foreclosure, pensions and salaries). Moreover, the specific agency must prepare a report where it includes elements such as the reasons for distress, the analysis of the indebtedness of the over-indebted and the certification of the feasibility of the plan.

Moreover, also the over-indebted can be discharged (*esdebitato*), as in the bankruptcy case.

2.4 The 2017 reform

As precised earlier in this chapter, recently the purpose of the Italian bankruptcy law is changing, going towards a preference for the legal tools which support the continuation of the company activities and the presence of quicker and less expensive (in particular for the debtor) procedures. As a consequence, in the 2017 the Italian Parliament approved the Law of 19 October 2017, no.155 (hereinafter, *Reform*) which authorizes the Government to perform a deep reform of the Legge Fallimentare by the 14 November 2018. By the date aforementioned, the government prepared a document which confirms what described by the Rordorf commission.

¹⁰¹ The consumer is defined in the Italian Consumer Code (*art. 3*) as “the person who acts for different purposes than his entrepreneurial, commercial, handcrafted or professional activity eventually performed”.

¹⁰² Converted in Law of 17 December 2012, no. 221.

Generally, the Reform aims at completing the passage from the bankruptcy law to the ‘corporate crisis law’, aligning the Italian legislation with the other countries’ one¹⁰³. Moreover, the Reform must consider the European legislation, in particular the Regulation 2015/848/EU – which provides for a criterion for determining the competent jurisdiction in case of international insolvency procedures – and the Recommendation no. 2014/135/EU aimed at promoting the identification of the crisis before the insolvency and the continuation of the activities of a distressed company.

The first step towards this new approach is to substitute the term ‘bankruptcy’ (*fallimento*) with ‘judicial liquidation’ (*liquidazione giudiziale*), in order to erase the negative aspect behind the whole legal framework. As already described, a company liquidation shall be seen as an ordinary phase of a company life-cycle, rather than a way to punish the ones which were managing the corporation in that period.

Together with the new terminology, the Reform substitutes the old bankruptcy procedure with a new one, which is almost equal to the original one; the new procedure must be quicker and must provide more power to the official receiver. Indeed, if in the recent reforms the legislator decided to increase the power of the creditors committee (to the detriment of the bankruptcy judge), the Reform is oriented to increase the importance of the official receiver; in particular, the official receiver will have more power when taking decisions about the company capital structure and will be legitimated to start legal actions towards the company bodies. Moreover, the Reform regulates in detail issues such as the incompatibility of the official receiver between different procedures and establishes a minimum content of the liquidation plan.

To increase the quickness of the procedure, the Reform indicates the possibility of substituting the functions of the creditors committee with telematic consultations in case of less complex procedures; also, the verification of the liabilities phase shall be adjusted in order to be faster. Moreover, to make the procedure more powerful, the clawback action is limited further and the rules on the real estate rights are clarified.

The Reform changes also the composition with creditors; in particular, this procedure is seen by the legislator as the most important one, replacing the bankruptcy institution that has been used the most so far. The legislator, indeed, wants to align perfectly the procedure to the new approach eliminating the possibility of performing a composition with creditors characterized by the

¹⁰³ In particular, the Reform is inspired to the American (in particular the Chapter 11 of the American insolvency law), British and German (particularly the rules about the unification of the insolvency procedures) law.

liquidation of the assets. Thus, the only way to use this procedure is the composition with creditors with continuation of the company operations (*concordato preventivo con continuità aziendale*)¹⁰⁴.

As for the procedure, the Reform adds that during the alert procedure (see below in this paragraph) the initiative is only on the debtor; by contrast, after the alert procedure, the Reform provides for the possibility of proposing a plan related to the composition with creditors with continuation of the company operations also to a third party. Finally, the Reform provides for various small general changes in order to decrease the uncertainty related to issues such as the debtor protection, the analysis of the feasibility and reliability of the plan, the pending contracts and the financing occurred during the procedure.

The Reform provides also for new incentives for the out-of-court procedures. Also in this case, the aim is to support the procedures focused on continuing the company activities through two classes of ways: internal strategic plans and external agreements with creditors. In particular, it is important to offer the highest freedom possible when preparing the plan, that on one side must be made in favor of the creditors but on the other side must offer protection to the debtor¹⁰⁵.

In order to incentivize those procedures, the Reform provides for an extension of the *accordo di ristrutturazione con intermediari finanziari* and the *convenzione di moratoria* also to the other types of creditors (and not only the financial creditors); moreover, for the agreements for the debt restructuring the Reform wants to reduce or eliminate the threshold of 60% of the total credits for approving the plan¹⁰⁶.

Finally, for the certificate plan procedure the Reform wants to set the written form as mandatory, in order to solve partially the problems described earlier in this chapter.

Another innovation provided by the Reform is the higher specialization of the judges. The Rordorf Commission analyzed clearly the lack of quality and competence of the judges in certain Italian courts; accordingly, the Reform establishes that the biggest procedures are transferred to

¹⁰⁴ However, it is still possible to have compositions with creditors with the liquidation of the assets only if there is one or more third parties which confers cash or assets such that the creditors will be satisfied better than in the bankruptcy case.

¹⁰⁵ In particular, it is important that:

- the debtor is protected from the clawback action during the bankruptcy procedure started after the out-of-court agreement has failed;
- the debtor is protected from the legal activities on the assets performed by third parties during the out-of-court procedure.

¹⁰⁶ Only if the debtor does not ask for a delay for the payment of the out-of-the-agreement creditors and does not ask for the protection of its assets.

the Business Courts (*Tribunali delle Imprese*), the over-indebtedness procedures to the local courts as before and the remaining procedures to a reduced number of well-organized courts.

Furthermore, the Reform introduces a clear separation of the definitions of ‘crisis’ and ‘insolvency’, following a very similar approach than the one presented in the previous chapter of this paper¹⁰⁷. Furthermore, the Reform provides for a unique procedure for verifying the crisis or insolvency status, valid for all the corporations except the public entities; once the status has been clarified, it is possible to select the most appropriate legal tool (i.e. liquidation or continuation of the company operations). However, it is important to specify that the Reform institutes that the priority must be done to the procedure which supports the continuation of the company operations¹⁰⁸.

Linked with the separation of the definitions of crisis and insolvency is an important innovation provided by the Reform, i.e. the *alert procedure*. The procedure is aimed at anticipating the crisis appearance through a rapid analysis of the reasons for distress; once this analysis has been performed, the procedure to exit from the crisis follows. The alert procedure could start on the initiative of different parties and under different reasons:

- *internal alert*: an internal company body (or the company auditor) finds that the company is in distress and opens the procedure. For this purpose, the legislator suggests that it is important for a company to have a qualitative level of corporate governance such that the organization is able to detect every early sign of distress¹⁰⁹. Thus, in this case the ground for the opening of the procedure is the discovery of a distress scenario and the communication of it to the specific agency¹¹⁰;
- *external alert*: the so called ‘qualified creditors’ – i.e. the Agenzia delle Entrate, social security Offices (*Enti previdenziali*) and collection agents – are obliged to signal the continuous non-payments related to the company to the specific agency¹¹¹. Differently

¹⁰⁷ The crisis should be defined as a “probability of being insolvent in the future” (Cherubini, 2017), introducing a basic separation of the distress period, as seen in the various models presented in the previous chapter.

¹⁰⁸ In practice, the first step is to verify whether there is the possibility of recovering the debtor performance; if – and only if – the conclusion is negative, it is possible to focus on the liquidation.

¹⁰⁹ In this sense, the legislator establishes an obligation for the mentioned bodies to communicate as soon as possible to the managers the distress scenario discovered.

¹¹⁰ An alternative is the internal solution of the crisis – i.e. without the help of the specific agency –, through the communication to the manager of the distress and the implementation by the latter of the proper strategy to eliminate the insolvency threat.

¹¹¹ The choice to involve in the procedure the specific agency instead of a judicial body is aimed at eliminating the fear that the procedure will end directly in a bankruptcy procedure in case things go wrong.

than the first case, the ground for the inception of the procedure is the signal of continuous non-fulfillments.

The Reform provides also for the protection of the company, stating that the debtor can ask to the judge for protective measures on its assets until the out-of-court agreement is executed; moreover, the Reform institutes rewards in favor of the debtor if it uses the alert procedure.

Finally, the Reform provides for other material changes:

- new rules about the *prededucibili* claims: the aim is to reduce the huge increase of the claims classified as *prededucibili* occurred during the past reforms;
- a specific regulation related to the companies, since the current Legge Fallimentare text treats the debtor as an individual and uses the *analogia legis* technique to use those rules for the companies owned and managed by more individuals;
- the possibility of an automatic bankruptcy discharge (*esdebitazione*) in case of small insolvencies; in this case, the discharge would be given without passing from the court;
- the introduction of new types of guarantees, in particular a guarantee which does not require the possession of the asset as a requisite. In this way, it would be possible for the debtor to offer as collateral its assets and at the same time to use them in order to continue the operations. Moreover, the new guarantees may include also future assets, such as the result of a research or the future inventory;
- to include new rules about the groups of companies, together with a definition: indeed, currently the Legge Fallimentare does not include any definition nor procedures for the companies which are part of a group, or for a holding company¹¹². In particular, the Reform provides for the possibility to create a unique filing (or the creation of one plan for each company but linked each other) for both the composition with creditors and the agreement for debt restructuring in case of a group of companies. However, at the same time it is important to keep separated the different assets, since usually the creditors are related only to one company of the group. As for the procedure, the Reforms specifies that for a procedure regarding a group of companies only one court and one official receiver

¹¹² The Gruppo Baglietto case is emblematic to show the huge effects that the lack of a regulation for groups insolvency procedures can get. In that recent case, the Cassation court contested the legality of the plan simply because of this legal lack. For more details, see Menchinelli (2016).

must be appointed¹¹³, while there is the possibility to perform intercompany transactions if aimed at continuing the operations of one of the companies of the group.

¹¹³ Differently, of course, there is one creditors committee for each company of the group. When voting for the bankruptcy buy-out proposal, the vote is separated accordingly, and the companies which are also creditors of another company of the same group cannot vote.

Chapter 3: The continuation of the distressed company operations

Once the “legal field” has been described properly, in this chapter the focus will be shifted towards the procedures which permit to recover the company performance, avoiding every idea of liquidating the company assets. It is important to precise the fact that the tools which support the continuation of the company operations can be either in-court procedures or out-of-court ones. In particular, the attention will be addressed to three procedures already described in the last chapter:

- the agreements for debt restructuring;
- the certificate plan;
- the composition with creditors with continuation of the company operations.

The aim of the chapter is to describe in detail the way in which a debtor shall select the proper legal tool, the best practices and the main players for each procedure and the different interests of the main stakeholders about the plan.

3.1 The plan

The main aspect which associates all the legal tools aforementioned is the fact that a plan must be presented. The plan must be provided by the debtor, which usually is supported by the advisors, i.e. an advisory company expert in the preparation of plans aimed at recovering the debtor performance. However, regardless of whether the advisors have been appointed, the responsibility on the content of the plan is solely on the debtor.

The law does not provide a determined content of the plan, since the willingness of the legislator is to give freedom to the debtor when deciding which items the plan should include. However, the activities included in the plan shall be enough precise to be determinable, in order to take advantage of the benefits guaranteed by the law¹¹⁴ (such as the classification of the financing

¹¹⁴ On the other side, it would not be optimal to include all the details about all the operations related to the plan. In other words, when preparing the plan, the debtor should find the right balance between the necessity to disclose the activities in order to take advantage from the benefits provided by the law and the need to prepare a concise plan that communicates to the stakeholders the main elements delivering the right message.

performed in execution of the plan as *prededucibili* claim and the ban of the clawback action for the acts performed in execution of the plan in case of a subsequent bankruptcy procedure).

Thus, when deciding what the plan should include, there is a sort of best practice that the advisors or the entrepreneur follow. If on one side – as it seems obvious also for a competitive advantage point of view –, each advisory company has its own way to prepare a plan, on the other side some Italian think-tanks or associations has tried to create some guidelines in order to help those entrepreneurs who have not idea about how to create such a plan to create it in a credible way. As the years go by, thanks to those guidelines the strengthening of this procedure will create an increasingly higher level of standardization of the plans, providing more clarity of their content.

A first attempt has been provided from the Italian Ordine dei Dottori Commercialisti e degli Esperti Contabili (2010), relative to the certificate plan procedure only. First of all, the committee specifies that the plan shall include the economic, operative and financial outlook of the company, in order to deal with the crisis properly and to find the right strategy to recover the performance. Secondly, from a structural point of view, they suggest a scheme which lists all the main sections that the plan shall have:

- *analysis of the reasons for distress*: before making the plan, it is crucial to understand the reasons why the company is in distress. Thus, for the reader of the plan it is important to have a clear starting point when observing the strategy planned by the company;
- *description of the strategy selected in order to recover the performance and related timeline*: it is important to include into the plan the main strongholds of the turnaround strategy and the main operations to implement in order to improve the company performance. Usually this part of the plan is called ‘industrial plan’, since it comprehends the operative actions to perform, without projecting the operations mentioned with the financial data. Usually the industrial plan is divided into:
 - a component aimed at stabilizing the current critical situation: for example, in this phase there could be some cost cutting just in order to ‘put pressure on the wound’ and preserve the company before the new strategy starts to take its effects;
 - a part addressed at realizing the strategy planned to recover the company performance: this is the key element of the industrial plan, where it is clearer to understand whether the company could really return to a healthy status;

- a third section which includes all the provisions related to the going concern trend of the company when the effects of the plan will be completed;
- *extraordinary operations necessary for achieving the goals included in the plan*: it is important to recall that the company which is preparing the plan is in troubles, thus it could be necessary to undertake some extraordinary measures. Those actions can be very different, and may include assets disposals, standstill agreements, debt-equity swaps, debt write offs, equity injections and new financings;
- *forecasted income statement*: this section shall include the projection in terms of economic data of what planned in the industrial plan and in the extraordinary operations section;
- *forecasted balance sheet*: similarly to the previous point, all the financial effects of what has been included in the industrial plan and in the extraordinary operations section shall be comprised. In particular, it is important to forecast the effects of the strategy on the cash position as soon as the main operations will be performed;
- *scenario analysis*: it is important that the plan shows flexibility and resiliency in case something goes against what planned at the beginning. For this purpose, the plan should include a ‘what-if’ analysis which examines what could be the results in case of better or worse scenarios, such as a material increase of the raw materials cost or an aggressive competition from new entrants;
- *governance changes*: as precised in the first chapter, in most cases the main reason which have led a company to a distress scenario is bad management. Thus, it may be helpful a change of the management, at least partially. Moreover, in case of an equity injection from an external agent as extraordinary operation, the latter may ask for a seat on the management board. Finally, especially for big companies it is important to include into the plan the way in which it deals with the minorities.

Similarly, Rutigliano (2010)¹¹⁵ tries to standardize the plans related to both the certificate plan procedure and the agreements for debt restructuring one. Following his approach, first of all the plan must be created adopting the most used guidelines about the creation of the business plan¹¹⁶.

¹¹⁵ In particular, inside the document the referred article is titled “*I piani industriali e finanziari nelle crisi di impresa: casi ed esperienze*”, written by Penna L.

¹¹⁶ In Italy, the most common guidelines are provided by Borsa Italiana (2003). In short, a strategic plan shall be composed by five components:

Accordingly, the plan shall include:

- the company profile, i.e. a general description of the corporation value proposition, competitive advantage and main operations;
- the definition of the company market and competitive positioning;
- the analysis of the past economic data and an examination of the reasons for distress: in particular, it is important to analyse the distress stage, in order to select the right strategy;
- the industrial plan, which includes the strategy planned to recover the company operations, the operative plan and the change in the management;
- the financial plan.

At this point, it is important to note that this list is similar to the one provided by the Ordine dei Dottori Commercialisti e degli Esperti Contabili (2010), under certain aspects; furthermore, the two lists are complementary in the elements which diverge.

Moreover, the same document provides some recommendations, which – again – are perfectly in line and complementary with the former list. In particular, the starting data must be examined by an independent expert, the assumptions shall be explained clearly and shall be realistic and the activities in execution of the plan shall be detailed; moreover, the plan shall include scenario and sensitivity analyses, automatic adjustments and some milestones which will act as a monitoring instrument.

A very similar point of view has been provided by AIDEA et al. (2014)¹¹⁷ and CNDCEC et al. (2015)¹¹⁸, confirming the fact that currently a standardization process about the production of a restructuring plan is ongoing¹¹⁹.

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- *strategy pursued*: the analysis of the starting point and the acknowledgement of the need for a strategic renewal;
 - *strategic aims*: the strategic choices decided by the management about the value proposition and the positioning;
 - *action plan*: the actions undertaken in order to reduce the gap between the strategy pursued and the strategic aims;
 - *assumptions*: the quantitative measures that give the possibility to formulate the forecasts, related to the key value drivers of the company;
 - *forecast financial data*: the projected financial statements based on the new strategy.

¹¹⁷ The paper lists the following sections: i) company presentation; ii) analysis of the past economic and financial data; iii) description of the crisis situation and the reasons for distress; iv) presentation of the assumptions and the strategy for recovering the company performance; v) action plan; vi) industry analysis; vii) competitors analysis and expected evolution of the performance and the market; viii) presentation of the economic and financial assumptions and the projected financial statements.

¹¹⁸ As in the case of Rutigliano (2010), firstly the document refers on the most used procedures to prepare a business plan, underlining the fact that it is important to identify the reasons for distress and the liquidity position. Then, it includes some recommendations which regards the introduction inside the plan of: i) the assumptions, the data

In order to provide a further element toward the standardization of the plans, Trentini (2016) provides, from a legal perspective, a general classification which can serve to give a first idea about the plan to prepare.

Under his viewpoint, the plan can be divided in:

- plans which include an *agreement between the parties*;
- *unilateral plans*, where there are not any negotiations among the parties. These ones can be divided further in:
 - disposal plans;
 - managerial or corporate reorganization plans;
 - plans which include a unilateral modification of the capital structure (for example, an equity injection or equity cure on the existing shareholders' initiative).

However, in qualitative terms the content of the plan changes also considering the type of legal tool selected by the debtor. Indeed, the purposes of each instrument are slightly different each other. Under certain aspects, this is valid also for a quantitative aspect: for example, one of the most important differences between certificate plan and agreements for debt restructuring is that the creditors which do not have agreed to the terms of the plan must be satisfied fully under the agreements for debt restructuring procedure; thus, to be considered as sustainable, the plan must not only consider the cash position looking at the sustainability of the debt service and the limitations existent because of the covenants, but also must consider the fact that there will be another “fix cash outflows” to consider, i.e. the payment of the creditors which have not accepted the plan. Accordingly, it is important that the debtor finds the right legal instrument among the ones provided by the law.

Finally, the content of a plan depends also on the objective of the debtor; a first distinction is between plans which have a liquidation element (also partially) and the ones aimed at continuing the company operations. In this case, not only the actions included in the plan are different, but also the data and forecasts are different, *ceteris paribus*: for example, the accounting for an asset for which a disposal is going to be planned is completely different than the value of the same asset in case of the application of the going concern assumption.

sources and the methodologies used to formulate such assumptions; ii) the length of the timeline, which usually cannot be longer than 5 years; iii) sensitivity analyses; iv) milestones.

¹¹⁹ Another more recent evidence can be found in CNDCEC (2017).

3.2 Which legal tool to select?

When trying to recover a distressed company performance, before preparing the plan it is important that the management (or the advisors) selects the right legal tool among the three aforementioned – i.e. the agreements for debt restructuring, the certificate plan and the composition with creditors with continuation of the company operations. Indeed, the three instruments are different under various aspects, even though it may seem, at a first glance, that an entrepreneur can be indifferent among them.

In reality, not only each instrument has its own degree of in-court involvement, but also the purposes are slightly different. As for the in-court involvement, as already described in the last chapter, the certificate plan does not require the intervention of a judicial player, while the composition with creditors is an instrument which needs the creation of some judicial actors in order to perform the procedure required by the law; in the middle there is the agreements for debt restructuring procedure, where the intervention of a court is minimum (i.e. required only for the homologation of the agreements). Regarding the different purposes, Rutigliano (2010) assumes that the certificate plan and the agreements for debt restructuring have the same purpose (i.e. the return to a positive and stable performance) but are used in different stages of the crisis¹²⁰; moreover, according to the most relevant doctrine, the certificate plan and the agreements for debt restructuring are aimed at solving the crisis (i.e. without being bound to the necessity to assure the going concern of the company), while the composition with creditors with continuation of the company operations seems more linked to reach an agreement about the complete recovery of the performance.

Moreover, each legal tool has its own rules. For example, it is possible to obtain a financing before the completion of the plan only for the composition with creditors and the agreements for debt restructuring. Generally, the dispositions related to each legal instrument cannot be used for the other ones applying the *analogia legis* technique, since they have an exceptional nature. Accordingly, it is useful to compare the main differences between the three instruments, in particular between the certificate plan and the agreements for debt restructuring and between the agreements and the composition with creditors.

¹²⁰ In particular, the certificate plan shall be used when the distress is at an early stage (i.e. less serious), while the agreements for debt restructuring shall be adopted when the distress is more advanced. However, the doctrine does not completely agree with this view; in reality, even a single non-complex operation such as the disposal of non-core assets can represent a way for rebalancing the financial situation (Trentini, 2016), so that even a certificate plan may be appropriate for a company in a serious crisis scenario.

Before making the comparisons aforementioned, it is important to mention a further way when listing all the tools available when looking for the continuation of the distressed company operations, i.e. the bankruptcy buy-out. Indeed, it is possible to create a buyout which can provide for the continuation of the activities after a bankruptcy declaration has been accepted by the court. Under certain cases, it could be convenient (also for some players only) the selection of this tool, due the special characteristics of it as seen in the previous chapter.

3.2.1 Certificate plan versus Agreements for debt restructuring

As precised before, it is very difficult to find differences about the purpose of the two procedures; it is not surprising that the orientation of the doctrine is not very clear. The fact that the content of the plan is (not) regulated in the same way proves that in terms of purpose if there is a difference, it is not material¹²¹. Trentini (2016) says that while the agreements for debt restructuring are aimed at restructuring the company, the certificate plan is oriented at solving the crisis; however, it is not clear which is the real difference among the two, in particular because the going concern condition is not required by the law in both the cases. Therefore, the main reason why a manager should prefer a tool instead of the another one is related to the different rules which regard them. Among the numerous differences provided by the law, the main ones about the two tools are:

- the agreements for debt restructuring have a negotiation element, while the certificate plan is a unilateral document. In particular, to go on with the agreements for debt restructuring procedure it is necessary to have the consent of creditors which represent at least the 60% of the total liabilities; on the contrary, for the certificate plan it is necessary the certification of the attestor;
- the certificate plan procedure does not have a judicial intervention, while for the agreements for debt restructuring one it is necessary the homologation provided by the court¹²²;

¹²¹ Moreover, as analyzed above in this chapter, the main guidelines published during the last decade tend to describe the content of a plan without making any reference to a single legal procedure.

¹²² To be more precise, the certificate plan enters a court only in case of a bankruptcy procedure following a failed attempt to solve the distress situation through a certificate plan. In that case, the plan is examined by the court in order to detect the activities performed in execution of the plan, which will have the exemption from the clawback action.

- under the agreements for debt restructuring procedure, the exemption from the clawback action takes its effects automatically from the homologation date; in the certificate plan case, it is necessary the consent of the court under a bankruptcy procedure;
- it is not mandatory to publish the certificate plan. It is on discretion of the debtor, which usually keeps it secret in order to not disclose clearly the distressed condition¹²³;
- under the agreements for debt restructuring procedure it is possible to get financing either before or after the homologation of the plan. Those financings will be labeled as “*prededucibili* claims” in case of bankruptcy procedure. For the certificate plan, it is not possible to do so;
- the agreements for debt restructuring procedure provides for the full payment for the dissenting creditors; this rule cannot be applied for the certificate plan;
- under the certificate plan procedure, it is not possible to protect the debtor assets from the actions undertaken by the creditors, while the agreements for debt restructuring tool provides for it also during the negotiations about the plan.

3.2.2 *Agreements for debt restructuring versus Composition with creditors with continuation of the company operations*

If the main differences between certificate plan and composition with creditors can be roughly assimilated to the one listed in the last paragraph, the issue is dissimilar when differentiating the agreements for debt restructuring and the composition with creditors. The main differences are the following:

- the composition with creditors is an in-court procedure, where the presence of the judicial bodies is pervasive;
- under the agreements for debt restructuring procedure it is possible to not respect the *par condicio creditorum* rule, since there is the possibility to treat the unsecured creditors better than the secured ones; under the composition with creditors, the *par condicio* must be satisfied;

¹²³ The only advantage from the publication of the certificate plan is that it is possible to avoid paying taxes on the windfull profits (*sopravvenienze attive*) ex art. 88 TUIR.

- with the agreements for debt restructuring procedure the consent of the creditors must be obtained before the deposit of the plan subject to the homologation, while the composition with creditors permits to negotiate with the creditors after the presentation of the demand;
- if the court does not homologate the agreements for debt restructuring, it is not possible to declare bankruptcy immediately after, while it is possible for the composition with creditors;
- the agreements for debt restructuring procedure is cheaper, quicker and less complex than the composition with creditors one;
- differently than the composition with creditors case, with the agreements for debt restructuring procedure the entrepreneur preserves the administration of its assets.

Under this issue, it is important to precise two common behaviors observed from the recent experience. Firstly, the fact that usually the composition with creditors is used after a certificate plan or agreement for debt restructuring has failed. Secondly, sometimes it may happen that a debtor decides to pass from an ongoing composition with creditors procedure to the agreements for debt restructuring on, or *vice versa*.

3.2.3 Selecting the proper tool: the main drivers

From this analysis, it seems very clear that the selection of the correct legal tool is a critical part of the whole restructuring process. In this sense, it is important to know which are the main drivers that the manager should control when performing this selection.

Following CNDCEC (2015), the main drivers are the following¹²⁴:

- *the need of short-term liquidity*: in this circumstance, the distressed company has a serious cash scenario, for example because the deadline of a huge term loan is incoming or the relationships with the suppliers is in a deterioration status. If this is the case, the company will need a new financing during the negotiation of the plan or directly in execution of the completed plan. It seems obvious that the best solution in such a situation would be to

¹²⁴ Obviously, to make an exhaustive list is an impossible work, since the dispositions about the three legal instruments are very detailed, and sometimes the technicalities are so complex that the only way to arrive at a solution is by being inside the practical case.

select the agreement for debt restructuring or the composition with creditors procedure, since they give the possibility to obtain a financing under the protection of the law;

- *the number and the characteristics of the creditors*: if, when negotiating a plan, a distressed corporation has to deal with a high number of different creditors, to reach the 60% threshold required by the agreements for debt restructuring procedure seems very difficult; potentially the management (or the advisors) should employ a lot of time for contacting each creditor looking for obtaining a positive reply for the plan. On the other side, a composition with creditors is a more structured procedure which increases the probability of success. Moreover, it depends on the characteristics of the creditors: as described in the previous chapter, there exist a procedure – inside the family of the agreements for debt restructuring – called *accordo di ristrutturazione con intermediari finanziari* which is tailor-made for the companies whose debt is mainly composed by financial debt (i.e. a debt contracted with financial institutions). In this case, the distress company has the possibility (but not the obligation) to select that procedure;
- *the risk to not succeed in the medium-long term*: if the going concern assumption is not feasible, to use a legal tool addressed at continuing the company operations would not be the best solution. Thus, for example, to select the composition with creditors with continuation of the company operations instrument would be a mistake. However, it is possible to use the other two tools, since they are not aimed directly at continuing the company operations; in alternative, there is the possibility to use the other in-court procedures (i.e. composition with creditors¹²⁵ and bankruptcy);
- *the risk to be subject to actions addressed at diminishing the debtor assets*: if there is a high probability that the creditors will behave in an aggressive way, it would be preferable to use a legal procedure which protects the debtor assets from the beginning of the process. Thus, to select the certificate plan tool would be a mistake, since it does not provide any judicial protection of the assets. Differently, the other two procedures offer this benefit also before the homologation or presentation of the plan;
- *the risk of alteration of the par condicio creditorum rule*: if, for some reasons, there is the need to overcome the *par condicio* rule, the debtor should avoid the composition with creditors procedure, for the reasons explained in the last paragraph. For example, a

¹²⁵ It is important to recall that one of the new Reform's aims is to eliminate (or minimize) the composition with creditors aimed at liquidating the company.

company may prefer to preserve one particular creditor by promising to it the full payment. However, in case of agreements for debt restructuring the plan must reach the 60% threshold while the certificate plan must be certified, so the proposal shall be convenient also for the damaged creditors;

- *the severity of the crisis*: part of the doctrine believes that some tools are more addressed for situations where the crisis is not serious (in particular the certificate plan), while on the other side other procedures such as the composition with creditors have been created for dealing with the recovering of the performance of a company in an advanced stage of distress. In reality, a serious scenario could be solved simply by taking a few simple measures, so this theory seems not valid (Trentini, 2016);
- *the willingness to pay in full the creditors that do not approve the plan*: if a distressed company prefers to negotiate with all the creditors – instead of giving to the ones which disagree with the plan the benefit to get paid in full –, it should avoid the agreements for debt restructuring instrument. In particular, it may prefer the composition with creditors in order to have the possibility to enjoy the institute of the discharge (*esdebitazione*);
- *the existence of huge losses which could undermine the legal equity level*: if the risk to have material losses – such that the level of the capital will be lower than the minimum level required by the Italian civil code – is high, the manager should select the agreements for debt restructuring tool since it suspends the effects of the Italian civil code rules¹²⁶ on the obligation for the management to restore immediately the level required (*art. 182sexies l.f.*).

3.3 The actors of the procedures

In the procedure participate various actors, which have different roles and interests. This section will provide an analysis of all the actors which can participate a process aimed at continuing the company operation. Some of those actors are mandatory (automatically or because the law provides for it) while others are optional. For the purposes of this section, the actors are divided in two parts:

¹²⁶ The art. 2447 of the Italian civil code establishes that if the legal capital decreases at a level below the minimum level required by the law, the management must call immediately a meeting in order to approve the legal capital reduction and, at the same time, to increase the legal capital itself in order to restore the minimum level required.

- *players*, which enter the procedure only after the distress period has started;
- *stakeholders*, which are already in a relationship with the company when it becomes distressed.

3.3.1 The main players of the procedures

Apart from the judicial bodies already discussed in the last chapter (in particular the composition with creditors ones since the other two tools do not have judicial bodies appointed by the court), in the three procedures other players participate: some of them are mandatory since they are part of the procedure described by the law, while others are discretionary. In general, all those players are experts in the restructuring field that help the debtor (or the other parties interested in the turnaround process) in managing the procedure and certifying that it has been made properly. The role of those players is similar for all the three procedures; thus, they will be treated generally since it is out of the purposes of this paper to focus on their differences among the procedures.

3.3.1.1 The advisors

As already precised, when preparing a plan with the characteristics abovementioned, the debtor (i.e. the single entrepreneur or the board of administration) can be assisted by the advisors. The advisors are not mentioned by the law, proving the fact that it is not a mandatory player for the procedure. In most cases, the advisors are one or more advisory companies or an individual expert in the restructuring field which is external from the distressed company and has advanced competences and an important experience in dealing with distressed companies, so that its activity is considered unbiased and reliable. Officially, the advisors are appointed by the debtor, but in practice it is necessary the consent of the creditors since it is important that also the latter are willing to deal with the advisory companies that they consider appropriate¹²⁷; thus, the selection of the advisors is an activity performed in concert by both the debtor and the

¹²⁷ This ‘negotiation’ for the right advisor could be seen as a sort of protection against the preparation of bad plans, which will never be approved by the court or certified by the attestor. Thus, it is a kind of mechanism of quality control of the procedure.

creditors¹²⁸. The main risk in this case is to appoint some advisors which have, also unintentionally, a point of view oriented towards one of the stakeholders of the procedure; for example, the advisors may support the financial creditors viewpoint. In that case, the outcome of the negotiation can be unbalanced, threatening the quality of the whole operation.

As for the activity performed, the advisors collaborate and accompanies the debtor throughout the whole procedure in the creation of the plan and the fulfillment of all the operations for complying with the procedure.

One of the first activities that the advisors shall perform is to analyze the suitability of the current management in dealing with the crisis scenario (Pellerone, 2014). Indeed – as already analyzed in the first chapter –, the management ability under a normal scenario has nothing to do with its ability in case of a distress situation; in the last case, the managers act under pressure since there is the need to undertake drastic and extraordinary decisions. In other words, the management of a distressed company under a complex environment – where there are different stakeholders with different purposes – is a completely different task than handling a firm under a normal scenario. A manager should be able to take the right decision in a restricted period of time, without any margin of error. Accordingly, it is important that the advisors observe whether the current management has the right competencies and self-control to deal with the crisis properly.

Secondly, the advisors shall – together with the debtor – prepare the plan, with the content explained earlier in this chapter. In particular, the advisors shall focus on the determination of the reasons for distress and the strategy to be performed to recover the debtor performance. Regarding the first aspect, the advisors shall not only understand the drivers of the distress, but also to be sure that the current management has understood them properly; if this is not the case, there would be the risk that the managers are not the right ones to participate in the turnaround process.

Generally, it is possible to identify two main functions that the advisors give to the procedure. On one side, they provide a high-quality technical contribute, by managing the emergence daily until the completion of the procedure; on the other side, they help to coordinate the objectives of all

¹²⁸ However, also the other parties interested in the turnaround process can appoint, on its own initiative, an advisor which controls for them the plan and the procedure. Thus, it could happen that other advisors are involved in the procedure beyond the main one. The issue is important if we think that, in some cases, all the advisors appointed by the stakeholders of the plan are paid by the debtor.

the stakeholders of the procedure towards the achievement of an agreement that does not hurt anyone (or minimizes the losses for all of them).

Finally, it is possible to distinguish between four types of advisors (Pellerone, 2014):

- *industrial advisors*: its main scope is to prepare the industrial plan. Thus, it is expert on all the issues related with the creation of a business plan, such as market analysis, industry analysis, study of the reasons for distress and creation of the assumptions related to the strategy to implement;
- *financial advisors*: it is specialized in controlling the performance of the cash position both during the plan execution and after the plan under a going concern analysis. Its main goal is to adjust the capital structure in order to ease the successful implementation of the turnaround strategy. The financial advisors are crucial in case of a company whose distress is linked with a serious difficulty in collecting enough cash in order to support the operations;
- *legal advisors*: this type of advisors is expert in preparing the documentation required for the legal tool selected and in dealing with the procedure itself from a legal point of view;
- *fiscal advisors*: its main aim is to deal with the fiscal law, for example by signaling to the debtor – in case of certificate plan – the possibility to save money in terms of less taxes in case of publication of the plan.

3.3.1.2 *The distress investor (brief introduction)*

The distress investor is a company (usually a fund) which invests in distressed companies. The aim of the distress investor is to maximize its return by investing – using its broad knowledge in the business, financial and legal field – in distressed companies: the aim of its strategy can be either speculative or strategic, depending on the purposes of the fund and the opportunity it is going to face.

When entering a procedure aimed at continuing the distressed company operations, the distress investor may purchase the distressed company debt, its assets or directly the equity. The way in which it enters affects also its possibility to obtain the control of the distressed company. Accordingly, the distress fund must combine its purposes with the strategy to implement.

Moreover, the strategy to implement depends also on the practical case and the opportunities which are available.

This player, its main strategies and the procedure it performs in order to implement its strategy will be described in detail in the next Chapter.

3.3.1.3 *The attestor*

The attestor is a qualified expert¹²⁹, in possession of the requisites demanded by the law, whose aim is to guarantee to the stakeholders of the turnaround process (in particular the ones which do not take part of the agreement) that the plan and the procedure is valid on its content and feasible. The role of the attestor is so important that his presence is included for all the three procedures part of this chapter¹³⁰, with slightly different roles but very similar. As happens for the advisors, the appointment of the attestor is a responsibility of the debtor.

The requisites to be an attestor are described in detail by the law. Indeed, the *art. 67, third clause, letter d)* precises that to be attestor it is important to be:

- registered in the register of auditors;
- to have the requisites to be official receiver, namely:
 - to be a lawyer or an accountant;
 - to be a professional association, only if the partners are lawyers or accountants;
 - every person who has been a manager and has demonstrated high managerial competencies in the past.

Moreover, the attestor must be independent. In particular, it must declare to not be connected with the debtor or the other stakeholders from both professional and personal connections and not to have worked for the debtor company in the last five years. However, the attestor can participate in the meetings with the debtor and the advisors where they prepare the plan, in order to serve as an ‘advisor’ and explain the methodologies they have to adopt in order to achieve a positive opinion; obviously, the attestor cannot participate in the preparation of the plan. The

¹²⁹ It can be either an individual or a professional association.

¹³⁰ Apart from those three procedures, an attestor can also make some ‘special’ attestations, namely: i) the attestation related to the financings during the negotiation and before the homologation in case of agreements for debt restructuring tool; ii) the attestation for the payments of some creditors before the homologation of the agreements for debt restructuring; iii) the attestation required for the continuation of the public contracts and the participation to the public tenders.

participation of the attestor during the meetings aforementioned is important because it creates a positive contrast with the optimistic point of view of the advisors.

From a practical perspective, the aim of the attestor is to analyze the plan subject to attestation; obviously, the attestor objective cannot be linked with the attestation itself, since not necessarily the activity of the attestor finishes with the attestation of the plan (AIDEA et al., 2014). Indeed, the attestor could also give a negative opinion about the plan.

However, the main document which entails the attestor activity is the report which explains the way in which the attestor have formed an opinion about the plan and the opinion itself. The report does not have to repeat the content of the plan but has to certify, explaining the reasons, that the plan is able to restore the company performance, achieving the objectives of the legal tool selected.

The content of the report must follow two main drivers:

- *reliability*: the attestor must perform an analysis of the data provided by the debtor to see whether they represent a fair portrayal of the reality. Such verification is important because the data provided by the debtor are the starting point of the plan; if those data are wrong (or voluntarily modified with fraudulent purposes), the whole plan cannot have any sense¹³¹. Indeed, it would not have any sense to guarantee the ban of the clawback action in case of bankruptcy procedure if the data which originates the benefit are not fair. To perform this analysis, the attestor shall use the common tools adopted by an auditor and suggested by the most common guidelines¹³² (i.e. test of controls, test of details and substantive analytical procedures, dividing the total risk of material misstatements into inherent risk, control risk and detection risk); however, an attestor is not an auditor, in the sense that it does not have to perform its work as an auditor. Moreover, the high risky scenario makes impossible for the attestor to achieve a reasonable assurance about the data included in the plan;
- *feasibility*: this judgement consists in a predictive analysis about the viability of the expected results presented in the plan at the moment of the release of the attestor's report. In order to get such analysis, the attestor shall have gained a global vision of

¹³¹ In particular, if the attestor concludes affirming that the data are not reliable, also the feasibility analysis will have a negative opinion.

¹³² The most used European guidelines are the ISAE (International Standards on Assurance Engagements), prepared by the IAASB (International Auditing and Assurance Standards Board).

the whole company, including the assumptions, the turnaround strategy, the action plan and the what-if analyses. Moreover, the attestor shall be extremely convinced that the probability to realize what included in the plan is materially high. The analysis should not be based only on the content of the plan, but also on the coherence of all the assumptions and on the conclusions reached by the management. As for the verification of the assumptions, the attestor shall use the IAASB (2017)¹³³ perspective, which distinguishes forecasts¹³⁴ and projections¹³⁵; thus, the attestor shall examine the feasibility of the assumptions explaining the reasons which support the positive thesis.

Finally, the final report is composed by three components:

- i. introduction and description of the review performed to verify the data provided by the debtor;
- ii. analysis of the plan;
- iii. feasibility opinion.

If the feasibility of the plan depends on future events within a defined period of time, the certification is valid from the beginning – i.e. the date in which the attestor has completed it – if the attestor gives a high probability to the verification of the events aforementioned. By contrast, if there is more uncertainty on the probability of the verification of the event, the validity of the report is conditioned on the effective realization of the event.

The attestor is not supposed to check the correct execution of the plan, but there is the possibility that it is appointed by the debtor (or other stakeholders) in order to inspect the way in which the provision of the plan is performed.

3.3.1.4 Other players

In a restructuring process can participate other types of experts, such as:

¹³³ In particular the ISAE 3400.

¹³⁴ A “forecast” is related to an event which the management expects will take place at the time of the preparation of the plan. They are referred to the so called “best-estimate assumptions”.

¹³⁵ A ‘projection’ is an assumption prepared on the basis of either hypothetical future events which are not necessarily expected to take place or a mix of best-estimate assumptions and hypothetical assumptions.

- *temporary manager*: it could be defined as an external manager expert in the restructuring field. Its task is to manage temporarily the company either under negative conditions (as distress scenarios) or in positive ones (such as the introduction of a new product). The presence of a temporary manager during a distress situation can be crucial for reinvigorating the credibility of the company strategy, both internally and externally; the appointment of an expert person as the temporary manager can give the necessary management discontinuity crucial to keep involved the core stakeholders of the company. Since it is directly involved in the management of the company, the temporary manager is different than the advisors; however, the two players can cooperate in order to arrive to the best turnaround strategy with a higher probability. Finally, the temporary manager provides also for a negotiation advantage, since it can manage the talks between the main stakeholders of the distressed company;
- *loan agent*: it is an independent agent which acts with both the financial creditors and the debtor; it guarantees a simplification of the procedure by monitoring the way in which the plan is produced, the fulfillments are performed and the periodical reports on the performance of the distressed company during the creation of the plan are produced. Usually this player is appointed by the creditors – in particular from the financial ones – since its activities are aimed at protecting them. However, not only the creditors are advantaged by the presence of the loan agent, but also the debtor is advantaged since it would receive more certainty about the willingness of the financial creditors to maintain the credit lines during this troubled period of time;
- *Chief Restructuring Officer (CRO)*: it is a manager characterized by strong competencies on the restructuring field which takes the responsibility of the implementation of the plan, as happens for a CEO in normal times. Its main activities are related to the creation of the plan, the negotiation of the debt with the creditors, the research for external financing and the management of the turnaround procedure. Its role is very similar to the temporary manager one, with the difference that the CRO may remain inside the company board of management for a longer period;
- *judicial bodies*: in particular for the composition with creditors, the judicial bodies can be relevant for the quality of the procedure¹³⁶.

¹³⁶ For the details about the composition with creditors bodies, see the second chapter of this work.

3.3.2 *The stakeholders of the restructuring procedure*

The preparation of the aforementioned plan is a very complex procedure, since every decision, every action and every other element must be weighted properly in order to balance the interests of all the stakeholders, i.e. every person or entity which is interested, for different reasons, in the content and the execution of the plan. Indeed, one of the main aims of the plan – in the sense that there cannot exist a plan without such precondition – is to obtain the proper consent in order to pursue the strategy selected by the debtor. In other words, since the scenario is critical – and assuming that every alternative (i.e. in-court liquidation procedures) are less convenient –, the debtor on one side must minimize the dissatisfaction of all the stakeholders, while on the other side must equalize their degree of dissatisfaction.

The problem is that the goals of the different stakeholders of the plan are not aligned; in particular, only some objectives are aligned, but the main interests are in conflict. As Lai & Sudarsanam (1997) precise, “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. [...] 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” (Lai & Sudarsanam, 1997).

A further complexity is represented by the fact that it is not possible simply to determine, in absolute terms, the monetary payoffs of each stakeholder in order to balance them and guarantee equality; if a manager acts in this way, it assumes that all the stakeholders are rational and risk neutral. In reality, each stakeholder has its own utility function: some of them are risk-averse while other ones are risk-seeking. For example, let's think about the employees: if the company fails, they risk losing their job; accordingly, they will give a higher weight to their payoff in case of failure of the plan, and mathematically it means that, *ceteris paribus*, their expected utility is far lower than the one of a less risk-averse player, such as a supplier.

Moreover, there is the risk that the debtor (or the advisors which prepare the plan together with the debtor), when preparing the plan, gives preference to one of the stakeholders. In particular, it depends on which stakeholder has more power; in most cases, the risk is that the financial creditors (i.e. banks and other financial institutions) are in the position to appoint some advisors which tend to support them. This possibility can be seen also as a threat which can damage the

environment even though in reality the advisors appointed is fair; as stated by Slatter et al. (2006), “The perception of bias in favour of a particular stakeholder group can become a significant obstacle to the restructuring process”.

Another important aspect is that some stakeholders are more expert in dealing with a distress scenario than others. In particular, the financial institutions deal with companies in trouble very often, while the management itself has never dealt with such a situation before. Thus, there is the risk that who is more expert tries to take advantage of the “economy of experience” it has developed in the past. To solve this problem, the restructuring manager shall bridge the gap between the experience of the financial institutions and the inexperience of the managers.

As a general rule, if there is not an insolvency situation, the probability to have conflict of interests between the stakeholders is low: both the creditors and the shareholders are interested in the continuation of the company operations. By contrast, in case of insolvency, the likelihood of a conflict between them is material, even though there still are some points where all the parties agree. Those conflicts on one side are solved by the law through the establishment of measures such as the *par condicio creditorum* and the clawback action, while on the other side shall be solved by the new management (i.e. temporary manager or CRO).

3.3.2.1 *Financial creditors*

The financial creditors class is the most critical one for a turnaround procedure, since once the crisis has been communicated to the public the main risk is that those agents (in particular the banks) block the credit lines, with the consequence of worsening dramatically the debtor cash position (already dangerous). This class is composed by users such as banks, bondholders and other lenders which have contractual monetary rights towards the debtor; in other words, those creditors have a precise sum of money to receive by a specified date, so under a turnaround process they risk giving up a part of it. Thus, to deal with them is complex, first of all because of the complexity of the standardised contracts they provide (contracts that the financial creditors know well, so there could be an information asymmetry problem), secondly because they could be oriented only to collect the sum under contract, damaging the whole restructuring process. Moreover, nowadays the financial environment is even more complex, since also the medium companies are starting to have a complex capital structure composed by several types of

syndicated loans, high-yield debt and mezzanine finance; on the other side, those types of debt, together with the more traditional bonds, are increasingly traded to others investors whose purposes are so different that it is impossible for the debtor to find their real purposes (some of them are simply speculators, while others could be informed traders).

Obviously, the goal of those agents is to maximise their payoff. It is important to note that not necessarily their objective is to maximize the amount of cash they have the right to receive; a financial institution shall think also on the future contracts it may renounce in the case that the highest sum of money – in absolute terms – is obtained in case of a debtor bankruptcy. In other words, it may happen that a bank selects a solution which guarantees a lower amount of cash today, but in exchange gives the possibility to get more contracts with the “reborn debtor” in the future.

The alternatives that the financial creditors have are multiple:

- *debt write-off*, i.e. the elimination of all or part of the debt in return for the going concern of the company (which in terms of the bank means more contracts in the future);
- *stand still*, i.e. an agreement where the financial institutions promise to the debtor: i) to suspend the request of the debt service for a period of time; ii) to stop using the covenant negotiated in the contract as indicator for a period of time (the so called “covenant holidays”); iii) to guarantee the already existent credit lines;
- *debt consolidation*, i.e. the repayment of a debt through a new debt contract, usually at better conditions for the debtor;
- *new financing*: the debtor can ask to the financial institutions not only the modification of the actual debt conditions, but also the possibility to improve the cash flow through a direct cash injection by the bank itself, in exchange for either a new debt contract or a participation in the company equity. This activity can be very risky for a financial creditor since it would give more cash without guarantees;
- *Debt-Equity swap*: i.e. the transformation of the debt (or part of it) into equity instruments, either normal or with some limitations (as for example shares without voting power or limited voting). It is also possible to assign in exchange of the debt shares of an amount which is more than proportional than the debt written off; this possibility has been provided in order to improve the degree of flexibility during this problematic phase. In

general, the banks do not like to pass from a creditor status to a shareholder one; firstly because of the higher level of intrinsic riskiness, secondly because the banks should have to see a relationship with the debtor from a completely different perspective¹³⁷. Moreover, on average an equity investment in a distressed company offers low returns, while in terms of payoffs the downside is more probable than the upside. When becoming shareholder of a company, the banks shall also plan a way-out, i.e. how to exit from the investment: the two possibilities the most feasible ones are to sell to a third party (maybe a fund) or to sell to the company itself;

- *Debt-Hybrid instruments swap*: it consists in the conversion of the debt (or part of it) into hybrid financial instruments. In Italy there is a financial instrument called SFP (*Strumenti Finanziari Partecipativi*) which is used often¹³⁸: it is a financial instrument which can contain either equity rights (for example, participation at the earnings distribution and right to get some cash in case of liquidation of the debtor) or administrative rights (for example the veto power for extraordinary decisions and the presence in the board of directors¹³⁹). Other hybrid instruments are subordinated bonds (subordinated to the normal bonds in case of bankruptcy) and index-linked bonds (whose performance is linked to some indexes connected to the debtor performance);
- *debt extension*, i.e. the expansion of the payment deadline for a debt;
- *extension of the current amount of debt offered*, i.e. an increase of the debt with or without further guarantees. In the latter case, the financial institutions undertake further risk without anything in exchange; thus, to accept this condition, the bank shall be very confident on the probability of the debtor to recover its performance, as in the case of giving new financing to the debtor.

In this sense, Rutigliano (2010) suggests a decision tree approach. Under this model, first the bank should decide whether to provide new finance (often without obtaining new guarantees but only gaining the *prededucibili* claim label in case of bankruptcy procedure); secondly, the financial institutions shall decide up to whether to convert the debt in equity or quasi-equity

¹³⁷ Moreover, the banks must comply with the Istruzioni di Vigilanza rules. The rules say that the banks can convert its debt in distressed companies' shares, but only if the operation is aimed at recovering the company performance. Moreover, the bank has to compare the Debt/Equity swap outcome with all the possible alternatives, such as a bankruptcy procedure. Thus, the only condition the law provides is that the distress of the company must not be irreversible.

¹³⁸ For example, they are going to be used for the Stefanel restructuring, one of the most famous Italian restructuring cases.

¹³⁹ However, the law provides that it is not possible to vote at the company meetings.

instruments; thirdly it has to deal with all the decisions about the treatment of the existent debt (consolidation, stand still, write off, etc.); and so on. Thus, before deciding the strategy, the financial institutions shall estimate the payoff (usually in terms of expected value) considering the different combinations.

Inside the class, there is the possibility that some conflicts of interest occur. A conflict of interest arises when two parties inside the class (i.e. banks, bondholders and public administration) have different purposes or are damaged while the other parties are fully satisfied¹⁴⁰.

For example, it may happen because the new temporary manager or CRO has been appointed on initiative of the banks; in this case, there is the possibility that the new management undertakes a strategy aimed at satisfying the banks as a first objective. In particular, the plan can impose the payment of the bank debts before all the other ones or the creation of earnings with the sole purpose of paying back the banks debt.

Similarly, if the turnaround manager has been appointed by the bondholders, it may privilege them, for example by using the retained earnings to repay the bonds.

Finally, also the public administration could be preferred in a similar way to the last two cases. In particular, the CRO may privilege the tax debts in respect of the other ones, or it may focus on the creation of earnings in order to create more income taxes.

To solve those problems, usually the financial creditors create a committee, similarly to the bankruptcy case. This committee – which usually includes the trade creditors as well – acts on behalf of all the creditors which take part of it and negotiates with the debtor in order to avoid any conflict of interest.

There could be conflict of interests also between financial creditors and other types of stakeholders. In particular, it is important to analyse in detail the conflict between the financial stakeholders and the shareholders (see Box 3.1).

3.3.2.2 Shareholders

At the distress date, the equity value may be equal to zero, or very close to zero. Thus, the condition of the shareholders must be reintegrated either through new provisions by the existent

¹⁴⁰ It may also happen that the debtor gives preference to one bank only, so there could also be a conflict of interest among banks.

ones or through the intervention of a new external player, such as a distress investor (this player will be discussed in detail in the next chapter).

If, on the contrary, there is not a too low level of equity, the shareholders can negotiate with all the other stakeholders considering their utility function and their payoffs. In general, the shareholders – in particular the dominant ones – prefer the operational restructuring, i.e. the set of strategies aimed at improving the positioning of the company and the internal efficiency; by contrast, they dislike either equity-based strategies such as dividends cuts and new equity issues or assets sales since they “extinguish the option value attached to the assets sold” (Lai & Sudarsanam, 1997).

As for the potential conflicts of interest, from an internal point of view there may be a conflict between the block shareholders and the minority ones. In particular, the lapse of time for the maximization of the earnings can be different, so that to find an agreement among all the shareholders can be almost impossible. Moreover, some shareholders are interested in remaining inside the company, while others would prefer to exit from the investment: also in this case there could be different payoffs.

Potential conflicts of interest with other categories of stakeholders may happen when the turnaround manager has been appointed by the shareholders. In this case, the focus of the turnaround strategy would be on the maximisation of the earnings, strategy which can damage the other stakeholders.

Box 3.1 Conflicts of interest between Financial creditors and Shareholders

Particularly important is to analyse in detail the relationship between the financial creditors (in particular the banks) and the shareholders when negotiating the plan. Indeed, often those two classes of stakeholders have specular objectives; thus, it is important to manage properly the conflicts of interest among them.

In particular, as noted by Lai & Sudarsanam (1997), “Lenders’ preference for cash generative action is in direct conflict with shareholders’ incentive to avoid such action”. For example, a bank may prefer that the debtor decides to sell the non-core assets to repay its debt, while the shareholders would prefer to avoid such measures in order to not lose the option value linked to the asset.

Moreover, a turnaround strategy based on equity injections from the shareholders is a good solution for the banks since the Enterprise Value (and so the probability to cash the debt totally) increases; on the other side, obviously, the shareholders do not like such a strategy since they would have to give money to the company in terms of risk capital. Finally, the financial creditors would like a strategy consistent in dividend cuts because of the higher amount of cash available for repaying their debt.

As for the shareholders preferences, “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” (*Ibidem*). Moreover, the shareholders may prefer high-risk investments

3.3.2.3 Trade creditors

The trade creditors are all those creditors, in general the suppliers, which give the possibility to a firm to create the products and services to sell to the clients. Generally, the suppliers are interested in the continuation of the company operations, since the alternative is to stop being supplier of the (failed) company. Moreover, if a supplier is strongly dependent on the debtor, its interest on the survival of the distressed firm would be even higher; the extreme case is a monopsony situation – as happens for some big corporations’ suppliers – where in case of bankruptcy of the debtor also the suppliers will go bankrupt.

From a debtor perspective, it is important to keep the key suppliers during the restructuring process. Their support is critical since the plan execution cannot exclude the production of the items or services sold to the clients. Thus, at least the key suppliers must believe that it is in their interest not to take aggressive actions against the debtor and to continue its supply in order to contribute to rescue the company.

The most common measures that the trade creditors have to negotiate are:

- *extension of the days in payables*: in order to accommodate the debtor necessity to improve the cash position, the suppliers may accept to be paid at a later date;
- *confirmation of the existent monetary conditions*: i.e. when the supplier does not modify the current monetary conditions present in the supply contract, without trying to force the payment of the debt as soon as it discovers the distress situation;

- *confirmation of the current supplying conditions*: in this case, the trade creditor assures the debtor to continue delivering the raw materials or providing the services during the turnaround period.

The presence of key suppliers can create situations of conflicts of interest, in the event that the new management tries to protect them primarily. In particular, if the privilege offered to them is related to huge amounts of cash, the negative effects for the other stakeholders can be relevant.

3.3.2.4 Management

The way in which the management pushes toward a certain strategy depends materially on their influences. A board of directors may be more banks-oriented or shareholders-oriented on the basis of who appointed them in the past¹⁴¹. Moreover, also the remuneration policy may be decisive; for example, a board may be inclined to avoid asset disposals if their remuneration is linked to the dimension of the company. Obviously, moreover, the management is against every type of managerial restructuring.

Basically, the orientations that the management may have are two: shareholders-oriented or entity oriented (Liao, 1975). The first ones are inclined in undertaking a strategy aimed at maximising the earnings in order to distribute dividends to the shareholders; the latter ones are oriented in preferring the activities aimed at maximising the revenues, looking for the highest company size possible. The shareholders-oriented managers' strategies consist of activities addressed at obtaining high EBITDA margins, while the entity-oriented managers' ones are linked to the research of the best market positioning policy. A turnaround manager should move between those two extremes, in order to find the right balance among the interests of the stakeholders.

Another important aspect about the way in which the management may act is the composition of the board, i.e. how many managers are insiders and how many are external. According to Lai & Sudarsanam (1997), the external managers have more incentives to monitor the management actions because they have to maintain their reputation as high-quality professionals; thus, the higher the incidence of the external managers in the board of directors, the higher would be the quality of the control on the activities performed by the managers. The direct consequence would

¹⁴¹ In particular, if the managers hold significant shares of the company they manage, their actions tend to be aligned with the objectives of the shareholders.

be the lower probability that the managers favour a single stakeholder instead of making the interests of the totality of them.

3.3.2.5 Employees

As well as the trade creditors, also the employees are interested in the continuation of the company operations, since the alternative would be a null payoff (i.e. unemployment)¹⁴². On the other side, from the debtor point of view, under a restructuring process the employees are seen as a cost. Thus, it is important to balance the need of the debtor to reduce the costs as much as possible and the aim of the employees (i.e. to avoid unemployment).

However, one of the most important aspects of a turnaround is the optimization of all the processes, in order to increase the company efficiency; it may happen that to achieve such objective it is necessary to reduce the number of factories, with the consequence of a reduction of the workers as well. For example, a distressed company turnaround strategy may include the dismissal of the non-core product lines; to implement this strategy, the managers shall deal with the unions in order to decrease the number of employees.

Also in this case there could be some conflicts of interest. For instance, the employees can be privileged if the new managers have been selected by the employees. In this case, the managers could address the restructuring strategy towards the maintenance of the employees, with the possibility to apply the wrong turnaround strategy.

3.3.2.6 Customers and Government

During a distress period, it is important to reassure the customers about the recovery of the company performance. Indeed, without customers it is difficult to prepare a feasible plan; on one side, the advisors which prepare the plan shall prepare a market analysis which includes the

¹⁴² In reality, the alternative depends on one side on the bargaining power of each employee (for example, an expert employee with critical capabilities may have a high bargaining power in case of potential layoff, so he could be less interested in behaving in order to prevent the company turnaround strategy), while on the other side it depends on the degree of unionization of the workers. Moreover, for simplification purposes, the analysis does not consider the possibility for the unemployed to obtain an unemployment subsidy; this issue may change country by country, since every country has its own degree of employment protection.

customers trend, while on the other side the attestor which certificates the document must be sure that the plan is feasible (i.e. that a customer basis will exist in the future).

A conflict of interest between the debtor and the customers may occur in case the managers are not oriented towards a sustainable growth (Consorte, 2017). In particular, the customers may stay away from the company if the distressed firm presents a bad reputation during the preparation of the plan, for example privileging one particular stakeholder during the negotiations.

Finally, another stakeholder which could become important in certain cases is the government, which may have an interest in the turnaround process as shareholder, financier or regulator (for example for antitrust purposes).

Chapter 4: Distress investors: classifications and strategies

Under a procedure aimed at continuing the company operations, there is a party which can be seen both as a player and as a stakeholder: the distress investor (or *distress fund* or again *vulture fund* in a more negative sense). Indeed, on one side this entity – which from a legal point of view can be seen as an asset management company – acts in order to maximise its payoff, while on the other side it is one of the parties which negotiate in order to approve a plan aimed at rescuing the company. However, not all the procedures aimed at continuing the company operations include the presence of this player; indeed, before starting a negotiation with the distressed company, a distressed investor applies a thorough screening of the whole financial market, looking for the perfect investment (as a vulture waits until approaching the death pray). Thus, this chapter includes an analysis of this player, which in some cases is the main protagonist of a turnaround procedure.

4.1 What is a distress investor?

Basically, a distressed investor is a fund which invests in distressed companies, looking for profitable opportunities as happens for every normal investment company. In particular, it may be assimilated to a private equity fund, with the difference that the latter invests in private companies which are not in a distressed status. However, the approximation makes sense if we think that a material part of the distressed investors is simply a division of a private equity fund. In practice – as will be briefly described later on – in the past there has been certain periods of time where the number of distressed companies was very high; thus, in those periods the need for the presence of individuals expert on the rescue of those firms was material. This fact has led to the creation of the divisions aforementioned. However, also thanks to the recent financial crisis, the amount of funds focused solely on the distressed companies' segment is increasing, since the “size of the market niche” increased significantly.

Generally, those funds are focused in investing in “special situations”. Inside the definition of “special situations” there are various particular cases: financial crisis, major client's financial crisis, temporary operational crisis, industry crisis, etc.; for every case the distress fund can

implement a different strategy aimed at rescuing the company in order to gain a positive payoff. The fact that a situation is ‘special’ means also that there is the possibility to recover the company performance; indeed, for a distress investor it is critical that a distressed company has a positive fundamental value. In other words, the distressed company must have a special characteristic which motivates the distress fund to invest on it: for example, the special characteristic can be a unique resource, key relationships or an advanced R&D department linked with the productive process. In short, a distress investor deals with the so called “*good businesses with bad balance sheets*”.

Historically, the first signals about the existence of someone focused on investing in distressed companies are located in the US during the 1929 Great Depression (Rosenberg, 2000). However, the boom of those funds occurred during the Eighties, when:

- the first effects of the US Bankruptcy Code reform – which introduced the Chapter 11 legal tool – started to take its effects;
- the introduction of the junk bond financial instruments offered for the first time a solution between debt and equity, i.e. on one side are subordinated to the normal debt but on the other side guarantee a higher interest rate.

The enormous success of the junk bonds led to the creation of the “*good companies with bad balance sheets*” aforementioned. In this way, the field for the rise of the distress investors was prepared.

After the first boom, the growth of those agents depended – and still depends – on the economic cycle of the country and the industries: generally, the rise of the distress funds is inversely proportional with the condition of the country or industry. In particular, the higher the “supply” of distressed companies, the higher the distress investors’ activity.

From the Nineties, the creation of new distress funds started to occur also in Europe, even though currently the greatest part of the distress investors is still located in the US. In Italy, the number of distress funds is still low¹⁴³ but it is increasing (Gaudiosi, 2016).

If on one side the presence of those funds can be seen as a negative aspect (i.e. they may give an idea of taking advantage of the fact that a company is in troubles just for own purposes), on the other side it may happen that without their presence the outcome would have been worse. Indeed,

¹⁴³ As demonstrated by the acquisition of Carige (an Italian bank in financial troubles) by Apollo Management, an American fund.

a distress fund invests on companies that no one else wants to touch – because of the complexity of its scenario. Thus, in some cases a distress investor is critical for the survival of a distressed company, contributing to save jobs, to increase the probability that a creditor gets the nominal value of its claim and to give the possibility to the entrepreneur to continue its job. In this sense, a distress fund can be seen as a “player of last resort”, which gives an opportunity to a distressed company when no one else is available to do that.

Moreover, the distress investors can be seen as an accelerator, in the sense that sometimes they solve deadlock situations. For example, a distress fund may accelerate the solution of a distress situation by injecting capital inside the distressed company in order to give to the latter the possibility to pay some critical suppliers in execution of a plan. Another situation in which a distress investor accelerates the procedure is when it accepts to purchase – at a discount – the debt of a financial institution which wants to close its position; in this way, the distress fund may obtain a profit by trading the security at a higher value (or maintaining the claims for negotiation purposes) while at the same time it has solved a problem for the financial institution. Other times they offer a link between the distressed company and a strategic buyer; indeed, a distressed company may be in a situation that it is not able to find any buyer. In order to accelerate the research for a potential buyer process – and in order to avoid that the distressed company reduces further the remaining part of its value – the distress fund can offer information about the presence of a potential target company in troubles.

First of all, as a private equity fund, a distress investor must be expert in analysing the business of the potential target; in particular, it must master the main techniques used to understand the industry (i.e. Porter five forces analysis, competitors analysis and profit pools analysis), the market (i.e. market segmentation, customers analysis and analysis of the market trends) and the target company business model (i.e. internal value chain, SWOT analysis and analysis of the sources of competitive advantage). Linked to the expertise on the target company business is the ability to understand the reasons for distress; a distress fund must understand if, for example, the target company is in distress simply because it has overpaid a company acquisition. If this is the case, there could be a good probability that the fundamental value of the company is positive. In general, the distress investor must be sure that there is room for future growth: in order to obtain this certainty, it must be able to understand everything about the target company business.

Secondly, a distress investor must be extremely expert in all the finance issues (such as valuation, corporate finance, capital markets and debt restructuring); also this aspect is common with the

private equity funds and the other financial investors. In particular, the distress fund should master all the main valuation techniques for assessing the Enterprise Value (multiple analysis, Discounted Cash Flow, liquidation value, etc.) and the securities (for example, methods such as the expected value and the decision tree approach). Moreover, the distress fund must be capable to identify the elements necessary for the restructuring, in order to determine which are the main drivers to change to restore a positive performance. To do that, it is important to have also strong accounting skills, since the financial statements must be analysed thoroughly at a financial statement line item level.

In addition, a distinctive characteristic and an important prerequisite of a distress fund is the expertise on the insolvency law. Indeed, in most cases a distressed investor has to deal with a legal procedure – as the ones described in the last two chapters – when dealing with a distressed company. This is one of the reasons why at a certain point there are no funds or industrial companies willing to deal with a distressed company: the knowledge that a distress investor must have is very complex and pervasive, and the activity *per se* is very risky. However, a positive aspect of this complex environment is that who is able to manage all the tools required for this job has a strong competitive advantage in some particular cases: often a distress investor is able to discover a distressed company before the market recognises it, so that it has a higher probability to be a first-comer on a distressed company without participating a bidding war, respecting the “buy low and sell high” dogma.

It is important to distinguish the distress investor from the strategic investor¹⁴⁴. Indeed, when dealing with a distressed company, the purposes are completely different; on one side, the distress fund aims at maximising the return of the investment (that is why it is important for it to plan the exit from the investment from the very beginning of the procedure), while on the other side the strategic investor decides to purchase a distressed company only when it believes to create high synergies (high enough to overcome the cost of recovering the distressed company). For this reason, usually a strategic buyer is willing to offer a higher price, since it has a clearer definition of the potential synergies that the transaction can bring because of a deeper knowledge of the industry in which the distressed firm is operating¹⁴⁵. Moreover, from the distressed company perspective, it would prefer to be acquired from a distress investor rather than a

¹⁴⁴ The distinction is very similar to the one between financial investors and strategic investors. A strategic investor can be either a competitor of the distressed company or other industrial companies such as holdings.

¹⁴⁵ Moreover, since on average the strategic buyers recognize the distress status of the target on a later stage than the distress investor, it is more likely that the strategic buyer is involved in a competitive procedure, increasing the price to pay to acquire the distressed company.

strategic one, in order to avoid giving too much information to the latter during the due diligence phase; ultimately, the distressed investors are preferred because they tend to pay for the distressed company by cash, usually a solution that the creditors like.

Finally – as explained before – the distress funds are expert also in the legal field, while the strategic investors do not have an in-house legal department specialized in M&A. Accordingly, commonly a distress fund is able to negotiate better with the main stakeholders of the distressed company, for example reducing the uncertainty about the deal obtaining a contingent payment form or an earnout (i.e. to condition the purchasing price to future positive performances).

The distress investors can be classified in several ways.

A first distinction is related to the toughness of the fund, i.e. its degree of aggression. Accordingly, a distress investor can be:

- *passive*: a fund is passive when it simply evaluates the convenience of the purchase of a financial instrument. If the price of the instrument is lower than the expected value of it, the fund will buy the instrument. This behaviour is passive because the distress investor does not try to influence the decision-making process of the distressed company, since it selects a “wait and see” strategy;
- *activist*: in this case, the fund tries to maximise its return by participating into the decision-making process of the distressed company, affecting the turnaround strategy. In practise, the distress investor negotiates with the managers and the creditors in order to create a “blocking position” aimed at increasing the bargaining power when deciding the turnaround strategy. To do that, the distress fund may prepare a concurrent plan which includes better conditions for the creditors;
- *aggressive*: those funds try to take the majority of the company shares (or a class of creditors) in order to block every plan that does not satisfy fully its claims.

Another classification deals with the financial instruments acquired in order to implement the strategy. Thus, a distress investor can purchase:

- *debt*: a fund may acquire some debt (usually with a high seniority) in order to convert it with an equity or quasi-equity instrument such as the SFP described in the last chapter (debt/equity swap or hybrid-equity swap);
- *assets*: a distressed investor may decide to purchase claims guaranteed by one or more assets. In this way, if the fund is able to obtain a blocking position, it can use its bargaining power to obtain successful conditions;

- *equity*: in this case, the fund acquires – usually at a discount – the shares of the distressed company in order to participate directly in the decision-making process.

A third distinction is related to the type of the target the distress investor deals with¹⁴⁶ (Gaudiosi, 2016):

- *special situations*: i.e. generally speaking, the companies which are in economic or financial troubles;
- *workout*: in this case the fund deals with procedures which are totally out-of-court (i.e. the court is not involved at all, so the agreement is private);
- *underperformer*: this type of distress investing is linked with the early stage of distress (see Chapter 1 of this paper). Here the company has a negative trend in performance, but it is not in distress yet;
- *restructuring*: in this case, the fund tries to restructure the capital structure of the distressed company;
- *turnaround*: i.e. the fund tries to restructure the operations of the distressed company;
- *stressed company*: in this case, the distressed company presents serious economic and financial problems that can still be solved by the management;
- *distressed company*: in this case, the distress is serious. Thus, there is a high probability that the fund enters an in-court legal procedure in order to recover the distressed company performance.

4.2 Main strategies

Generally, the activity of a distressed investor consists in investing in distressed firm's discounted financial instruments or debt (or low-priced stocks) obtaining a positive return when the distressed company will not be distressed anymore (or when the value of the financial instrument or stock will increase). Thus, a distress fund may have:

- a *strategic behaviour*, in the case where the fund looks for obtaining a positive return when the distressed company exits from distress or;
- a *speculative behaviour*, when for example a fund takes advantage of the low price of a stock¹⁴⁷ (acting like a technical trader) or of a discounted bond (selling it at a higher price

¹⁴⁶ This distinction is mostly used in the US, where the distress investing is more common and has a greater tradition.

as soon as the distressed company starts to improve its financial performance). In this case, a distress fund can act as a hedge fund, adopting also short selling strategies.

However, it is important to specify that the objectives of a distress investor are not perfectly aligned with the distressed company ones. If this is clearly true for a speculative behaviour, it is true also for a strategic one, since the aim of those funds is to maximise the return from an investment. Thus, a distress fund is interested in the future of the distressed company only until it has decided to exit from the investment obtaining a positive payoff.

An interesting explanation of the strategy performed by the distress investors has been provided by the current Apollo Global Management (one of the most important distress investor of the world) Senior Managing Director Marc Rowan: “Rather than looking for acquisitions in the traditional private equity fashion during these periods of time, we employ our fixed income skill set. We go in and we buy the debt, bank debt, subordinated debt, of fundamentally good businesses that are overlevered, and we work through a process with creditors — sometimes in bankruptcy, sometimes out of bankruptcy — and we end up, hopefully, backing into control of a fundamentally good capital structure at a good price” (Rowan, 2009).

The strategies that a distress fund can implement can be classified looking at the degree of pervasiveness of their presence and the type of the investment performed, as analysed by DePonte (2006)¹⁴⁸:

- *distress debt trading*: it involves purchasing debt at a significant discount (for example at the 30% of the nominal value) in order to resell it at a higher price once the distressed company has recovered its performance. In short, they assume that the debt instrument they are going to analyse is mispriced, so that it is possible to obtain a short-term capital gain¹⁴⁹;
- *distressed debt: Active/Non-Control*: the strategies included in this class are aimed at accumulating significant positions in firms that are likely to enter (or are already inside) a legal procedure aimed at continuing the company operations. The aim is to obtain the proper bargaining power to negotiate during the restructuring process, maximising the return. Rather than the former strategy, this one requires a longer time interval;

¹⁴⁷ Usually, when a company is distressed, the shareholders continue to maintain the company stocks since they hope to avoid losing money until the end. As a consequence, they will be willing to sell the shares too late, at a very discounted price. That is the perfect moment where a distress investor shall purchase the equity.

¹⁴⁸ In most cases the funds adopt a combination of those strategies.

¹⁴⁹ Usually the operation involves weeks, or days.

- *distressed debt: Control*: in this case, the distress fund tries to obtain the control of the distressed company purchasing the fulcrum security (see later in this paragraph), either alone or together with other funds (*syndicate*). This strategy requires even more time for the fund, since once it has obtained control of the distressed company, it has to define the operative strategy;
- *restructuring or turnaround*: this strategy is aimed at purchasing directly the equity of the distressed company, either in case of legal procedure or completely out-of-court. The final purpose of this strategy is to obtain the control of the distressed company in order to implement freely the restructuring strategy.

However, a distress fund may decide to implement a mix of the strategies aforementioned when investing in a distressed company, for different purposes. For example, if the distressed company shares are marketable, a distress investor which wants to implement the “distressed debt: Active/Non-Control” strategy can hedge its investment – in case the possibility to increase the bargaining power during the negotiations disappears because of an unexpected strong decrease of the distressed company performance – by short selling the stocks (implementing also a strategy similar to the “distress debt trading”). The mix of strategies can also be horizontal: for instance, the fund may decide to protect its “distress debt trading” strategy by – again – short selling the stock, combining the different payoffs of the transactions as happens for an investment on futures or derivatives.

Moreover, a distress investor can decide its strategy also considering the timing. In particular, a short-term investment is appropriate when it believes that a trigger event¹⁵⁰ is incoming, such as the presentation of a certificate plan, or the demand of composition with creditors “in bianco”¹⁵¹; in this case, a short term investment is necessary in order to take advantage of the current mispricing or to purchase the proper financial instruments (debt or equity) before the other investors start to consider an investment on the same distressed company. Otherwise, a long-term strategy is more suitable if the distress fund has assessed the fundamental value and has concluded that there is room for improving the performance and eliminating the distress status

¹⁵⁰ Generally, the market reacts disproportionately when a trigger event occurs; thus, the distress fund may prepare a short-term strategy (speculative) in order to take advantage of the mispricing. Moreover, the distress investors are able to assess better the potential effects of a legal trouble; in this case, the fund may also adopt a long-term/control strategy obtaining significant advantages.

¹⁵¹ Other trigger events that a distress investor usually considers are: i) change of the legal auditor; ii) continuous decrease of the operative performance; iii) sale of the “crown jewels”; iv) material deviation from the content of the action plan; v) unexpected top managers’ resignation; vi) downgrade of the company rating; vii) abnormal trend of the capital structure (ex. covenant breach).

(the so called “growth investing”). However, the long-term investments are riskier than the short-term ones; indeed, if the convenience of the latter are easier to assess, the former ones require a detailed due diligence process where the target company must be analysed properly.

Among all the strategies aforementioned, the one which characterizes the most a distress fund involves the purchase of debt securities addressed to obtaining the control of the distressed company (*loan-to-own strategy*). In order to be implemented, this strategy requires the ability to select the correct security among the ones which represent the capital structure of the target company: in other words, the distress fund must find the so-called *fulcrum security* and buy it at a reasonable price. As the American literature on distress investing says, “vulture investing is all about leverage!” (Schultze & Lewis, 2012); in order to have this “vulture leverage” – since every lever has a fulcrum –, a distress investor needs a “fulcrum security” which allows it to implement the strategy planned. In general, the fulcrum security is the debt instrument which is more likely to be converted in equity during a restructuring process with a debt-equity swap procedure; in other words, “the fulcrum security is the last security to recover less than par value under a capital restructure and is the one most likely to be converted into equity” (FCS Commercial Finance Group). Indeed, once those instruments have been converted, the fund will have the possibility to vote and influence the distressed company strategy. To purchase the fulcrum security, the fund must analyse thoroughly the capital structure of the distressed company (in order to select the right instrument) and wait the right moment for the purchase itself (in order to avoid paying too much). In most cases, the fulcrum security corresponds to the debt instrument with the highest seniority, since those debtholders will be the first to be reimbursed even when the plan provides for an asset disposal (Gaudiosi, 2016).

In some cases, a distress fund may purchase directly the equity of the distressed company when looking for obtaining the control of it; however, it may happen that the equity-holders are not willing to sell the shares since they hope to an increase of the distressed company performance. Thus, the purchase of the fulcrum security may be the only solution available for a distress investor which aims at controlling a distressed firm.

In conclusion, the ideal strategy for a distress investor would be: to purchase the fulcrum security at a large discount and be able – thanks to the fulcrum security itself – to obtain a blocking position in order to be able to influence the restructuring or turnaround strategy. This is the best solution because the distress fund would spend a low amount of money for the security, decreasing the degree of risk exposition, while at the same time it can vote and exercise power.

Summarising, the success of the distress investor's strategy is based on:

- a complete *understanding of the distressed company business model and financial statements*;
- a complete *understanding of the distressed company industry and market*;
- the ability to *wait for the right moment* of intervention;
- the capacity to *find the fulcrum security* that gives the possibility to influence the determination of the turnaround strategy.

4.2.1 Main activities

After having described the way in which a distress investor decides the strategy to implement, it is important now to describe briefly the main activities that those funds implement in order to achieve the goals planned. The most common activities are:

- *prededucibile debt*: a distress fund may decide to lend some money to the distressed company, taking advantage of the fact that the loans provided by a lender in execution of the plan is *prededucibile*, i.e. with a super-seniority¹⁵². If this is the only activity performed by the fund, the outcome is the reimbursement of the money lent plus the interests. However, often a distress investor lends money to the target as an ancillary operation, in order to support the main strategy (such as the obtaining of the control of the company) and increasing the possibility of making it succeed. Moreover, since the distressed company is in desperate research of money, the fund may act as a “lender of last resort”, obtaining an agreement that includes some advantages for it (an agreement that the distressed company would have never accepted under normal conditions);
- *turnaround in collaboration with a performance improvement expert*: sometimes – even though it knows how to recover the company performance from a financial and legal point of view – the distress fund does not have the right competences to adjust the operations of the distressed company. In this case, the distress investor may abandon every idea of investment on that distressed company. In alternative, the distress fund can cooperate with an advisory company expert in improving the companies' performance through cost optimization, operations improvement and corporate support strategies. For

¹⁵² In the US the security is known as DIP (Debtor-In-Possession) financing.

example, the advisory company can optimize the distressed company cost structure while the distress fund uses its expertise in the bankruptcy law to find the right agreement aimed at rescuing the distressed company;

- *convertible bonds purchase*: a distress fund can decide to obtain the control of the company through a hybrid-equity swap, purchasing or subscribing convertible bonds. Apart from the control purposes, the distress investor may obtain a significant payoff if the price of conversion of the bonds in stocks is lower than the stock value in case of completion of the turnaround process for the distressed company¹⁵³;
- *loan-to-own*: as already mentioned, the most common strategy implemented by a distress fund is the purchase of the fulcrum security, i.e. the most senior part of the distressed company debt. However, in these situations there are some particular aspects, due to the fact that some entities cannot (or are not willing to) maintain a financial position in a distressed firm, becoming *forced sellers*. Firstly, the mutual funds sometimes are obliged by the charter to exit from the investments considered too risky. Secondly, the financial institutions can be incentivized to dismiss a high-risk investment for balance sheet purposes: indeed, the banks have to register the value of the financial position basing on the degree of riskiness of the investment itself, thus a higher risk would imply a lower asset value. Accordingly, those two scenarios could be used for its own advantage by the distress funds, that can purchase the claims at a very discounted value;
- *deleveraging*: this operation is performed often by a distress investor, in particular when there are also other entities (both financial and strategic investors) willing to invest and obtaining control into the distressed company. The deleveraging is a strategy suitable for dealing with overindebted distressed companies; the aim of the operation is to restructure the capital structure of the distressed company by exchanging the debt (or a part of it) with the participation in the equity of the distressed company, merged in a Newco. Accordingly, this operation is composed by several stages:
 - a) the distress fund buys the debt of the target company from a debtholder which wants to exit from the investment (such as the mutual funds or the financial institutions aforementioned), at a significant discount;

¹⁵³ That is why usually a convertible bond pays an interest lower than a normal bond: it gives to the subscriber the possibility to realize a gain when converting the bonds in shares.

- b) the distress investor, together with other investors willing to control the target (including the owners of the distressed company itself), create a Newco composed by: i) an amount of cash equal to the nominal value of the debt purchased by the debtholder mentioned in the point a); ii) equity equal to the amount of cash provided, owned by both the distress fund and the other investors;
 - c) the Newco pays the distress fund, using the cash provided by the fund itself and the other investors, in exchange of the claim towards the target company. In practise, the Newco has exchanged the cash with the credit towards the distressed firm (at the nominal value);
 - d) the Newco exchanges the credit towards the target company with a participation on it equal to the amount of the claim written off;
 - e) now probably the Newco has the majority of the distressed company (target), which in exchange of the loss of control has written off a significant part of its debt, so that the capital structure is healthier. Accordingly, if the turnaround strategy is successful, it is likely that the equity value increases, while the remaining amount of debt (if any) decreases because of the cash inflows provided by the new strategy;
 - f) after some years, the distress fund exits from the investment, selling its position on the distressed company to a third party (or to the former owners). Since the value of the equity has increased, the fund obtains a positive return in terms of capital gain. Thus, from the deleveraging operation the distress investor gains in two different ways: i) the capital gain aforementioned; ii) when transferring the target claim (purchased from the debtholder at a discount) to the Newco (which pays the nominal value);
- *securitization*: a distress fund can make a mistake. In this case, it may risk being forced to maintain the (now illiquid) security until the maturity, with a material probability that the terminal value of the claim will be very low (if not zero). If that security is marketable, the distress investor may try to apply the so called “*originate-to-distribute*” strategy, creating new financial instruments composed by the toxic claims through a SPV (Special Purpose Vehicle). In practise, the SPV takes the claim from the fund and divides it in different parties with different seniorities. Then, it sells those new financial instruments

(called ABS, Asset-Backed Securities) to the market. In this way, the distress fund may exit from the investment, since the credit risk is sustained by the SPV;

- *business unit purchase*: the distress fund can decide to purchase directly only a part of the distressed company, i.e. a division or business unit. Usually the purchase of some assets only is a signal of pressure by the distressed company creditors, that are forcing the debtor to liquidate some assets in order to be able to pay the claims. The main advantage of a business unit purchase is that the fund would avoid bearing also the debt of the distressed firm (aspect that would happen in case of acquisition of the total company).

4.3 Main procedures

Once the main strategies that a distress fund can implement has been described, it is important to understand how those funds generally work, i.e. which procedures they make before deciding whether to invest into a distressed company and the way in which they select the proper investment among the available ones. Generally, the fund looks at those companies that are likely to enter a distress period in the short-term, in order to anticipate the behaviour of the market.

As described before, a first preliminary activity is the analysis of the business model, industry and market of the distressed companies that can represent a potential target for the fund. A first operation is to discard all those companies which industry is out of the knowledge of the distressed investor. It is important for a distressed investor to be confident about what it is analysing; thus, it may find uncomfortable to analysing new industries and markets. An alternative would be a partnership with another advisory company (under a sort of syndication) where the two companies put together their competences.

A second preliminary activity consists of *understanding the reasons for distress* of a distressed company. Indeed – as described in detail in Chapter 1 – the reasons why a company is in troubles can be internal or external, or both at the same time. Moreover, a distress can be due to operational problems or financial ones, or a combination of the two. Accordingly, a distress investor must know in detail why a company is risking being insolvent; it shall avoid any type of investment if it is not completely informed about it¹⁵⁴. For example, if the main reasons for distress are related to a decreasing path of the performance of the industry, the distress fund has

¹⁵⁴ As Warren Buffett says, “Risk comes from not knowing what you’re doing”.

to understand thoroughly what is happening to the industry, and which are the responsibilities of the distressed company management; after having performed this type of analysis, the fund can decide not to invest or to wait for the beginning of the industry recovery. Alternatively, if the main reasons for distress are linked to bad management, the fund can decide to obtain the control of the company and replacing the old management. Finally, a financial distress can trigger other types of strategies, such as the deleveraging operation described in the last paragraph¹⁵⁵.

Once the distress investor has a clearer idea about the potential investments available, the fund may enter a *screening* process, where the most interesting opportunities are analysed in detail. This activity involves for sure a financial statement analysis, in order to find the numerical outcomes which outline the reasons for distress found during the qualitative analysis mentioned above. Together with the analysis of the operative performance, the distress fund will focus its attention on the levered Free Cash Flow, which includes the effects of the debt service in the cash position of the distressed company. Moreover, the attention goes also on the operative cash flow, when deciding as to whether applying a turnaround strategy on the target company. Indeed, a distress fund is not worried of the over-indebtedness of the company, but on its capacity to sustain, in the medium-long term, the debt service with the operative cash flow only.

Thus, the distress fund prepares the so called “research review note” (Schultze & Lewis, 2012), which includes issues such as “the nature of the investment opportunity, an overview of the fundamental business, and an analysis of comparable companies and of the industry” (*Ibidem*). Usually this analysis includes an accurate analysis of the distressed company-target capital structure and a forecast of its financial statements, together with an estimate of the expected internal rate of return (IRR) of the investment itself.

After the screening process, the distress investor selects the best investment available. However, the decision is not definitive yet. Indeed, in this phase the fund starts a *due diligence* process, in order to be more confident when approaching the management properly and obtain more sureness about the feasibility of the investment in terms of positive IRR. Obviously, the higher is the time spent to perform the due diligence, the better is the ability of the fund to make a good deal. To perform the due diligence, usually the distress fund uses different sources, taking advantage of the relationships that it has created in the past (for example historical partners, lawyers and

¹⁵⁵ Usually, the SMEs (Small and Medium Enterprises) have a higher risk to be financially distressed since they cannot solve the situation by adopting an assets disposal strategy.

investment banks); since the fund's network is limited, it is likely that a fund prefers to invest in known industries, where the insights is easier to obtain, and the experience is higher.

During the due diligence phase, the distress investor analyses the plan eventually proposed by the management. It is likely that the plan mentioned is too optimistic since it is made by the managers, who have the incentive to stay positive because they want to demonstrate to be able to solve the distress scenario. On the contrary, the plan could be considered too pessimistic if prepared, for example, by a creditor which has interest to start a bankruptcy procedure (for example an aggressive distress fund). Accordingly, whether a plan is optimistic or pessimistic may influence the distress fund strategy; for example, the fund can decide to improve the plan (if it is considered too pessimistic) in order to avoid the full satisfaction of an aggressive fund under a bankruptcy procedure. If instead the plan is aligned with the expectations of the fund, the distress investor may decide to purchase the securities at a discount, since the confidence about the strategy planned is improved.

Apart from this process, usually the distress investor does not have enough time to execute a proper screening strategy and an exhaustive due diligence. A distress fund must act quickly, since a distress company can worsen in a few months (or weeks). Accordingly, Moyer (2005) lists four steps a distress investor must perform:

1. to analyse the most recent financial data in order to determine the capital structure and the debt structure (i.e. the characteristics of the debt and its seniority);
2. to prepare an own valuation of the distressed company and the capital structure;
3. to analyse the EBITDA recent trends and to perform a ratio analysis, in particular related to the capital structure;
4. to conclude about the convenience of the investment: if the valuation of the company is greater than the one provided by the market, the investment can worth it.

4.4 Conflicts of interest with the other stakeholders

The distress investors goal is to maximise its payoff. It follows that the distress fund strategy may enter in conflict with the objectives of the other stakeholders of the procedure. For this purpose, the fund shall examine properly the different parties that participate in the restructuring process.

Usually, inside all the restructuring procedures the distress fund finds multiple situations of conflict of interest, for example between creditors with different seniorities, between managers and owners or between shareholders and creditors (see Chapter 3). This implies that it is very difficult that a fund that wants to enter the procedure finds a solution which satisfies all the stakeholders of the restructuring process. Thus, it may happen that such distress investor selects a strategy which supports only one stakeholder; for example, it may decide to give preference to the shareholders if during the due diligence it has discovered that the distress company fundamental value is significantly positive. By contrast, if the distress fund retains more convenient the return related to the debt of the distressed company, it will support the creditors (or a single class of creditors) looking for creating a blocking position. Alternatively, the fund may decide to stay neutral supporting the going concern of the distressed company by injecting capital adopting one of the growth strategies mentioned above in this chapter.

The distress fund position depends also on the composition of the debt. For example, if the greatest part of the debt is maintained by the financial institutions, the fund knows that it is easier to implement the strategy planned if it is able to obtain the support of those stakeholders.

However, it is important to recall that the distress investor strategy can be perfectly complementary to the one of the financial institutions which want to exit from the investment for balance sheet purposes (*forced sellers*): in this case there would not be any problems in terms of conflicts of interest. A similar way of thinking is valid for those shareholders which want to exit from the equity participation because of a too high degree of risk aversion; those equity-holders can easily sell their share to the distress fund offering a significant discount for the favour.

Another situation of conflict of interest that a distress fund must consider deals with the presence of other investors (both turnaround or industrial) in the turnaround procedure. If this is the case, the investors can decide to cooperate (*investors syndicate*) if they have the same purposes; this implies that all the funds that participate in the procedure commit to maintain the financial position until they decide, in concert, to sell the securities (or shares). On the contrary, they can have different goals; this may lead to a strong competition between the funds, with the consequence of increasing the purchasing price of the distressed company or the securities¹⁵⁶.

¹⁵⁶ That is why the Italian Legge Fallimentare wants to be sure that the sales of the distressed company assets are made through “competitive procedures”, since this is in the interest of the creditors.

4.5 Effects and returns

As for the effects of those funds in the economy, it seems clear that on average they improve the profitable ratio of the distressed companies. This happens because the distressed investors are a unique type of funds – highly specialized in the business, finance and bankruptcy law issues – which combine those three main areas of expertise in order to improve the performance of the companies in serious troubles. Indeed, they intervene in extraordinary situations (i.e. corporate distress) where a normal manager is not able to recover the deteriorated performance simply because he does not have the proper capabilities.

The returns of those funds tend to be volatile because of the high degree of riskiness of the investment. However, investing in distressed debt is an attractive opportunity to obtain significant returns in a very short period of time; thus, who has a consolidated expertise and strong skills in distress investing can make very high returns in a couple of weeks or months. Accordingly, if a distress fund has a positive reputation, an institutional or individual investor can decide to finance its activity, preferring the expected return offered by a distress investor to the lower (but safer) ones offered by other funds.

The returns of a distress investor depend materially on the level of distress that a distressed company has reached. In particular, it is easier to obtain a significantly positive IRR when the investment has been made in the period which follows a default peak. For example, Edison Investment Research (2001) hypothesizes a “potential for a 20-30% IRR in the 12-24-month period following a default peak”. However, the same research assessed for the sample of distress funds considered an average return of -27.1% in the 2008 and of +29.8 in the 2009, underlining the volatility that those returns may have and the tendency to have higher returns in the year after the negative default peak has occurred.

The performance of a distress fund depends also on its launch date: if the fund has been founded at a low point of a distress period (of the financial markets as a whole or of the distressed company, depending on the type of target selected by the distress investor), it is more likely that it obtains high returns because it purchases the securities at a deep discount. On the contrary, if a fund invests just before a financial crash, its performance would be negative.

Moreover, the extent of the returns depends also on the type of transaction performed by the distress fund; in general, an equity investment has an unlimited upside while the purchase of a debt instrument has the nominal value (plus the interests) as maximum gain. On the other side,

the payoff downside can be very high, since both an equity investment and a debt one can be worth zero at the end of the day; for this reason, a distress investor must assess more the downside than the upside, since the investment is risky. Furthermore, it depends also on the strategy selected by the distress fund; in particular, Hotchkiss & Mooradian (1997) found that on average if the distress investor strategy is aimed at controlling the distressed company, the returns are higher. Finally, the returns may depend on the timing of investment; obviously, to invest when the value of the security is at its lowest point helps to increase the return.

4.6 Conclusions

At this point, it seems clear that to be a successful distress investor is very difficult, since it is critical to be specialized in various fields. In particular, differently than the other funds, the distressed ones must add a further competence, i.e. the understanding of the legal insolvency framework. Their strategies vary basing on the opportunities and the purposes, and before selecting the right investment they have to analyse in detail the business, the reasons for distress, the financial statements and the convenience of the potential investments. If the distress investor recognizes to be not enough expert to go on with a potentially profitable operation, it may be obliged to abandon the project; in alternative, it may ally with another distress fund under a syndicate of distress funds or collaborating with a performance improver expert in the required sector.

A distress investor – as all the other entities – deals with an environment. As a consequence, the financial, legal and cultural framework affects the probability of success of a distress fund strategy. In particular, the Italian business environment is composed by a strong presence of Small Medium Enterprises¹⁵⁷ characterized by a high degree of personal relationships with the local banks; the consequence is that the capital structure of those companies is not diversified properly, so that they risk relying too much on the possibility to raise funds by those local banks. For this reason, there could be room for a distress investor to intervene as soon as the scenario of those firms starts to worsen. By contrast, on the other side usually those SMEs are family-owned, with the consequence that often it is difficult to persuade those family-owners to give up the control to external agents. Accordingly, apart from all the competences that the funds' managers have to improve, it is important to analyse thoroughly the local environment. For example, it may

¹⁵⁷ In the 2018 the 76% of the total Italian firms were SME, according to Banca IFIS (2018).

happen that a country-wide distress investor has to co-invest into a distressed company together with a local fund that is embedded properly inside the area.

Another important issue about the way in which a distress fund manager is able to perform efficiently its strategy is related to the role of the information. Indeed, before starting to analyse the business of the potential target distressed companies, the distress investor has to know about the presence of the distressed company. Since in Italy the greatest part of the companies are SMEs, it is likely that the news about a company which is going to enter a distress period are not disclosed. Accordingly, it is important for a distress fund manager to create an important network with some main advisory companies and legal offices, in order to be able to know with the right timing all the necessary information about the presence of one or more companies which are entering the distress period. To obtain the information network aforementioned requires a lot of years, and that may be seen as an important entry barrier for new distress investors.

In sum, in order to have a successful transaction, Victor (2006) lists five key elements:

- *understanding the company's situation*: it is important for a distress investor to assess how long the distressed company can survive as a going concern firm. In particular, when the distressed company is burning cash quickly because of the crisis situation immediate actions must be undertaken in order to guarantee the company going concern. In order to perform positively those operations, the distress investor must know perfectly the company and its environment;
- *setting expectations and communicating with all constituents*: a very important characteristic that a distress investor must have – which sometimes is not mentioned at all – consists in high communication skills. Indeed, first of all to communicate to the entrepreneur of a SME that his company is in distress is a very complex thing which requires a lot of resolve and empathy. Secondly, to have good communication skills is useful also when negotiating with the other stakeholders of the procedure, for example when persuading the banks to provide a standstill agreement in order to delay the cash disbursement of the distressed company;
- *running the right sale process*: it is important to be focused on the sale process procedure, for example preparing the correct teaser document of offering memorandum. Moreover, the proper level of due diligence must be performed in order to prepare all the basis necessary to obtain the best result possible from the transaction;

- *finding the right buyer*: a distress investor must act quickly and offer highly reasonable conditions. Thus, usually the best distress investor is the one which shows confidence from the very beginning of the process, knowing perfectly what to do in order to extract the highest value possible from the distressed company;
- *solving obstacles to get to closing*: during both the negotiation process and the execution of the plan, it may happen that some obstacles occur. Thus, a good distress investor must be able to solve any potential deal-breaker factor (such as short-term liquidity problems, labour issues and stakeholders' contrary reactions). Moreover, it is important that feelings such as ego and greed are set aside. All the stakeholders must be focused and motivated to complete the process.

Moreover, the ability of a distress investor consists in dealing with some market inefficiencies, as explained by Edison Investment Research (2011):

- *low levels of liquidity of the distressed debt market*: thus, before concluding an operation in distressed debt, an investor shall consider that it may be difficult to exit from the investment if things will go wrong in the future;
- *the fact that mistakes are extremely costly and not easily undone*: a wrong investment in distressed debt securities or equity instruments has a material potential to lead to a null final value, implicating a significant capital loss;
- *the circumstance that distress debt can provide considerable upside, but the downside is highly probable*: this aspect is strictly linked to the previous ones. Indeed, it is important also the exit from the investment in case things go wrong;
- *to be effective it is important to know in detail the insolvency legal framework*: as precised before in this Chapter, without knowing properly the bankruptcy legal framework it would be difficult to select and implement the right strategy;
- *on average, the information coverage about the distressed company is not high*: another problem linked with distress investing is the lack of information about the distressed company. As a consequence, a distress investor must be able to create the right network (composed mainly by courts, advisory company and legal offices) in order to be informed with the right timing about the presence of a distressed company.

Chapter 5: A comprehensive case study¹⁵⁸

After having investigated properly the definition of distress – considering different models aimed at standardizing the issue and identifying the most common reasons for distress – and describing the Italian bankruptcy legal framework for continuing the operations of a distressed firm – and its main players, with a focus on the distressed investors –, the focus of this work shifts from the theoretical aspects to the practical ones. Accordingly, a comprehensive case study is presented, with the aim of observing how a distressed company can be rescued and how the different stakeholders (in particular the distress funds described in the last chapter) behave in a complex situation like a company crisis. We will see that not in every case the solution is simple, in particular it may happen that various attempts are made before finding the right solution: a potential solution may fail because of different reasons, both economic and legal. Furthermore, we will see how important is to have a strong knowledge in both the legal and finance-business fields, differently than a classic situation of Mergers and Acquisitions under non-crisis conditions where the strategic component can be sufficient¹⁵⁹. Finally, we will observe the strategy adopted by the distress investor, and why it has selected one particular strategy rather than another one.

The chapter starts with the presentation of the company, in particular its main activities and the industry and market composition, as well as the most important historical aspects. Then, the reasons for distress will be presented and analysed, adopting both a descriptive and financial analysis of the scenario. Finally, the events which regard the post-crisis identification are described and examined, understanding the reasons why the main protagonists of the procedures have taken those particular decisions. When describing the way in which the stakeholders have tried to rescue the company, a focus will regard the distress fund, in order to see the reasons behind its strategy.

¹⁵⁸ Since the distressed company is private, its name and the most important information and data are not disclosed. Accordingly, some details that would have been analyzed exhaustively in case of public information may not be described properly.

¹⁵⁹ It is important to recall that one of the main differences between a financial investor (as a distress fund) and a strategic one is that usually a financial investor has an in-house legal department specialized in legal issues (such as the bankruptcy law) while a strategic buyer tends to rely on external professionals for that. Accordingly, in case of corporate crisis, a distress investor on one side is advantaged because it has already the knowledge required for such operations, but on the other side to get all those competences is a very complex aspect which requires time.

5.1 The Distressed Company

5.1.1 Overview

The *Distressed Company* is an Italian medium company¹⁶⁰ headquartered in the North-Eastern area of Italy. The company core activity deals with the design of various products, from footwear to leather goods. Basically, the company works in the fashion industry; it is composed mainly by designers and ancillary experts (such as engineers, marketing experts and other professionals who support the core activity) that provide the research, development and creation of graphic solutions aimed not only at designing a fashionable product (i.e. aligned with the last fashion trend) but also at offering the proper quality in terms of wearability and material selection. Furthermore, recently the Distressed Company started to offer industrial design services for completely different purposes such as outdoors places (i.e. parks), packaging, interior design and digital graphic support (i.e. creation of slideshows and digital brochures). The addition of this second set of activities (which can be seen as a new strategic unit) has provided a horizontal perspective to the company, giving the possibility to offer its experience and capabilities also to markets different than the fashion ones; the consequence has been the possibility to diversify the market risk, avoiding depending too much on the trend of one single market only¹⁶¹. It seems clear that the company aspires, at least in the long term, to be considered as a sort of “*factory of design*”, distancing gradually (or at least being less dependent) from being considered as one of the most skilled design company only for the fashion industry.

Accordingly, as mentioned before, it is possible to separate two main set of activities that the Distressed Company offers to different clients:

- *fashion*: generally, this strategic unit deals with the creation of new collections or the restyling of the existent ones. Moreover, in this set of activities the company may create special projects, such as the creation of shoes prototypes starting from zero, deciding both the design and the materials for the shoes itself;

¹⁶⁰ The Distressed Company has a turnover lower than € 10 million in all the years considered except the 2007 (necessary condition to be considered small company), but the number of employees is greater than 50 (a small firm must have less than 50 employees). Thus, according to the EU Commission Recommendation 2003/361/EC of the 6 May 2003, the Distressed Company is considered medium.

¹⁶¹ Indeed, during the financial crisis period, the management reports linked with the Distressed Company financial statements state clearly that the new business unit's market was responding badly to the financial crisis, while the core business' market was more resilient.

- *industrial design and other activities*: in this set of operations, the company takes advantage of the skills, the expertise and the reputation of its designers to execute other operations such as interior design (for example for temporary stores), digital graphic design, labelling, packaging and the creation (or improving) of logos.

Table 5.1 summarizes the main activities performed by the Distressed Company.

Fashion	Industrial design and other activities
<ul style="list-style-type: none"> - Creation of <i>new collections</i>, or the <i>restyling</i> of existent collections, for: <ul style="list-style-type: none"> ▪ men, women and/or kids; ▪ shoes, bags or other accessories; ▪ different styles: luxury, casual, sport. - <i>Market advisory</i>: <ul style="list-style-type: none"> ▪ market and sales analysis; ▪ trend hunting; ▪ preparation of merchandising plans; ▪ colours selection. - <i>Research and Development</i>: <ul style="list-style-type: none"> ▪ research of the proper materials for the products designed; ▪ research for new materials, healthier designs and improved materials; ▪ development of new technologies. - <i>Special projects</i>: <ul style="list-style-type: none"> ▪ design and production of completely new products; ▪ application of new technologies to the production process; ▪ production engineering with the obtaining of patents when possible. 	<ul style="list-style-type: none"> - <i>Interior design</i>: <ul style="list-style-type: none"> ▪ creation of retail concepts, for visual merchandising purposes; ▪ interior design for temporary shops, shop-in-shops and flagship stores; ▪ design of stands for mobile expositions (ex. fairs). - <i>Logo creation</i> or improving. - Conception and development of <i>packaging</i>. - Conception and development of <i>labels</i>, for packaging and marketing purposes, also in digital form. - Creation of <i>brochures</i>, <i>videos</i> and <i>slideshows</i> in order to present the client to the public properly. - Development of a <i>coordinate graphic</i> which represents the client in every document it prepares for the external environment. - Creation of <i>mood boards</i> for summarizing a particular concept.

Table 5.1: The Distressed Company main activities divided for class of activities. Own elaboration.

As for the process of the core activities performed by the Distressed Company (i.e. the creation of new collections, under the fashion strategic unit) – which are the most important activities in terms of revenues –, usually it is composed by the following phases:

- *preliminary phase*: during this phase, the client provides to the company all the data and information necessary to understand the client itself, its style and the characteristics that the collection shall have. After the company has received all that information, it makes all

the preliminary activities necessary to perform the work properly (i.e. trend hunting, market research and data analysis);

- *briefing phase*: once the preliminary phase has been completed, a direct communication process starts between the client and the company. In particular, the client indicates the desires and objectives of the collection and all the conditions of the project (ex. colors and materials). Then, the two parties discuss the project and the timeline of the work;
- *design phase*: the company proposes its ideas and interpretation about the collection and presents the concept of the project. When presenting the project, the company has to explain in detail the reasons why it has selected that particular color, material and design. Then, the project is discussed with the client, in order to take a definitive decision as to whether the project can start;
- *project development phase*: in this phase, the company executes the project and presents the prototypes created to the client. Obviously, the prototypes must be aligned with the guidelines provided by the client. The prototypes are discussed with the client in order to reach a final decision about the presentation of the final product to the market;
- *final definition phase*: the final sketches of the products are sent from the company to the client and the client decides whether to produce it;
- *industrialization process*: usually this phase is managed solely by the client, but the contract may include the possibility that the final product is produced by the client under the supervision of the company, or the possibility to co-produce the final product.

On average, those contracts are between one and two years long, so the clients' turnover can be high under high-pressure periods such as macroeconomic crises; for this reason, it would be important to obtain a high client fidelization, in order to guarantee stable revenues for the medium-long period.

However, the service offered by the company is characterized by its flexibility to every clients' request. For example, the company may create a prototype starting from zero or supporting only the initial or final phase of the client's project (for example performing a market analysis or preparing a merchandising plan, respectively). Moreover, the procedure described above can be implemented with other activities, as for example the development of a coordinated graphic for the marketing campaign, or the creation of slideshows and videos to present properly the product to the market.

5.1.2 Historical background

The company was founded in the second part of the Eighties by two designers who during the previous years have developed strong skills thanks to the presence of an industrial district in the area, specialized in the high-quality craftsmanship of footwear. Those designers have been able to work in some companies inside the local industrial district area, taking advantage of the unique ability of those artisans and learning from their ordinary work, in particular the abilities related to the production of the shoe model from the very beginning.

Once the two designers have been able to obtain enough confidence about the skills aforementioned, they decided to become autonomous, creating a new entrepreneurial activity based on the design of the footwear, oriented towards an international market. The aim was to produce innovative products – related both to new forms and new materials (or combination of materials) – and to sell them to the footwear factories through the participation to specialized fairs for shoes designers.

After some years – when the first successes have been achieved – the two designers decided to start an “integrated center of product development”, in order to manage internally, inside the company, the whole process regarding the complete production of footwear prototypes. Moreover, thanks to this integration strategy, the two designers were able to assume the creative direction of whole collections, improving the “exclusivity” of the final product offered to the market.

In the Nineties, the success of the company continued to increase. Indeed, in this phase the company started to be considered as a high-quality and reliable partner, so that it obtained important partnerships with some of the most important international shoes and accessories companies. Moreover, also in order to reach the most important potential clients, the company integrated its marketing channel creating an international sales network (however, they continued to attend fairs as well, in order to maintain the old clientele).

In this period, the company started to increase the amount of R&D investment about new graphic and design solutions, in order to keep the pace of the market quickly and to enhance the strong creative skills of the designers (and the other employees); for example, the company completed some R&D projects about the weight reduction of the shoes, the comfort of the product and the research for new or improved raw materials.

In the following decade, the company continued its positive path, becoming – as the designers themselves said – a “worldwide creative design factory”, continuing the innovation and competences development process and consolidating its role at an international level. In this period, the company turned out to be a “factory of design”, entering new businesses such as the interior design, architecture and graphic design ones. In the 2007, the company reached a turnover level of € 10 million. For those purposes, the company integrated its personnel obtaining a composition of eight teams composed by specialized designers, architects, graphic designers, trend hunters, market analysts and other marketing experts.

At the end of the 2011 – as at the foundation time – the company was owned completely by the two designers, with a slight majority (51%) for one of them.

The financial statements of the Distressed Company are presented in Table 5.2 and Table 5.4, while Table 5.3 includes a breakdown of the costs.

(€/000)	2008	2009	2010	2011	2012
Sales revenues	8.845	7.353	7.611	8.038	3.846
<i>YoY revenues growth rate</i>	-	-17%	4%	6%	-52%
EBITDA	355	184	926	1.210	(2.137)
<i>EBITDA margin</i>	4%	2%	12%	15%	-56%
EBIT	235	(148)	740	1.109	(2.251)
<i>EBIT margin</i>	3%	-2%	10%	14%	-59%
Net income	(120)	(305)	78	103	(4.305)

Table 5.2 The Distressed Company Income Statement (2008-2012).

(€/000)	2008	2009	2010	2011	2012	Average incidence
Operative costs	9.376	7.572	7.469	7.282	8.374	
Raw materials	270	285	282	232	201	3,20%
Change in raw materials	11	(24)	(39)	(5)	23	-0,10%
Services	2.908	2.545	2.710	2.862	3.516	36,44%
Leasing	1.558	1.247	974	773	758	13,16%
Personnel	4.305	3.125	3.204	2.695	2.173	38,61%
Depreciation and Amortization	119	332	186	101	61	2,05%
Other provisions	0	0	0	0	53	0,13%
Other operative costs	205	61	153	624	1.589	6,52%

Table 5.3 The Distressed Company cost breakdown (2008-2012).

(€/1000)	2008	2009	2010	2011	2012
Current assets	4.015	4.093	4.738	5.821	2.628
<i>Inventory</i>	358	279	577	321	994
<i>Account Receivables</i>	3.235	3.464	3.873	5.188	1.322
<i>Accrued revenue and prepaid expenses</i>	421	350	287	312	313
Current liabilities	926	1.005	1.717	2.128	3.871
<i>Account Payables</i>	542	833	933	936	1.418
<i>Advanced payments</i>	48	0	272	861	1.872
<i>Other debts</i>	325	160	504	317	570
<i>Prepaid revenue and accrued expenses</i>	11	13	9	14	11
Trade Working Capital	3.089	3.088	3.020	3.693	(1.242)
<i>Trade Working Capital/Sales</i>	35%	42%	40%	46%	(32%)
Other current assets	761	784	940	1.601	1.221
Other current liabilities	(413)	(360)	(853)	(1.469)	(1.505)
Net Working Capital	3.437	3.512	3.108	3.825	(1.526)
Fixed assets	298	227	191	148	111
Other assets and liabilities	200	163	171	33	(303)
TFR and other provisions	(294)	(455)	(209)	(146)	(162)
TOTAL ASSETS	3.641	3.447	3.261	3.859	(1.880)
Net Financial Position	2.932	2.843	2.579	3.075	1.640
Cash and Cash equivalents	(154)	(159)	(552)	(155)	(164)
Bank debt	3.086	3.002	3.131	3.230	1.804
<i>NFP/EBITDA</i>	8,27	15,48	2,79	2,54	-0,77
<i>NFP/Equity</i>	4,14	4,71	3,78	3,92	-0,47
Equity	709	604	682	785	(3.521)
TOTAL LIABILITIES	3.641	3.447	3.261	3.859	(1.880)

Table 5.4 The Distressed Company Balance Sheet (2008-2012).

5.1.3 The reference market

Since in the first decade of the new century the Distressed Company started a new set of activities, it has been able to diversify the clientele, reaching not only the footwear market but also other ones (such as the graphic design and interior design market). Indeed, as specified in the management reports of the company, the two different strategic units may have different trends and performance because the clients' characteristics are different; for example, during the financial crisis the "Industrial design and other activities" clients were suffering the crisis while on the other side the historical clientele seemed more resilient. However, the reference market still remained the footwear ones because of its high incidence on the total revenues.

Focusing, for the reasons aforementioned, on the footwear market, the company was able to offer its services to different types of companies, both shoes producers and not-only-shoes producers. Furthermore, inside the shoes specialists the company served different niches maintaining the same quality of the service provided; the company might serve:

- cheap shoes producers or luxury ones: the designers were able to adapt themselves to the different styles;
- Italian, European or international clients;
- customers which are focused in the sport, casual, fashion or comfort niches: the company was flexible also when adopting different perspectives when performing the same service to differently positioned clients.

As for the non-shoe specialists, the company could provide specific services to both luxury and non-luxury clients, thanks to the strong skills of the professionals deeply established and rooted in the territory (i.e. the local footwear industrial district).

The average duration of the main contracts (i.e. the ones related to the core activity of creation or restyling of collections) was about 20 months¹⁶² (between one and two years); thus, in order to maintain a stable revenue trend in the medium-long period, the company had to find the right marketing strategy which includes a set of operations aimed at increasing the degree of fidelization of the clients.

The per-year value of those “core contracts” was about € 0,4 million¹⁶³; however, inside the contracts analysed, there were some important long-term contracts which were important to keep stable the operative cash inflows. On the other side, considering the fact that the revenues usually were lower than € 10 million, the loss of an important client might have significant negative impacts on the company performance.

One of the main advantages of the company was the geographical composition of its revenues, i.e. the geographical differentiation of the clients. Indeed, in the last decades the company has been able to obtain a balanced composition of its clients, with both a strong presence in the local Italian area and good relationships with some of the biggest players in the world fashion industry.

¹⁶² The average time length of those “core contracts” has been calculated observing the terms of the contracts object of the company rent contract between the Distressed Company and the Newco.

¹⁶³ Also in this case, the amount has been obtained by analysing the contracts mentioned in the previous Note.

REVENUES BY GEOGRAPHY

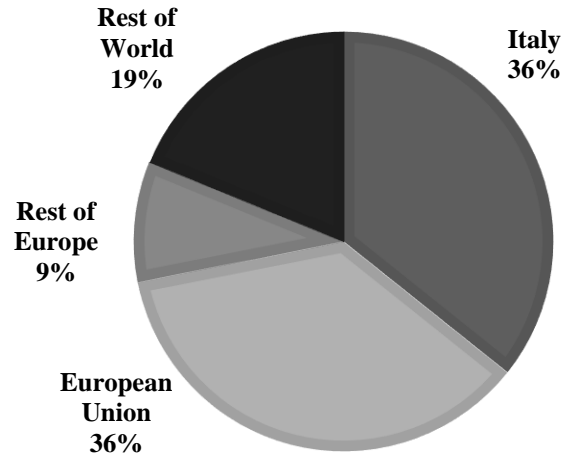


Figure 5.1 Geographical composition of the Distressed Company revenues (avg 2008-2012).

Figure 5.1 shows that only the 36% of the total revenues are related to the Italian market, an abnormal result for a medium company embedded in an industrial district. This diversification allows the company to reduce significantly the country risk.

GEOGRAPHICAL REVENUES INCIDENCE ON SALES

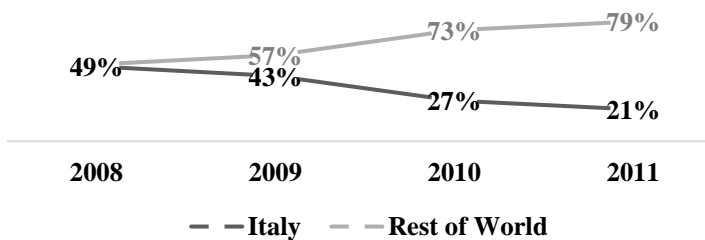


Figure 5.2 Incidence of Italian and Rest of World revenues trend.

Observing the trend, it seems clear that the incidence of the Italian customers on the total revenues is decreasing, demonstrating a higher potential of reduction of the country risk aforementioned.

5.1.4 Competitors, Industry and Competitive advantage

As explained before, the Distressed Company was embedded in one of the most important Italian industrial districts – since it has been founded there. Accordingly, the main competitors of the Distressed Company were all the design firms located in the industrial district, and a first thing to do is to observe the competition among those firms.

In this sense, it is important to notice that the Distressed Company – in the 2012 – was at least 6 times bigger than every other designer located in the industrial district area, in terms of EBITDA; moreover, considering the revenues, the second bigger firm was about 3 times smaller than the Distressed Company. In other words, the Distressed Company had a dominant position if we compare its size with the other similar firms one.

Apart from the company size, the Distressed Company had some competitive advantages that decrease further the degree of competition. In particular, one of the main strengths of the company is its degree of integration. As explained above, from the Nineties the company integrated the prototypes production process; this strategic decision permitted the company to cut some transaction costs and to coordinate the activities more efficiently. Another competitive advantage was represented by the network and partnerships that the company – especially thanks to the presence of the two designers – had obtained during the decades. As already mentioned, the company was collaborating with some of the most important fashion brands and shoes (and not only) specialists of the world. A third competitive advantage was related to all the investments in R&D made in the past; the Distressed Company has acquired enough know-how to guarantee a pervasive and high-quality service, while on the other side usually the competitors were specialized only in one phase of the design process or did not have enough knowledge to provide a competitive service.

Inside an industry, and in particular inside an industrial district where the knowledge spill-over phenomenon is very common, another important aspect to observe is the entry barriers of the industry, which may be very low. For the Distressed Company, however, the threat was not very high because of its dimension and high economies of experience obtained in the last decades.

A similar reasoning is valid for the bargaining power of the suppliers, in particular the threat of integrating the supply business with the designing processes. Indeed, it was very difficult for a supplier to begin a designing activity, because of the material differences between the two activities (the latter is creative while the former is more operative). Moreover, usually it is easier

to integrate the supply activity for a designer than integrating the design activity for a supplier, since the creative tasks require more years to be learned and the reputational aspect is more important.

By contrast, a significant characteristic to examine is the bargaining power of the clients. Indeed, since the Distressed Company was dealing with important fashion companies and shoes producers, there was the significant risk that they decide to integrate totally the design process. Obviously, the consequence would have been the irreversible loss of some important clients, affecting negatively the revenues.

5.1.5 The negative SWOT approach

Now that the Distressed Company (and its reference market and industry) has been presented – and before analysing the negative path which have led the company to distress – it is important to see what could happen to enter a distress stage. In other words, the aim here is to understand all the reasons why a company may become distressed given the situation described so far. The managers should be attentive to the possibilities of crisis in every moment – also when everything is going fine – and maintain a proactive behaviour towards the possibility of a deterioration of the performance; broadly speaking, this is also a way to manage the company risk, which is an important component of every management activity.

For those purposes, the “negative SWOT” approach presented in the first Chapter of this dissertation will be used. As mentioned above, the aim of this approach is to see every aspect of a company – both positive and negative – from a different perspective, i.e. the distress that may arise because of a bad treatment of each aspect. To perform this analysis, it is sufficient to prepare a normal SWOT analysis and to think about how every item of the scheme may lead the company to distress – or even to bankruptcy.

Figure 5.3 shows the application of the model aforementioned to the specific case: it is important to notice that the analysis has been congealed to the 2011, i.e. before the distress started to become serious.

<p style="text-align: center;">Strengths</p> <ul style="list-style-type: none"> - Skills of the two designers and economies of experience (<i>inertia</i>) - Uniqueness and flexibility of the service offered (<i>no improving</i>) - Integration of the processes (<i>rigidity</i>) - Positive reputation (<i>inertia</i>) - Dominant position in the industrial district (<i>competitors' retaliation</i>) - Easy access to new techniques because of the industrial district (<i>inertia</i>) - International presence and attitude (<i>to forget the roots</i>) - Geographical and horizontal subdivision of clients (<i>too high differentiation</i>) 	<p style="text-align: center;">Weaknesses</p> <ul style="list-style-type: none"> - Small dimension and low equity (<i>bad capital structure</i>) - High incidence of fixed costs, in particular leasing (<i>rigidity</i>) - Dependence on major clients (<i>no fidelization policies</i>) - Low contracts duration (<i>no new clients</i>) - Decreasing level of revenues (<i>no reaction</i>) - High indebtedness (<i>bad capital structure</i>)
<p style="text-align: center;">Opportunities</p> <ul style="list-style-type: none"> - Further development of the new strategic unit (<i>inertia</i>) - Further expansion in other countries (<i>no further marketing efforts</i>) - Higher fidelization (<i>no marketing effort</i>) - Entrance of new partners in the equity (<i>to maintain a bad capital structure</i>) 	<p style="text-align: center;">Threats</p> <ul style="list-style-type: none"> - Process integration of the major clients (<i>low marketing effort</i>) - Unions between competitors (<i>no M&A or alliances</i>) - Financial and macroeconomic crisis (<i>no hedging</i>) - No payment by the clients (<i>bad contracts</i>)

Figure 5.3 Application of the “negative SWOT” approach.

To think about the possibilities of entering a distress scenario because of a *strength* may seem paradoxical, at a first glance. However – as analyzed in the first chapter observing the main literature about the reasons for distress – a company might become distressed because, for example, of a too intensive focalization on a single production process or an inertial behavior of the managers. Thus, it is important to see what can go wrong starting from a consolidated competitive advantage, in order to avoid any type of error which can lead the company in serious troubles.

In the case of the Distressed Company, the exceptional skills of the designers can create an inertial behavior which can corrode the gap with the other competitors, that by contrast can increase its investments in R&D approaching the company level of quality. Linked to this aspect

is the fact that the flexibility and uniqueness of the company service (that is a strength) can be imitated in the medium-long term by the competitors¹⁶⁴, so the company should be able to continuously improve the quality and the perceived benefit of the services offered. Also the high reputation that the designers have towards the clients may create an inertial behavior, where no further innovations are created simply because they think that what they have done in the past is sufficient to maintain the clientele.

Another advantage of the Distressed Company is the degree of integration of the production process; indeed, the company is able to follow the whole process from the preliminary research phase to the complete production of the prototype. However, the company may enter a distress scenario if it becomes too rigid, i.e. in the case that it decides to perform too much activities standardizing the processes. For example, the company may lose the uniqueness of its services because of a too high standardization of the processes. Accordingly, the managers-designers should maintain the right balance between flexibility and rigidity of the production process, also for a matter of fixed costs.

For a competitors' point of view, also the dominant position that the Distressed Company has can lead to distress if the managers do not control whether the competitors are implementing some strategies (such as unions or mergers) to increase its size, undermining the dominant position that the company has created during the last decades.

In some cases, also the international presence can be a problem for a company. For example, since the Distressed Company is embedded in a highly traditional industrial district, a too high degree of internationalization can lead the company to abandon and forget all the traditions which represent a significant component of the competitive advantage of the company itself. Accordingly, the company should be attentive in preserving that component – that it is possible to call “made in Italy” – that is critical to maintain the competitive advantage created during the last years.

Shifting now to the *weaknesses*, the link between them and the reasons for distress is more logical.

Firstly, a too low level of equity can be a problem when the managers are going to decide about the convenience of an investment; in particular, with a too low level of equity it may not be

¹⁶⁴ It is important to recall that the Distressed Company is embedded into an industrial district, where it is difficult to maintain secret an information.

possible to raise a significant amount of debt capital in order to avoid a deterioration of the equilibrium of the capital structure.

Another problem is related to the high incidence of some fixed costs on the profitability of the company. In particular, as showed below in Figure 5.4, on average the leasing costs represent the 16% of the total revenues. Those costs cannot be recovered (if not through a renegotiation of the leasing costs) in case of a decrease of the revenues.

Furthermore, the Distressed Company relies significantly on some major clients, both for reputation and for revenues matters. Clearly, the loss of those clients – either because of their decisions (for example if they decide to integrate the design process) or for a manager’s mistake (for example the management does not focus the attention to a proper marketing campaign) – might undermine the profitability of the company.

Another criticality is linked to the duration of the contracts. As mentioned above, the average duration of the “core contracts” of the company is about 20 months; thus, if the client decides to not repeat the partnership the company risks losing revenues. The consequence of this fact is that the future revenues are not stable; the company should consider this aspect in order to avoid bad consequences.

Another company weakness is related to its capital structure; indeed, the company has a negative Debt-to-Equity ratio – as will be explained better below. An over-indebted company may have serious problems, in particular if the operative performance is not sufficient to cover the debt service. Accordingly, the managers should find a way to rebalance the capital structure.

The Distressed Company can also take advantage of some *opportunities* to grow.

For example, as precised before, recently it integrated the core activity with new ones (interior design, digital graphic support, architecture services, etc.); a significant opportunity would be to implement further strategies in order to develop the new strategic unit. Accordingly, the non-development of the new set of activities would stop the internal growth process that have accompanied the company throughout the years; in this case, the company would remain too dependent to the old “*fashion*” strategic unit, avoiding any potential of revenues diversification.

A similar reasoning is valid for a possible geographic broadening of the market; indeed, the company may have the possibility to enter new geographical markets. Thus, if the managers avoid considering other market opportunities, the competitors may take advantage of the situation, undermining the dominant position in the industry.

Another opportunity is related to an increase of the fidelization of the current clients. As stated before, one of the main weaknesses of the Distressed Company is the low duration of the “core contracts”; the managers may let the company enter a distress scenario if they do not take the necessary measures to increase the customer fidelization.

Finally, an opportunity is the adjustment of the capital structure – at the time in a bad situation – through the entrance of a new financial partner which helps the company to grow financially. A mistake would be to decide *a priori* to remain small, avoiding any financial intervention by a third party.

As for the *threats*, they can be seen as potentially external reasons for distress, so the company should seek to avoid them by maintaining a proactive behavior in order to avoid the verification of them in the future.

A first threat presented in the model is the process integration of the major clients, i.e. when a client decides to integrate the design process. If on one side this aspect is not directly controllable by the company, on the other side the managers can try to eliminate the threat by implementing a more aggressive marketing campaign, or by performing more R&D investments in order to guarantee a higher level of quality.

Secondly, in the future the competitors can decide to join themselves in order to compete better with the Distressed Company. To eliminate this threat, the company may employ a strategy which includes the conclusion of alliances or M&As with the competitors, promising a higher payoff (in terms of synergies) in respect of a “competitive battle”.

Lastly, another threat is related to the possibility that a financial crisis occurs, both at country and world level. In this case, the company cannot protect itself completely since often the financial crises are sudden; however, the managers can decide to apply some hedging policies (such as geographic revenues diversification and stronger agreements with the clients) which can reduce the losses.

5.1.6 Rise and fall of the Distressed Company: the reasons for distress

As mentioned before, the first decade of the new century represented a period of important internal growth for the Distressed Company; for this reason, the managers decided to transform

the legal form of the company, from Srl (Società a Responsabilità Limitata) to Spa (Società Per Azioni), in order to adjust the capital structure to the new dimension of the company.

This internal growth period led the two designers to implement a huge increase of the workplace dimension, since the increasing work to be performed required more factories, more machineries and a more sophisticated equipment. This is why the two designers decided to find a bigger headquarter in order to align the dimension of the building and the laboratories to the level of production reached. The designers-managers chose to get the new headquarter by signing some expensive leasing contracts¹⁶⁵. Moreover, the company adopted the leasing instrument to get other assets such as furniture, vehicles (in particular a helicopter), printers, computers and a show room. In total, the company arrived to spend more than € 1,5 million in leasing costs, reaching a peak of € 1.8 million in the 2007. These costs had a significant impact on the profitability of the company, in particular if we think that the company had an amount of total revenues lower than € 10 million¹⁶⁶. Figure 5.4 shows the material impact of the leasing costs on the profitability of the company (the low 2011 level is due to the renegotiation of some contracts, resulting in a lower value of the leasing costs). However, the company needed a way to increase its facilities quickly, so that might be the most convenient way.

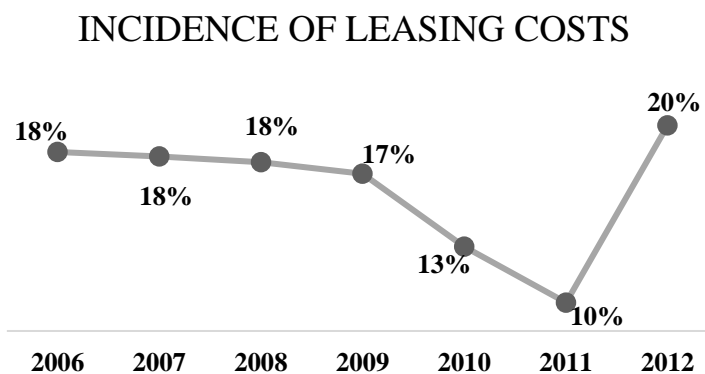


Figure 5.4 Incidence of leasing costs on total revenues.

¹⁶⁵ Some of those contracts have been signed directly from the Distressed Company itself, while the other contracts have been concluded by two subsidiaries and then rent to the Distressed Company.

¹⁶⁶ The total revenues were slightly higher than € 10 million only in the 2007.

Notwithstanding the high price of the leasing, the investment was considered sustainable because of the positive trend of the company revenues. Indeed, in the 2007 (all the main leasing contracts have been signed before) the company reached level € 10 million of total revenues, perfectly in line with the scenario predicted when the designers decided to lease those buildings and assets. The amount of debt was high, but the business outlook seemed positive also for the future, from every perspective: the competitive advantages obtained so far appeared difficult to imitate, and the relationships with the most important clients were stable. Moreover, during the period observed, the EBITDA (which included the leasing costs) was positive in all the years, signalling that the profitability of the company was sufficient to sustain those costs.

However, toward the end of the first decade of the new century the situation started to worsen. The first negative signals have been provided by the 2008 financial crisis; as happened for most companies, the market demand started to decline, including the ones served by the Distressed Company. In particular – as explained in the management reports in those years:

- *fashion strategic unit (footwear industry)*: the financial meltdown provided a material reduction of the investments in external designing services by the “core clients”;
- *industrial design and other activities*: the financial crisis decreased significantly the architecture industry, so that the internal design activities have been reduced seriously, in particular because of the total absence of new financings on the real estate sector.

A further consequence related to the Distress Company market due to the financial crisis has been the increase of the degree of integration of the design activity by the clients, including some of the most important ones. Indeed, in order to save costs those companies decided to be less dependent on external costs such as the Distressed Company services, preferring for a matter of convenience to hire internally some designers. This behaviour may be also due to a change of the strategy of the clients; however, the timing of the strategic change is perfectly aligned with the financial crisis, so that it is possible to argue that the world financial crisis had a significant role in provoking those changes.

Moreover, from the beginning of the current century the cost and capital structure were not optimal; in practise, the unbalanced company structure was “covered” by the good performance of the revenues, so that the managers considered worthwhile to maintain this dangerous situation. If the incidence of the leasing costs has already been presented above (see Figure 5.4), the second structural problem was referred to the amount of debt.

NET FINANCIAL POSITION/EQUITY

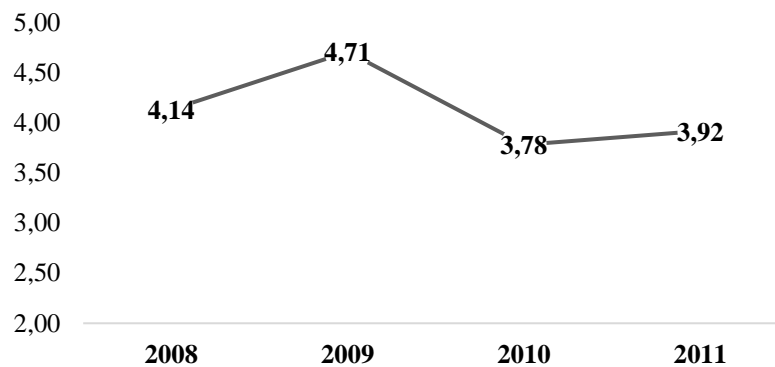


Figure 5.5 The Distressed Company Net Financial Position-to-Equity ratio (2008-2011).

Figure 5.5 shows an alarming situation. Indeed, in the years considered the Net Financial Position-to-Equity ratio can be considered significantly high, demonstrating that the financial debt raised by the company is not covered enough by a proper amount of risk capital, undermining the solvency of the company.

In particular, as shown in Table 5.5, the increase of the stock of debt is not due to an increase of the debt provided by the financial institutions¹⁶⁷; instead, the increase of the indebtedness is due both to a persistent increase of the account payables and to the accumulation of debts toward tax agencies and social security institutions. Moreover, in those years the managers started to ask to the clients to be paid partially in advance (i.e. before the completion of the services); this aspect on one side had a positive impact on the cash flow, but on the other side implicated an increase of the total debts. Figure 5.5 explains well this characteristic of the Distressed Company capital structure; on one side it is possible to see a stable path of the bank debt, while on the other side the commercial debt and the tax debt increase significantly. All those trends signal a negative (or at least delicate) aspect for the Distressed Company; indeed:

- the stable path of the bank debt reveals a situation where the banks were reluctant to increase significantly the credit lines since the company was in a difficult situation, in particular because of the performance of the commercial debt. However, as presented in Table 5.5, the long-term component of the bank debt is decreasing (because of the

¹⁶⁷ A proof of that is the fact that during the observed period the Interest Coverage Ratio – which represents how many times the EBITDA covers the interest expenses – has a positive trend. Indeed, from the 2008 to the 2011 it went from 1.59x to 6.31x.

reimbursement of a long-term loan), while on the other side the short-term bank debt is increasing until the 2011. Thus, the relationship with the banks does not seem very bad. This aspect is important if we think that the banks were many (about 10). Inside a complex situation as a distress period, it may be seen as a positive aspect since in case of irremediable crisis scenario the financial institutions are the first entities that react, in order to block the credit lines as soon as possible.

However, this level could not be sufficient if we think that the Distressed Company main contracts provided for highly deferred payments; thus, usually a company with such deferred cash inflows may need a higher bank financing, in particular revolving credit lines;

- the increasing trend of the commercial debt (i.e. advanced payments from clients, account payables and other debts) signals a difficulty in respecting the deadlines when paying the suppliers and the other creditors. Indeed, according to internal sources, in those years the Distress Company had a tension with some suppliers;
- the increasing trend of the tax debt shows a difficulty in paying the taxes, cumulating a significant amount of debt as the years went on.

Table 5.5 shows those trends in absolute terms.

(€/000)	2008	2009	2010	2011	2012
Due to banks (short term)	2.188	2.248	2.702	2.946	1.687
Due to banks (long term)	898	755	429	284	117
Advanced payments	48	0	272	861	1.872
Account Payables	542	833	933	936	1.418
Tax debts	209	221	665	1.120	1.505
Due to social security	209	139	188	489	395
Other debts	325	160	504	317	625
Total debts	4.417	4.355	5.692	6.953	7.619

Table 5.5 The Distressed Company debt composition (2008-2012).

This aspect can be confirmed observing the trend of the current ratio (i.e. the ratio between current assets and current liabilities) showed in Figure 5.6. The even higher level of total debts decreases the possibility to cover the liabilities through the current assets.

CURRENT RATIO

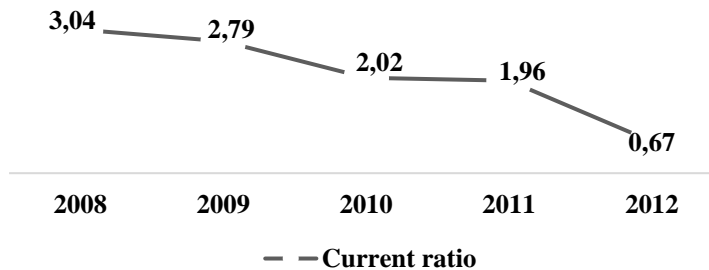


Figure 5.6 The Distressed Company current ratio trend (2008-2012).

After some years of stability, with a return to two years (2010 and 2011) of revenue growth, in the 2012 the performance fell dramatically. In particular, in this period a significant component of the Distressed Company clients went into troubles mainly because of the financial crisis; this aspect led to two consequences (apart from the higher degree of integration aforementioned):

- the loss of a significantly high amount of credits;
- the cancellation of a material number of orders.

The first consequence led the company to record a huge credit loss¹⁶⁸, which deteriorated dramatically the net profits. The second consequence implicated a fall of the level of revenues¹⁶⁹, from about € 8 million to € 3.8 million; in practice, the cancellation of the orders halved the total revenues. Moreover, the EBITDA was already negative, equal to € - 2.1 million.

This dramatic combination of extraordinary costs and decrease in revenues led to a negative net result of € - 4.3 million. Since the level of equity was not high, this loss represented a death sentence for the Distressed Company.

¹⁶⁸ The 2012 amount of credit loss was higher than the one estimated adopting the accrual accounting principle because the company did not account for the credit loss in the last two years. Accordingly, the 2012 dramatic fall may have been more gradual, starting from the 2010.

¹⁶⁹ This fact may explain also the dismissal of some employees during the year.

REVENUES AND GROWTH RATES

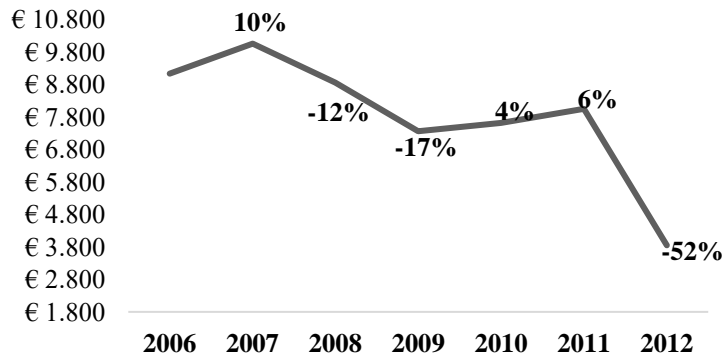


Figure 5.7 The Distressed Company revenues and relative growth rates (2006-2012).

Figure 5.7 shows the trend of the revenues (and its per-year growth rate) for the period observed. It is easy to notice the direct effect on the revenues of the financial crisis, in particular a decrease of 12% in the 2008 and 17% in the 2009. In the 2010 and 2011 it is possible to see a slight recovery, i.e. a positive growth of the revenues of 4% and 6%, respectively. However, for the reasons aforementioned, in the 2012 the level of total turnover decreased of 52%, damaging seriously the EBITDA. In reality, the greatest part of the 2012 negative effect on the revenues is related to the abroad sales, as showed in Figure 5.8; indeed, the Italian revenues dropped only of 12%, while the revenues of the European Union, Rest of Europe and Rest of World decreased of 63%, 79% and 54%, respectively.

GEOGRAPHIC REVENUES COMPOSITION (2011-2012)

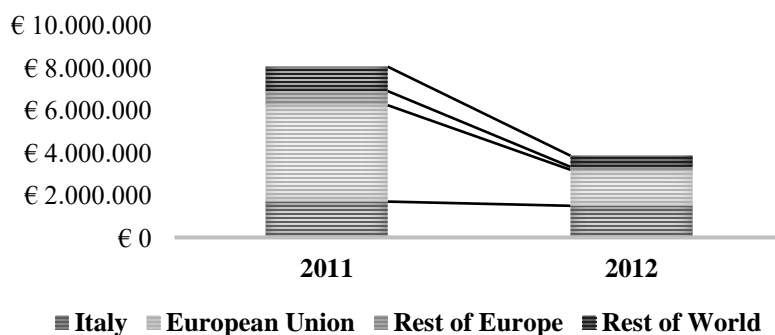


Figure 5.8 The Distressed Company revenues geographically divided (2011-2012).

Figure 5.9 represents the EBITDA trend for the relevant period and the relative margin on the revenues. The trend follows roughly the revenues one, with an increase of both the EBITDA level and its profitability (represented by the margin on the revenues) in the 2010 and 2011. However, in the 2012 the material drop of the revenues led to a dramatic deterioration of both the operative margin level and its profitability.

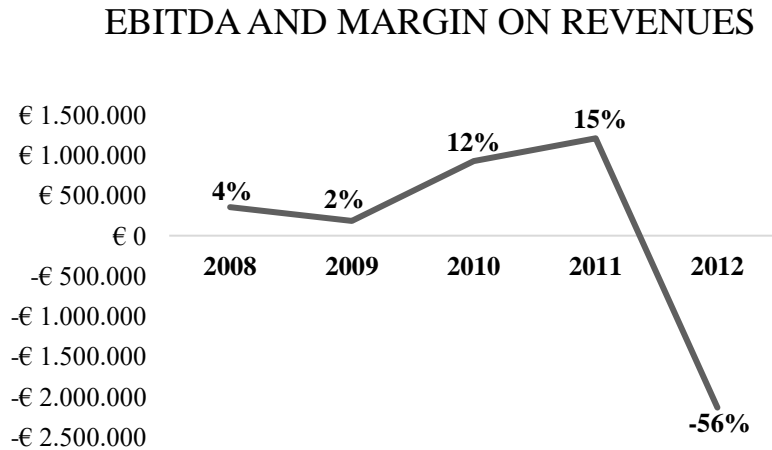


Figure 5.9 The Distressed Company EBITDA and relative margin on revenues (2008-2012).

In sum, the distress of the company has been caused by a mix of different but correlated reasons:

- *financial crisis*: as the greatest part of the Italian medium companies, also the Distressed Company suffered because of the financial crisis; in particular, the world crisis led to a change of the behavior of all the economic agents, starting from the individuals. A worse financial situation of the end-consumers has decreased – as a consequence – the possibilities for the companies to sell their products or services; obviously, this situation has been translated also to the companies, such as the Distressed Company, that sell its products or services to other companies (B2B);
- *bankruptcy of some old clients*: as mentioned above, some Distressed Company clients have not been able to pay the company anymore mainly because of the financial crisis. This fact has contributed significantly to the dramatic fall of the 2012 because the managers had to account for a huge credit loss in the Income Statement;

- *cancellation of orders*: since some clients entered a distress scenario mainly because of the financial crisis, the Distressed Company has not been able to conclude the contracts related to the related services. In particular, some clients decided to conclude unilaterally the contract; this event, as already described, implicated a huge decrease of the total revenues (- 52% from the 2011 to the 2012), contributing significantly to the 2012 performance disaster;
- *fixed costs incidence*: the negative effects of the past decision to purchase a huge amount of assets (buildings, vehicles, furniture and other equipment) with leasing contracts started to show immediately after the distress has begun. In particular, even though the managers have tried to decrease the leasing costs through some negotiations, the incidence of those costs on the total revenues remained high (20% in the 2012). Moreover, the Distressed Company business is labor intensive; as a consequence, the company had a significant component of costs composed by personnel costs and services costs (which includes the expensive costs related to the collaboration with external designers and professionals). On average, the personnel costs account for the 39% of the total revenues, while the service costs represented the 36% of the company turnover. Those costs are very difficult to decrease when the work to perform starts to decrease. Accordingly, when the distress started to become serious, the company could not try to absorb the negative contingency by employing an efficient cost cutting strategy because of those high fixed costs (i.e. leasing costs, personnel costs and services costs);
- *bad capital structure*: from the very beginning of the period observed, the Distressed Company capital structure was unbalanced, with a too high level of debt (or a too low level of equity). In particular, on average the Net Financial Position-to-Equity ratio for the period 2008-2011 is equal to 4x, signaling an unsustainable incidence of financial debt if we combine the ratio with the amount of commercial debt. In particular, the banks were not willing to increase the credit lines anymore, while the Distressed Company struggled to respect the deadlines for the account payables and the tax debt;
- *clients' integration strategy*: a final reason which contributed to the company distress is related to a change of the strategy of some of the Distress Company clients, i.e. the decision to integrate inside the company the design process. This strategy – which can be partially due to the financial crisis – has decreased the potential number of orders for the Distressed Company, affecting negatively the revenues.

Once the reasons for distress have been listed, it may be useful to classify them following the main classifications described in the first chapter of this dissertation.

The first classification presented in Chapter 1 regards the dichotomy *internal vs external* reasons for distress. In this practical case, the distress has been provoked by a mix of internal and external reasons; in particular:

- inside the “internal reasons” class there are:
 - *fixed costs incidence*: obviously, the high incidence of the fixed costs – in particular the leasing ones – has its origins from a decision taken by the managers in the past. Thus, by definition it is an internal reason for distress;
 - *bad capital structure*: the high degree of indebtedness is due to some strategic decisions undertaken by the management in the past, such as the treatment of the commercial and tax debt;
- inside the “external reason” class there are:
 - *financial crisis*: obviously, the global 2008 financial crisis is an event which has not been created by the Distressed Company. Instead, it has been the main trigger event which has activated all the other reasons for distress listed above;
 - *bankruptcy of some old clients*: the fact that some of the Distressed Company clients went bankrupt because of the financial crisis has nothing to do with the company internal decision-making process;
 - *cancellation of orders*: the non-completion of the orders because of the unilateral cancellation of them is outside the control of the Distressed Company, even though the latter might have included inside the contracts some protecting clauses;
 - *clients’ integration strategy*: clearly, the strategies of the clients – as the competitors ones – are very difficult to predict. Accordingly, this could be considered as an external cause.

The second dichotomy analyzed is the *operational vs strategic* reason for distress. The main difference between the two classes is that the operational reasons are more related to the decisions (not) undertaken by the managers in order to maximize the internal efficiency. Accordingly, in general there is a connection between internal causes and operational causes (and external reasons and strategic reasons). In particular:

- on one side, the *fixed costs incidence* and the *bad capital structure* are related with the operational reasons, since they undermine the possibility to maximize the internal

efficiency of the company. In particular, the two reasons limit significantly the possibility to adjust the cost structure as a consequence of a decrease of revenues and to get more financing when necessary, respectively. Accordingly, those two reasons are operating causes for distress since they affect the internal efficiency of the company;

- on the other side, all the other external reasons aforementioned (*financial crisis, bankruptcy of some old clients, cancellation of orders and clients' integration strategies*) affect the strategy of the Distressed Company. Indeed, all those reasons deal with a change of behavior of external agents (global economy, clients, end-consumers, competitors, etc.) which affect the company strategy. i.e. it has nothing to do with the way in which the company structures its production process.

A third classification regards the second part of the “negative SWOT” approach presented in Chapter 1, i.e. *balance sheet vs income statement* reasons. The usefulness of the approach is due to the possibility to see clearly where the problems are located in the financial statements. In the Distressed Company case, some reasons for distress are a balance sheet problem, others are an income statement problem while other are related to the whole financial statements. In particular:

- *income statement problem*: first of all, the *fixed costs incidence* is completely an income statement problem, since it affects directly the EBITDA – as mentioned above in this chapter. Secondly, the *bankruptcy of some old clients* could be seen (mainly) as an income statement problem, since it has provoked a huge drop of the net income¹⁷⁰. Thirdly, both the *cancellation of orders* and the *clients' integration strategies* have led to a material decrease of the total revenues, because of the financial crisis and an unforeseeable change of strategies, respectively;
- *balance sheet problem*: among the reasons for distress identified, only the *bad capital structure* is related to the balance sheet only. Indeed, the problem regarded the huge amount of debt in respect of the low value of equity;
- *general financial statements problem*: the *financial crisis* is a pervasive event, which entails both the operative performance (i.e. drop in revenues and higher extraordinary expenses) and the financial one (i.e. the difficulty in obtaining new financing or the missed payment of some credits).

The quantitative impact of the reasons for distress in the different schemes of the financial statements (or in the financial statement as a whole) are summarized in Table 5.6 (Income

¹⁷⁰ In reality, the credit loss affects the balance sheet as well.

Statement), Table 5.7 (cost structure) and Table 5.8 (Balance Sheet), which recall the Tables 5.2, 5.3 and 5.4 respectively.

(€/000)	2008	2009	2010	2011	2012
Sales revenues	8.845	7.353	7.611	8.038	3.846
<i>YoY revenues growth rate</i>	-	-17%	4%	6%	-52%
EBITDA	355	184	926	1.210	(2.137)
<i>EBITDA margin</i>	4%	2%	12%	15%	-56%
EBIT	235	(148)	740	1.109	(2.251)
<i>EBIT margin</i>	3%	-2%	10%	14%	-59%
Net income	(120)	(305)	78	103	(4.305)

Table 5.6 The Distressed Company Income Statement (2008-2012).

(€/000)	2008	2009	2010	2011	2012	Average incidence
Operative costs	9.376	7.572	7.469	7.282	8.374	
Raw materials	270	285	282	232	201	3,20%
Services	2.908	2.545	2.710	2.862	3.516	36,44%
Leasing	1.558	1.247	974	773	758	13,16%
Personnel	4.305	3.125	3.204	2.695	2.173	38,61%
Depreciation and Amortization	119	332	186	101	61	2,05%
Change in raw materials	11	(24)	(39)	(5)	23	-0,10%
Other provisions	0	0	0	0	53	0,13%
Other operative costs	205	61	153	624	1.589	6,52%

Table 5.7 Distressed Company cost structure and average incidence on total costs (2008-2012).

Table 5.7 shows the structure of the costs for the Distressed Company; apart from the personnel costs, the highest impact on the total operative costs is provided by services costs and leasing costs, i.e. costs which may have a significant component of rigidity. In particular, the services costs are mainly related to relationships with external designers and other professional, i.e. costs which usually are completely fixed and expensive. Thus, it seems alarming the increasing trend of the services costs, since they do not reflect the sales performance. As for the personnel costs, during the distressed period the managers tried to cut part of the total employees because of the decrease of the orders from the clients; however, to dismiss the employees can be expensive and usually requires several months to be performed, so that those costs can be seen as fixed.

(€/1000)	2008	2009	2010	2011	2012
Current assets	4.015	4.093	4.738	5.821	2.628
<i>Inventory</i>	358	279	577	321	994
<i>Account Receivables</i>	3.235	3.464	3.873	5.188	1.322
<i>Accrued revenue and prepaid expenses</i>	421	350	287	312	313
Current liabilities	926	1.005	1.717	2.128	3.871
<i>Account Payables</i>	542	833	933	936	1.418
<i>Advanced payments</i>	48	0	272	861	1.872
<i>Other debts</i>	325	160	504	317	570
<i>Prepaid revenue and accrued expenses</i>	11	13	9	14	11
Trade Working Capital	3.089	3.088	3.020	3.693	(1.242)
<i>Trade Working Capital/Sales</i>	35%	42%	40%	46%	(32%)
Other current assets	761	784	940	1.601	1.221
Other current liabilities	(413)	(360)	(853)	(1.469)	(1.505)
Net Working Capital	3.437	3.512	3.108	3.825	(1.526)
Fixed assets	298	227	191	148	111
Other assets and liabilities	200	163	171	33	(303)
TFR and other provisions	(294)	(455)	(209)	(146)	(162)
TOTAL ASSETS	3.641	3.447	3.261	3.859	(1.880)
Net Financial Position	2.932	2.843	2.579	3.075	1.640
Cash and Cash equivalents	(154)	(159)	(552)	(155)	(164)
Bank debt	3.086	3.002	3.131	3.230	1.804
<i>NFP/EBITDA</i>	8,27	15,48	2,79	2,54	-0,77
<i>NFP/Equity</i>	4,14	4,71	3,78	3,92	-0,47
Equity	709	604	682	785	(3.521)
TOTAL LIABILITIES	3.641	3.447	3.261	3.859	(1.880)

Table 5.8 The Distressed Company Balance Sheet (2008-2012).

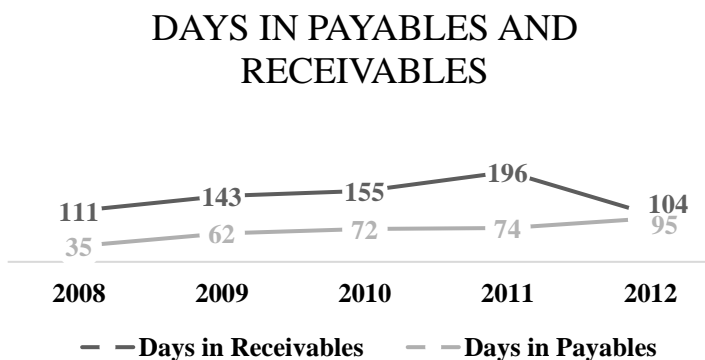


Figure 5.10 Distressed Company Days-in-Receivables and Days-in-Payables (2008-2012).

Figure 5.10 shows the average time that the company need to collect the cash from its operations and the average time of payments of the suppliers. From the figure it is possible to see an increase – during the distress period – of both the Days-in-Receivables and the Days-in-Payables. However, the two increases have a different explanation: indeed, the increase of the Days-in-Receivables are due to both an intrinsic characteristic of the company contracts¹⁷¹ and the financial difficulty of some clients, while the increase of the Days-in-Payables are due to a difficulty from the Distressed Company to respect the deadlines for the payments of some suppliers.

This fact is the consequence of a very high Trade Working Capital, which signals that the Distressed Company had some difficulties in the management of the operative cash flow since the cash inflow timing was higher than the average deadline related to the payment of the commercial debt.

Summarizing the distress period from a macro perspective, we can distinct two distress stages:

- *Stage 1*: this stage corresponds to the period 2008-2011, where the first effects of the financial crisis started to impact the financial statements. As already analyzed, in this period the performance declined at the beginning but improved slightly until the 2011. However, a significant component of the 2012 credit losses should have been accounted for during this period of time, so the first signals of distress were already present in this stage. According to the Weitzel & Jonsson (1989) model, it is appropriate to classify this stage as a mix of “*blinded stage*” and “*inaction stage*”, since on one side the managers were not aware of the situation while on the other side they did not implement (or were not in a position to implement) the proper countermeasures in order to soften the impact of the crisis;
- *Stage 2*: continuing to follow the Weitzel & Jonsson (1989) framework, the second stage – which corresponds to the year 2012 – represents the *crisis stage*, where the only solution available to recover from the situation was the creation of the proper turnaround strategy (the alternative would have been to move to the next stage, the *dissolution one*, where the possibilities to rescue the company are null). Indeed, in that year the combination of turnover decrease and credit loss increase led to a materially negative net

¹⁷¹ It is not a case that the Distressed Company requires a significant amount of advanced payments from the clients.

income, so that the value of the Distressed Company equity became negative. Thus, the managers had to find a successful way for continuing the company operations.

Once having determined a “distress period”, an interesting aspect is to see the path of the distress, in order to see – according to the D’Aveni (1989) model if the crisis period follows a sudden, gradual or lingering decline. Since the trend of both the revenues and the EBITDA are similar, Figure 5.11 considers only the level of total revenues as benchmark for determining the trend of the period of distress.

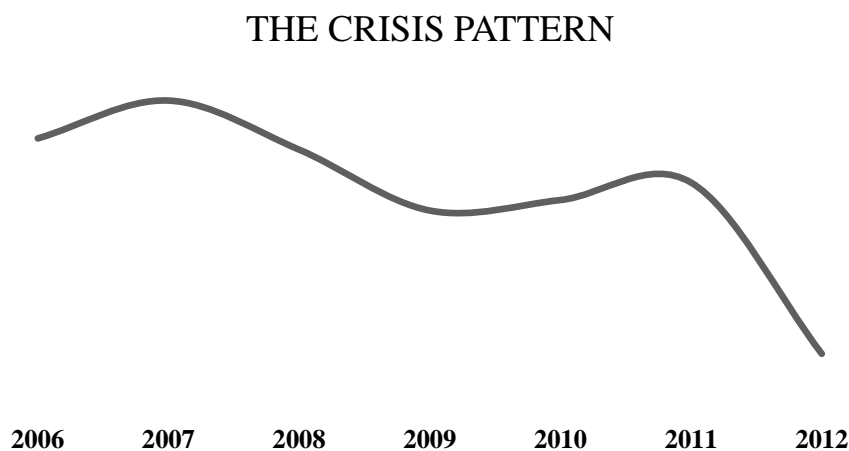


Figure 5.11 The crisis pattern (revenues trend 2006-2012).

According to the model, the pattern represented in the figure is composed by a mix of *gradual decline* and *sudden decline*. However, the “sudden” component seems more appropriate for a general definition of the whole distress period. Indeed, in the 2011 the situation seems positive, while after one year only the scenario changed dramatically. This fact implies that it is not possible to match perfectly the D’Aveni (1989) model with the reality of the Distressed Company distress period, since the distress period provides different paths in two different stages. In practice, the *Stage 1* can be related to a gradual decline, while the *Stage 2* (i.e. the year 2012) represents clearly a sudden decline phase. Thus, it is preferable – as made before – to focus on each sub-period of the distress period instead of relying on the complete version of the model.

5.2 The turnaround process

Once the Distressed Company has recognized the distress situation, it tried to find a solution in order to save the company operations and in particular its competitive advantage created during those decades.

Accordingly, this section includes all the strategies that the Distressed Company implemented, in particular some attempts to restructure the financial situation of the company through a restructuring plan, an attempt of composition with creditors and, finally, a bankruptcy buy-out.

5.2.1 *The first attempt: the unsuccessful business plans*

During the 2012, as mentioned before, the Distressed Company performances collapsed. This aspect led to two main consequences:

- firstly, because of the quick decrease of the performance – and the already bad capital structure – the banks were not willing to support financially the company anymore;
- secondly, since the equity value became negative, the shareholders (i.e. the two designers) had to find a way to cover the loss. For this purpose, in the 2013 the shareholders decided to reduce the share capital from € 400.000 to € 10.000, transforming the legal form of the company from Spa (Società per Azioni) to Srl (Società a Responsabilità Limitata).

However, during the 2012 the Distressed Company management started to try taking the first countermeasures in order to return to a positive performance adjusting both the operative and financial structure. For these purposes, at the half of the 2012 the managers asked to some advisory companies to collaborate in the preparation of a business plan which should serve as the basis for the recovery of the company performance. Accordingly, the aim of the business plans aforementioned was to adjust the capital structure (decreasing the over-indebtedness of the company) and to find a way to improve the operative performance (applying a cost cutting strategy and working on better relationships with the clients).

5.2.1.1 The first business plan

The first attempt regarded a plan created by the management with the support of an advisory boutique which includes the achievement of a better capital structure thanks to:

- the implementation of a strategy aimed at increasing the marginal profitability and the attractiveness of the services offered;
- the increase of the legal capital of € 300.000 to realize in the 2012, accompanied by new external financing.

In this way, on one side the legal capital increase would have offered an immediate adjustment of the Debt-to-Equity ratio, while on the other side the strategic change would have produced positive operative cash flows through which the company could reduce the stock of debt. The goal would have been achieved through a new set of investments (to execute in the 2012) aimed at improving the quality of the prototypes and standardizing the productive process (reducing significantly some fixed operative costs). Those investments would have been covered by new financings provided by some financial institutions.

(€/000)	2012	2013E	2014E	2015E	2016E
Net Working Capital	3.972	3.884	3.392	3.673	3.857
<i>Net Working Capital/Sales</i>	47%	44%	38%	39%	39%
Fixed Capital	4.549	4.500	4.343	4.175	3.997
TFR and other operative funds	(127)	(95)	(90)	(85)	(81)
Net Invested Capital	8.394	8.289	7.645	7.763	7.773
Net Financial Position	5.917	4.665	2.663	1.300	(264)
<i>NFP/EBITDA</i>	2.86	1.74	0.99	0.47	(0.09)
<i>NFP/Equity</i>	2.39	1.29	0.53	0.20	(0.03)
Equity	2.477	3.625	4.982	6.462	8.038
Total liabilities	8.394	8.290	7.645	7.762	7.774

Table 5.9 The Business Plan balance sheet (2012-2016E).

BUSINESS PLAN NFP/EQUITY

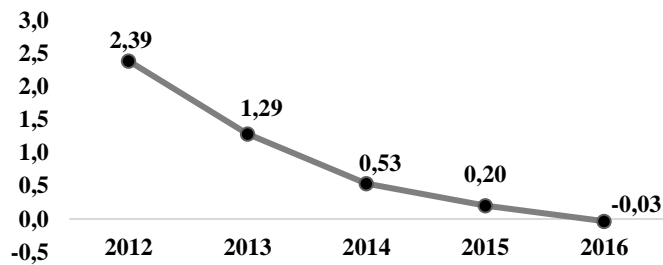


Figure 5.12 Business Plan NFP/Equity ratio (2012-2016E).

Table 5.9 and Figure 5.12 show the main effects of the plan on the Distressed Company capital structure. In Table 5.9 it is possible to see both the Decrease of the Net Financial Position – due to the return to a positive profitability – and the increase of the Equity due both to the immediate capital injection established by the plan and to the maintenance of the net profits inside the company. The consequence of this double change of trend is represented in Figure 5.12, which shows the path of the Net Financial Position/Equity ratio; at the end of the forecast period, the ratio becomes even negative, signaling a positive financial position.

(€/000)	2012	2013E	2014E	2015E	2016E
EBITDA	2.068	2.674	2.689	2.748	2.840
Non-monetary changes	(19)	(33)	(5)	(5)	(5)
Extraordinary changes	(476)	(392)	0	0	0
Taxes	(509)	(547)	(821)	(884)	(941)
Operative Cash Flow	1.064	1.702	1.863	1.859	1.894
Δ Net Working Capital	(532)	16	492	(280)	(185)
Capex	(668)	(180)	(80)	(80)	(80)
Free Cash Flow	(136)	1.538	2.275	1.499	1.629

Table 5.10 The Business Plan cash flow (2012-2016E).

The cash flow analysis represented in Table 5.10 shows two main aspects. Firstly, the positive effect of the strategy planned on the EBITDA, and consequently on the Free Cash Flow; indeed, from the 2013 the increase of the performance helps to improve the balance of the capital

structure mentioned above. Secondly, the Table represents the investments (*Capex*) that the Distressed Company should make in the 2012 in order to support the revenues growth.

(€/000)	2012	2013E	2014E	2015E	2016E
Revenues	8.424	8.800	9.002	9.307	9.811
<i>YoY revenues growth rate</i>	8%	4%	2%	3%	5%
EBITDA	2.068	2.674	2.689	2.748	2.840
<i>EBITDA margin</i>	25%	30%	30%	30%	29%
EBIT	1.856	2.445	2.452	2.500	2.582
<i>EBIT margin</i>	22%	28%	27%	27%	26%
Net Income	547	1.130	1.357	1.480	1.576

Table 5.11 The Business Plan Income Statement (2012-2016E).

Table 5.11 represents the income effect of the business plan, considering also the assumptions made by the management about the revenues and the costs. In particular, on average during the forecast period the revenues increase of the 3.5%, assuming that the company will be able to both maintain the most important contracts and attract new clients (at least 4 per year). Secondly, the effectiveness of the cost cutting strategy can be seen observing the improvement of the EBITDA margin on the revenues, which in the 2013 increases by 5 percentage points.

As analyzed above, in order to be economically feasible, the plan included some assumptions, such as a positive growth of the revenues, a significant increase of the EBITDA and the complete resetting of the Debt-to-Equity ratio by the end of the forecast period (composed by 5 years).

However, mainly because of the too optimistic revenues forecasts, the plan was not executed by the managers; in particular, the plan has not been able (for timing reasons) to predict the cancellation of some orders by the clients occurred during the second semester of the 2012. Moreover, the plan did not consider the credit loss registered in the 2012 financial statements, so that the net profit forecasts resulted too optimistic.

As a consequence, those negative events that occurred during the preparation of the plan eliminated the possibility of implementing the required capital increase. The capital increase was a critical aspect of the plan; thus, the non-occurrence of the capital injection avoided also the additional financing which should have been provided by the financial institutions.

A possible explanation of the failure of the plan could be that the Distressed Company managers decided to prepare the plan including optimistic values in order to persuade the banks to offer a large amount of financing. In practice, the managers aim might have been to see the extent to which the banks were willing to finance the company in order to avoid a more several stage of distress. As a consequence – after having made the proper valuations –, the bank offered an amount of cash that it considered correctly related to the risk of the investment. However, the mangers considered not sufficiently high the financing provided by the bank; thus, they decided to not perform the equity injection since they would have risked losing all their money (indeed, as precised in Chapter 3, if things go wrong, the shareholders would lose everything).

5.2.1.2 The second business plan

The second attempt to exit the distress period through a completely out-of-court agreement is related with a business plan produced with the support of another advisory company. This plan was more focused on restructuring the Distressed Company capital structure rather than implementing a new (or incremental) strategy. The main points of the plan were:

- an injection of new capital by the current shareholders of € 3 million (of which € 1.7 million as equity injection);
- the identification of further capital requirements (in debt form) of about € 750.000.

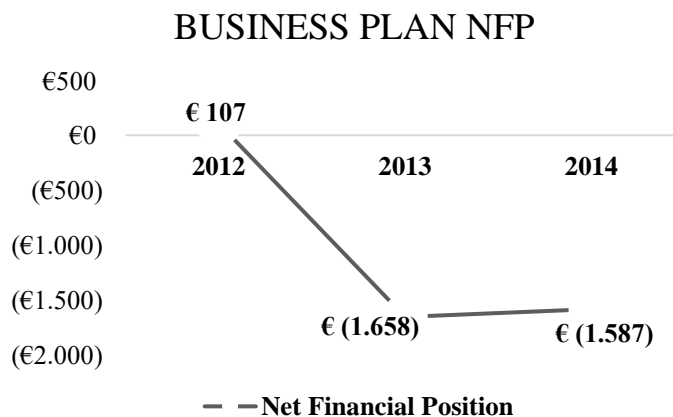


Figure 5.13 The Distress Company Net Financial Position according to the plan (€/000).

Figure 5.13 shows the positive effect on the Net Financial Position provoked by the intervention of the shareholders. In particular, the capital increase adjusts the capital structure leading to a positive 2012 cash flow since it permits to pay totally the debt reimbursement.

(€/000)	2012	2013E	2014E
Revenues	4.974	6.060	6.060
YoY revenues growth rate	-	22%	0%
EBITDA	(1.765)	399	829
EBITDA margin	-35%	7%	14%
EBIT	(2.135)	309	579
EBIT margin	-43%	5%	10%
EBT	(2.323)	184	454
Net Income	(2.427)	43	231

Table 5.12 The Distressed Company Income Statement according to the plan.

Table 5.12 shows the effects on the Distressed Company performance of the plan. In particular, the plan forecasted a significant increase of the revenues from the 2012 to the 2013 (+ 22%) because of the continuation of a significant contract. Moreover, the positive effect on the EBITDA is due not only to the improvement of the revenues but also to the cut of some costs, such as the leasing costs (- € 204.000) and the personnel ones (- € 475.000). For the 2014 the plan provides for a further improvement of the EBITDA mainly due to a cut of some services costs (- € 340.000).

As happened in the first attempt – even though the plan has been prepared close to the end of the 2012 – the revenues forecasts were too optimistic. For this reason, also this plan has not been executed and the Distressed Company management decided to not perform the capital increase planned since the risk of the equity investment was too high.

5.2.2 The entrance of the Fund, the company rent and the composition with creditors “in bianco”

In the 2013, a fund (hereinafter, *the Fund*) started to show its interest for the Distressed Company. The Fund found out about the Distressed Company thanks to a local advisory

company; in practice, the Fund did not do anything to know about the presence of the Distressed Company since it used its network of contacts that it has created during the past decades.

The procedure started from the Distressed Company owners, that appointed an advisory company in order to find someone willing to help the company to recover the performance. Thus – according to a Fund insider – the local advisory company, after having known the fact that the company was in a distress stage, informed the Fund about the possibility to conclude a deal with the Distressed Company owners¹⁷². Only at that point, the Fund started an internal analysis about the convenience of the investment; in particular, the analysis included the difficulty that usually a financial investor has when negotiating with an entrepreneur – as in the Distressed Company case – that was used to be free to do whatever he wants with his firm. In particular, one of the most difficult aspects – apart of the loss of the company ownership – regards the “financial education” that usually a financial buyer provides to the target company. For example, because of the intervention of the financial buyer the entrepreneur has to change the way in which he decides to spend the money gained from the company operations. Accordingly, a distress investor such as the Fund has to be able to accompany the entrepreneur finding the right balance between maintaining some entrepreneur’s behaviors and implementing the “financial education” aforementioned; in this case, it is possible to imagine this type of preliminary discussions between the Fund personnel and the two designers.

The Fund is a company which has a consolidated experience – and positive results – in the extraordinary finance operation field. The Fund has been created in the Eighties, and it has been one of the first Italian companies focused on the private equity investment niche. Currently, the Fund operates in the so-called *special situations* field, i.e. scenario characterized by a high level of complexity such as in-court procedures, presence of non-performing loans and equity investments in distressed companies; basing on the practical context, the Fund may act as a financial investor, provide technical competences or act as contractor (*assuntore*) in case of composition with creditors or bankruptcy buy-out. The recent Fund profitability is positive, signaling a good reputation¹⁷³ and strong capabilities provided by both the founders and the employees.

¹⁷² It is not clear whether the local advisory company informed also other potential buyers about the presence of the Distressed Company. However, it is probable that the Fund has been the only one informed since no auctions about the Distressed Company has occurred.

¹⁷³ The Fund itself says – when presenting itself to the public – that the high reputation it has obtained with the courts, the official receivers, the Italian Economic Development ministry and various financial institutions is a

Recently, the Fund opened a subsidiary specialized in rescuing and managing distressed companies characterized by a strong “*made in Italy*” component as competitive advantage. Accordingly, the aim of the Fund was to purchase the healthy component of the Distressed Company – if convenient – in order to associate the distressed company itself to the portfolio of all those “high made in Italy component” companies. Thus, for the companies inside the “made in Italy” portfolio, the strategy performed by the Fund may be seen as a mix of financial strategy and strategic strategy¹⁷⁴.

However, in order to assess the feasibility of the operation in terms of payoff, the Fund needed time in order to perform the necessary due diligence process. For this purpose, the first step undertaken by the Fund was the creation of a Newco, owned by the Fund itself and with the minority composed by the two designers. If the Fund decides to conclude the operation, the Newco will be the final destination of the healthy component of the Distressed Company. However, for the short term, the objective of the Newco was to conclude a contract of company rent with the Distressed Company. The contract was signed a couple of days after the registration of the Newco in the commercial registry (*Registro delle Imprese*) and concerned the part of the Distressed Company that were necessary to continue the operations. The aims of the company rent were: i) to conclude the pending orders in order to avoid expensive contract dissolutions; ii) to preserve the employees’ condition; iii) to avoid the impoverishment of the enterprise value of the Distressed Company.

One day after the signing of the company rent contract, the Distressed Company managers (formally alone but in practice in concert with the Fund) decided to apply for the admission to the composition with creditors “*in bianco*” discipline, *ex art. 161, sub. 6 l.f.* As already described in Chapter 3, the law gives to the debtor (i.e. the Distressed Company) the possibility to ask for the admission to the procedure without presenting the plan, but only if it provides information about the creditors and the last three years financial statements. However, the debtor must provide the plan¹⁷⁵ within a period (settled by the court) between 60 and 120 days.

competitive advantage which permits to be able to propose itself as a company that solves complex financial problems.

¹⁷⁴ Of course, since the Fund can be assimilated to an asset management company which manages money provided by third parties, the main component of the Fund strategy is financial.

¹⁷⁵ The debtor can also decide to present an “agreement for debt restructuring” plan *ex art. 182 bis l.f.*, changing the legal instrument during the period settled by the court.

In this case, the composition with creditors “*in bianco*” legal tool has been chosen in order to give to the Fund the necessary time to perform the due diligence and to prepare a convenient and feasible plan. For this purpose, the Distressed Company managers asked the concession of the maximum number of days admitted by the law (120). The court approved the demand a couple of weeks after its presentation¹⁷⁶.

The plan presented by the company (but practically considering the directives of the Fund) included:

- the full payment of the *prededucibili* claims;
- the payment of the secured claims until the full amount of the assets has been reached;
- the partial payment for the unsecured claims through new preferential financing equal to € 1.1 million. The financing aforementioned would have been guaranteed by a surety (*fideiussione*) obtained from a main financial institution.

Obviously, the plan was a critical step in order to create the basis for the purchase of the healthy component of the Distressed Company by the Fund.

However, the plan has not been approved by the court for a complex legal dispute about the interpretation of two legal instruments by different courts.

Indeed, the plan – produced on the basis of the *art. 161, sub. 6 l.f.* – included the necessity of downgrading the VAT claims. This fact was against the legal orientation of the court under which the procedure has been opened. In practise, in those years there was a situation where different courts interpreted differently the (potential) conflict of law between two articles of the Italian *Legge Fallimentare*:

- *art. 160, sub. 2 l.f.*: this article was directly related to the composition with creditors legal tool. The second subparagraph states that the plan may indicate that the secured creditors are not paid in full, but only if they are fulfilled in a better way than during a company liquidation under a bankruptcy procedure. Moreover, the treatment given to every class of creditors cannot alter the *par condicio creditorum* rule, i.e. the creditors must be satisfied equally, but respecting the fact that the secured creditors have a priority in respect of the unsecured ones;
- *art. 182 ter l.f.*: the article – that has been modified recently – disciplined the *transazione fiscale* sub-procedure. The *transazione fiscale* is a procedure linked to the composition

¹⁷⁶ However, the period of time in which the plan had to be presented has been extended until the beginning of the 2014.

with creditors one¹⁷⁷ where the debtor can propose the payment of a certain amount (reduced or deferred) of the taxes. Of course, if the tax claim is secured, the *par condicio* rule must be respected. As for the procedure, the article establishes that all the relevant documentation must be presented to the tax creditor; then, the tax creditor has to give to the debtor a certification about the exact amount of the claim. That amount will be included into the composition with creditors plan. For the purposes of the sub-procedure, the total tax claim is consolidated, and the tax creditor cannot take further legal actions against the debtor after the certification has been sent. However, the version in force in the 2013 included the impossibility to reduce the amount of the VAT, while it was possible to defer its payment.

The legal dispute was about the importance of the *art. 182 ter l.f.*, in particular as to whether this article must be used also for the composition with creditors *without transazione fiscale*. Indeed, the debtor can select the composition with creditors *without transazione fiscale*, where the applicable rules are only the ones related to the composition with creditors – as the *art. 160, sub. 2 l.f.*, where the ranking of creditors must be respected. On the contrary, the debtor can choose the composition with creditors *with transazione fiscale*, where the *art. 182 ter l.f.* is applicable, i.e. the VAT claims could not be paid partially but only deferred.

In short, the main question was: does the law permit to the debtor to decide about the destiny of the VAT claim simply selecting the proper legal tool? Can the tax creditors be subject to the debtor will?

Nowadays the issue is solved, since the new *art. 182 ter l.f.* does not include the limitation for the VAT claims aforementioned anymore.

However, in the 2013 the issue was considered differently by the different Italian courts, so that it was not clear whether the Distressed Company composition with creditors plan would have been approved or not. Indeed, on one side the Court of Cassation orientation were toward the adoption of the *art. 182 ter l.f.*; in particular, in the *sentence 4/11/2011, no. 22932*¹⁷⁸, the Court concluded that:

¹⁷⁷ In the sense that it can be chosen only in combination with the composition with creditors. Accordingly, it is possible to have a composition with creditors *without transazione fiscale* and a composition with creditors *with transazione fiscale*.

¹⁷⁸ Case *Il Guercino Srl vs Agenzia delle Entrate*, where the company selected the composition with creditors *without transazione fiscale* tool. The related plan included the partial write-off of the VAT claims. For this reason, after the Court of Appeal has rejected its complaint against the decree with which the Court approved the debtor proposal, the Agenzia delle Entrate appealed to the Court of Cassation.

- it has no sense that the legislator permits to leave to the discretion of the debtor the choice between paying the total VAT amount (deciding to select the composition with creditors *with transazione fiscale* ex art. 182 ter l.f.) and paying only a partial amount of the VAT claim (selecting the composition with creditors *without transazione fiscale*);
- the nature of the art. 182 ter l.f. is not simply processual (i.e. it is not connected only to the *transazione fiscale* sub-procedure) but it is substantial, in the sense that the article regards the treatment of a particular class of claims which the legislator has decided to treat differently. In other words, the directives provided by the article about the VAT credit has nothing to do with the type of legal tool selected by the debtor.

By contrast, on the other side some Courts, such as the Ascoli Piceno one¹⁷⁹, allowed a debtor to avoid paying in full the VAT claim by selecting the composition with creditors *without transazione fiscale* (i.e. avoiding the application of the art. 182 ter l.f.), since the article was considered directly related to the *transazione fiscale* sub-procedure. In other words, if – and only if – the debtor had asked for the *transazione fiscale* instrument, it would have been obliged to pay the full amount of the VAT; otherwise it could treat the tax creditors as a normal unsecured one¹⁸⁰. This position has been undertaken also by other courts (such as Varese, Perugia, Como, Milano and Genova), signalling that the case was not isolated, but there was a material legal conflict between different courts and agencies.

As revealed before, in the Distressed Company case the court did not approve the plan. This happened because the court followed the Court of Cassation orientation, treating the art 182 ter l.f. as a substantial rule. In other words, according to the court the art. 182 ter l.f. was automatically applicable as soon as the Distressed Company – under a composition with creditors procedure framework – decided to prepare a proposal which included the partial payment of the VAT claims.

This is the reason why the composition with creditors plan has not been approved; consequently, the debtor decided to file for bankruptcy.

¹⁷⁹ Sentence 311/2014, the case is very similar to the one explained in the previous note.

¹⁸⁰ “In definitiva, ritiene il Collegio che la previsione del primo comma dell’art. 182 ter L.F. opera esclusivamente ogni qual volta l’imprenditore voglia, e soprattutto possa, avvalersi dei vantaggi dell’istituto della transazione fiscale (quali il cd. consolidamento del debito tributario e l’estinzione dei giudizi pendenti), avendone le risorse. In tal caso infatti il debitore sceglie di utilizzare i vantaggi della transazione nella piena consapevolezza della non negoziabilità del credito IVA e dei crediti per ritenute per i quali l’amministrazione può unicamente assentire ad un pagamento dilazionato” (sentence 311/2014, Ascoli Piceno court).

5.2.3 The “*Accordo Quadro*” and the bankruptcy buy-out

In the meantime, at the end of the 2013 the Fund and the two designers signed an exclusivity agreement (hereinafter *Accordo Quadro*), under which:

- the two designers committed to collaborate exclusively with the fund for five years¹⁸¹;
- the two designers accepted to not compete with the Fund (and so with the Newco) for the three years which follow the completion of the collaboration between the two parties.

In practise, the *Accordo Quadro* eliminated any possibilities that the two designers worked for other companies than the Newco for eight years.

This agreement is very important because it signals that the Distressed Company cannot be sold together with the two designers. This means that if there is a third party (as for example another distress investor) which wants to purchase the healthy part of the Distressed Company, it will be obliged to prepare an offer regarding only the assets of the company, without including the skills and reputation of the two designers. In other words, thanks to the *Accordo Quadro* only the Fund can extract the positive value of the Distressed Company since without the presence of the two designers its value would be derisory.

A couple of months later, the Distressed Company filed for bankruptcy. Indeed, after the composition with creditors have failed, the company was in a serious position, sufficiently dangerous to satisfy the condition for filing for bankruptcy according to the *art. 5 l.f.*, since the company were not able to regularly fulfil its own obligations anymore.

Once the court has approved the demand – and consequently appointed the official receiver –, the official receiver started to prepare the assets inventory and created the list of creditors examining the declarations of claims (*domande di insinuazione al passivo*) presented by the creditors. According to the law, with the last activity the official receiver divided the creditors into three classes: *prededucibili*, secured and unsecured.

After some months – while the list of creditors prepared by the official receiver was still temporary – the Fund prepared a demand of bankruptcy buy-out.

First of all, it is important to precise – at that date – that the Fund had the possibility to present a proposal while the Distressed Company (which has filed for bankruptcy) could not do it; indeed, the *art. 124 l.f.* establishes that the bankruptcy buy-out proposal can be presented by one or more creditors, a third party and the debtor if one year from the bankruptcy declaration date has passed.

¹⁸¹ This part of the agreement can be renewed.

Secondly, even though the list of creditors was still temporary, the Fund could present the demand because the scenario respected the provision of the *art. 124 l.f.* Indeed, according to the article it is possible – for a creditor or a third party – to present the demand for bankruptcy buy-out if the accounting has been kept properly and the related information gives to the official receiver the possibility to prepare a temporary list of creditors¹⁸². This aspect is very powerful because it gives to the Fund the possibility to limit the perimeter of the stakeholders of the proposal; in particular, thanks to this particularity – unique in the Italian insolvency legal framework –, the Fund could address the proposal only to the creditors that made the admission to the declaration of claims up to the date where the Fund presented the proposal¹⁸³. However, even though the list of creditors is still temporary, the proponent has the possibility to address the proposal to all the bankruptcy creditors, i.e. also the ones that did not present the admission to the declaration of claims (Norelli, 2008); in practise, it is rarely a better alternative for the proponent¹⁸⁴. As a consequence, ex *art. 124 l.f.*, the Fund addressed the proposal to: i) the creditors included in the temporary list of creditors; ii) the tardive creditors (i.e. the one admitted after the proposal that have already made the demand for declaration of claims); iii) the creditors that have been admitted after they made opposition against the first refusal by the official receiver. However, when preparing the offer, the Fund had to consider the fact that also the other creditors (i.e. the one which were outside the temporary list of creditors) can apply for the procedure at a later stage; as a consequence, when preparing the plan the Fund had to be sure that the proposal was convenient also in case all the creditors were admitted to the procedure.

As for the content, the plan can be classified as “agreement with assumption” (*concordato con assunzione*) since the Fund works as a contractor (*assuntore*). Indeed, proposing this plan the Fund accepted to assume the obligation to pay the creditors according to the plan in exchange of the acquisition of the Distressed Company assets. In particular, the proposal included:

- the full payment of the *prededucibili* claims by 30 days from the homologation date;

¹⁸² However, it is not very clear when the official receiver has to prepare the temporary list of creditors. According to Norelli (2008), the temporary list of creditors shall be made, if possible, only after the bankruptcy buy-out proposal has been presented; indeed, there is not any rule which obliges the official receiver to prepare such list. Moreover, after the official receiver has prepared such temporary list, he does not have to stop its work, since the bankruptcy procedure is not completed until the bankruptcy buy-out has been approved by the court; accordingly, if during the bankruptcy buy-out process the official receiver concludes the preparation of the “official” list of creditors, the definitive list substitutes the temporary one, and the proponent must integrate its proposal considering this new list.

¹⁸³ On the contrary, if the proposal is made by the debtor, it must be addressed to all the creditors, also the ones which do not have prepared the demand for the declaration of claims.

¹⁸⁴ However, even if some creditors remain out from the proposal, they still can challenge the debtor in order to fulfil their claims.

- the full payment of the secured claims by 60 days from the homologation date;
- the payment of the 20% of the unsecured claims by 90 days from the homologation date;
- the payment of all the tardive creditors admitted to the procedure, respecting the percentages above (100% if the tardive creditor is *prededucibile* or secured, 20% if it is unsecured);
- the transfer of the cash of the bankruptcy procedure to the Fund;
- the transfer to the Fund of the ownership of the business branch related to the healthy part of the Distressed Company. The business branch has been evaluated by an expert specialized in company valuation¹⁸⁵; the expert gave a valuation equal to € 1.250.000, but only at the condition that the two designers continue to work for the Fund (the *Accordo Quadro* aforementioned confirms this possibility)¹⁸⁶. The business branch included all the assets – both material and intangible – that were necessary to perform properly the company operations; it does not include the Distressed Company past credits and liabilities. For example, together with the assets related to the execution of the operations, the business branch included the related contracts (such as the energy ones), the employees, the brands and the Distresses Company website;
- the transfer of all the bankruptcy procedure tax credits and all the other assets or credits/claim recognized after the homologation of the proposal to the Fund.

In total, the original proposal offered to the creditors about € 1.3 million, provided by both the bankruptcy procedure cash (equal to € 867.315) and directly by the Fund itself (€ 437.535). The cash provided by the Fund was guaranteed by a surety provided by a main Italian financial institution.

¹⁸⁵ In order to estimate the business branch value, the expert has considered the financial statements of the Distressed Company in the period 2006-2012, in order to find an average value of the financial statement line items which regards both the positive and the crisis period. Moreover, the expert normalized the average values found by applying some cost reduction related to extraordinary or useless costs (i.e. not related to the core activity of the Distressed Company). Finally, in order to reach a final valuation, the expert used a combination of two methods:

- market multiple analysis: in particular, the expert used the EV/EBITDA multiple after having create a list of comparable companies. The average multiple was equal to about 11x, but the expert decided to reduce the average multiple to 4x because of the crisis status of the Distressed Company and the fact that the company was closely held;
- “control method”: in order to see whether the Enterprise Value estimated with the market multiple method was reasonable, the expert used a secondary method. For this purpose, he checked the company rent contract signed in the 2014 between the Distressed Company and the Newco; he found that the parties gave a monthly rent related to the business branch only equal to € 16.000. According to the expert, this information was sufficient to give an estimate of the Enterprise Value.

¹⁸⁶ The expert estimated a business branch value equal to about € 80.000 without the presence of the two designers, as a prove that the only solution for continuing the operations was to deal with the Fund.

After almost one year the original proposal has been integrated because the temporary list of creditors has been updated considering the tardive creditors and the new *prededucibili* creditors which made opposition to the original list of creditors. As a consequence, the proposal offered to the creditors has been updated – and improved – to € 1.4 million; the difference than the original proposal consisted in the increase of the cash provided by the Fund (and consequently of the linked surety), from € 437.535 to € 551.542. The increase of the cash provided by the Fund has been counterbalanced partially from the increase of the bankruptcy procedure cash, from € 867.315 to € 904.007¹⁸⁷. The official receiver, when executing the plan, had to use first the cash provided by the bankruptcy procedure; once those money are finished, the cash provided by the Fund is used¹⁸⁸.

The cash provided by the bankruptcy procedure itself and the Fund is distributed as shown in Table 5.13.

Creditors	Amount	% on total	Total claims
<i>Prededucibili</i>	€ 180.000,00¹⁸⁹	12%	€ 180.000,00
Secured	€ 1.059.487,15	73%	€ 1.059.487,15
<i>Originals</i>	€ 805.123,22	55%	€ 805.123,22
<i>Tardive</i>	€ 91.189,59	6%	€ 91.189,59
<i>Oppositions</i>	€ 163.174,34	11%	€ 163.174,34
Unsecured	€ 216.062,25	15%	1.080.311,25
<i>Originals</i>	€ 195.108,39	13%	€ 975.541,95
<i>Tardive</i>	€ 9.481,47	1%	€ 47.407,35
<i>Oppositions</i>	€ 11.472,39	1%	€ 57.361,95
Total	€ 1.455.549,40		€ 2.319.798,40

Table 5.13 Distribution of the bankruptcy buy-out creditors according to the plan.

From the table it is possible to see that the greatest part of the claims – in terms of amount – are secured, as represented graphically in Figure 5.14.

¹⁸⁷ The amount of cash increased mainly because of the collection of the company rents.

¹⁸⁸ As for the surety, it decreases as the Fund money are used for executing the plan.

¹⁸⁹ This amount has been decided already during the preparation of the original proposal by the Fund, considering a maximum amount of total potential *prededucibili* claims. After the integration of the proposal, the increase of the *prededucibili* claims were still lower than that amount.

INCIDENCE OF THE PROCEDURE CREDITORS

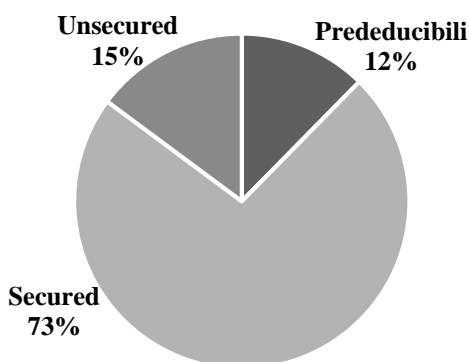


Figure 5.14 Incidence of each creditor on the total amount of cash provided by the procedure and the Fund.

The high incidence of the secured claims is mainly due to some oppressive claims such as the ones related to the tax agency, some professionals and an employment agency; in particular, all those claims have been accumulated in the past years. By contrast, the unsecured claims are related to a similar number of creditors but with a lower credit value.

It is important to observe that the bankruptcy buy-out plan is very similar to the one (rejected for the impossibility to pay only a part of the VAT claims) presented under the composition with creditors procedure. Thus, one may argue that also this plan can be rejected by the court for the same reason.

However, the *art. 182 ter l.f.* related to the *transazione fiscale* sub-procedure was in conflict only with the composition with creditors procedure, since it can be used only in combination with a composition with creditors. In other words, there were no reasons to link the *art. 182 ter l.f.* with the bankruptcy buy-out procedure, so that once roughly the same plan has been proposed under this new legal framework, the VAT matter ceased to exist.

At this point, according to the law, before homologating the plan some steps must be performed. First of all, the official receiver had to provide an opinion, according to the *art. 125 l.f.*; in particular, the official receiver must provide an opinion – which is not binding – about the convenience of the plan in respect of the bankruptcy alternative, the feasibility of it and the quality of the guarantees offered. In order to assess the convenience of the proposal, the official receiver has created the bankruptcy scenario and compared it with the one proposed by the Fund.

The result demonstrates that the bankruptcy buy-out alternative is more convenient; in particular, if on one side the *prededucibili* claims are paid in full in both the alternatives, on the other side both the secured and the unsecured claims are fulfilled at a higher percentage in respect of the best bankruptcy scenario (100% vs 83% and 20% vs 0%, respectively). The main reason why the proposal is more convenient is related to the fact that under the bankruptcy buy-out plan the Fund has limited the perimeter of the claims taking advantage of the *art. 124 l.f.* Indeed, thanks to this limitation remain excluded from the procedure claims for a total amount of about € 3.2 million. By contrast, in case of bankruptcy those claims would have been considered; that is why the total creditors' fulfilment are lower in case of bankruptcy. Accordingly, the official receiver's opinion was positive.

Secondly, the proposal passed to the creditors committee, which had to vote the plan. According to the *art. 127 l.f.*, only the creditors which had been admitted to the procedure could vote, i.e. the creditors which are listed in the temporary list of creditors prepared by the official receiver. Moreover, the same article establishes that all the secured creditors could not vote, unless they did not renounce to the guarantee. Finally, according to the *art. 128, sub. 3 l.f.*, the variation of the number of creditors admitted to the procedure occurred after the voting deadline has expired does not affect the computation of the majority. However, in the 2016 the creditors committee approved the plan with a large majority. Regarding the voting procedure, it is important to precise that the creditors composition was fragmented, so that there were no blocking positions that could get a bargaining power.

Finally, as established by the *art. 129 l.f.*, once it has received the official receiver's opinion and the vote of the creditors committee, the bankruptcy judge examined the legal legitimacy of the procedure, the result of the vote and homologated the proposal.

5.3 The Newco performance

After the bankruptcy buy-out has been homologated by the court, the official receiver could start the execution of all the dispositions presented in the proposal. Accordingly, all the effects of the proposal started to be effective. Thus, on one side the creditors started to be paid by the Fund (the execution of the proposal finished in the 2018), while on the other side the Newco entered in possession of the Distressed Company business branch. In particular, the transfer of the property

of the business branch occurred in June 2016, i.e. when the court homologated the bankruptcy buy-out plan.

Accordingly, it is important to see whether the Newco performance is better than the one of the Distressed Company during the distress period. Obviously, one of the main errors would have been to continue to make the same mistakes that led the Distressed Company to distress. Thus, it was important to maintain a sound and flexible cost structure and to have a recovery of the sales performance; moreover, the capital structure did not have to be as unbalanced as during the distress period.

The activity of the Newco includes the ones performed by the Distressed Company in the past; in other words, the vision of the company is to become an “industry of design”, performing the activities described in Figure 5.1. As precised before, the Newco is controlled by the Fund, but the two designers offer a significant role for the company performance. The detailed ownership is represented in Figure 5.15¹⁹⁰.

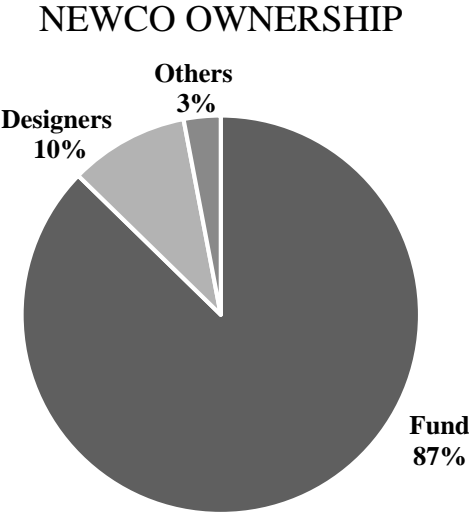


Figure 5.15 The Newco ownership.

¹⁹⁰ The “others” category consists of an employee already present for the Distressed Company considered important for the Newco operations.

(€/000)	2013	2014	2015	2016	2017
Sales revenues	1.857	4.183	3.784	4.861	5.657
<i>YoY revenues growth rate</i>	-	125%	-10%	28%	16%
EBITDA	351	203	127	749	587
<i>EBITDA margin</i>	19%	5%	3%	15%	10%
EBIT	173	156	71	624	296
<i>EBIT margin</i>	9%	4%	2%	13%	5%
Net income	22	45	253	350	164

Table 5.14 The Newco Income Statement (2013-2017).

Table 5.14 represents the summary of the results of the Newco Income Statement.

First of all, the revenues performance is positive; indeed, even though in absolute terms the amount of sales revenues is lower than the one achieved during the first phase of the distress period, the yearly growth is promising. In particular, from the moment in which the Newco bought the business branch, the sales revenues grew by 28% in the 2016 and 16% in the 2017, with a $CAGR_{2013-2017}$ equal to 32%. Moreover, the Revenue-per-Employee increases every year, from € 48.868 in the 2013 to € 131.550 in the 2017 (its $CAGR_{2013-2017}$ is 28%).

Secondly, it is important to observe that the EBITDA is positive from the beginning of the Newco activity; in particular, in the 2016 it grew almost 6 times from the previous year, demonstrating that the definitive acquisition of the Distressed Company business branch was a profitable deal. The EBITDA margin is in line with the performance of the Distressed Company before the 2012, as a prove that the marginality of the performance remained stable.

However, notwithstanding the revenue growth, the 2017 EBITDA decreased in respect of the 2016 one. The main reason is due to a significant increase of the personnel costs, showing that the company is hiring new employees (in the last 5 years the Newco hired 5 new employees). About the cost structure, it is important to precise that the incidence of the leasing costs is lower than the Distressed Company; a comparison is presented in Figure 5.17. As for the personnel and services costs, the incidence is similar to the Distressed Company one; this should not surprise because this type of cost structure is due to the fact that the company is labor intensive.

LEASING COST MARGIN ON REVENUES

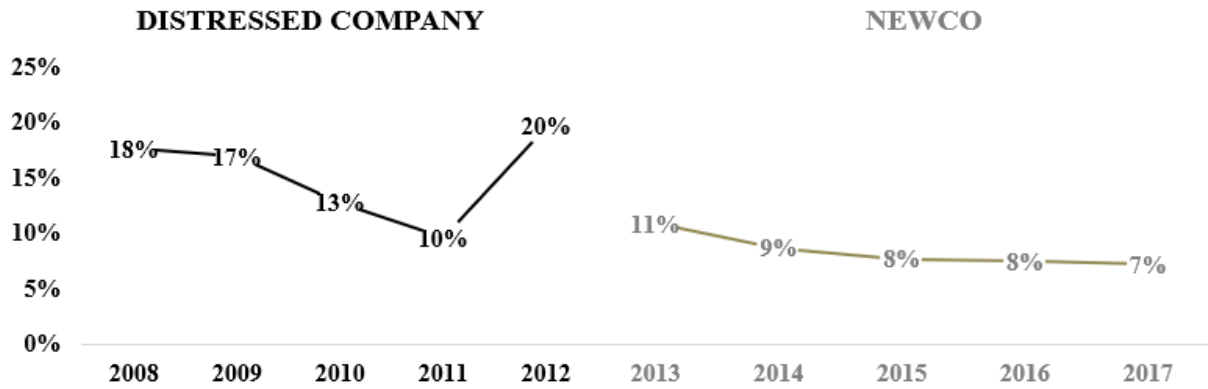


Figure 5.16 The leasing cost margin: a comparison between Distressed Company and Newco.

(€/1000)	2013	2014	2015	2016	2017
Current assets	1.547	1.543	2.415	4.225	3.937
<i>Inventory</i>	970	944	1.244	1.856	1.930
<i>Account Receivables</i>	406	584	1.167	2.296	1.934
<i>Accrued revenues and Prepaid expenses</i>	171	15	25	73	73
Current liabilities	1.774	2.084	2.266	2.797	2.385
<i>Account Payables</i>	239	347	513	816	547
<i>Advanced payments</i>	901	1.450	1.479	1.806	1.670
<i>Other debts</i>	634	284	272	169	166
<i>Prepaid revenues and Accrued expenses</i>	0	3	2	6	2
Trade Working Capital	(227)	(541)	150	1.427	1.552
<i>Trade Working Capital/Sales</i>	(12)%	(13)%	4%	29%	27%
Other current assets	337	497	583	742	796
Other current liabilities	(320)	(162)	(215)	(744)	(729)
Net Working Capital	(210)	(206)	517	1.425	1.620
Fixed assets	110	174	286	1.039	848
Other assets and liabilities	0	0	(40)	(500)	(500)
TFR and other provisions	84	83	102	190	255
TOTAL ASSETS	(185)	(114)	661	1.773	1.713
Net Financial Position	(216)	(280)	241	1.004	779
Cash and Cash equivalents	(216)	(614)	(262)	(6)	(29)
Bank debt	0	334	503	1.010	808
<i>NFP/EBITDA</i>	(0.62)	(1.38)	1.90	1.34	1.33
<i>NFP/Equity</i>	(6.75)	(1.69)	0.57	1.30	0.83
Equity	32	166	420	770	934
TOTAL LIABILITIES	(185)	(114)	661	1.773	1.713

Table 5.15 The Newco Balance Sheet (2013-2017).

The Newco Balance Sheet is represented in Table 5.15.

After a couple of years of stabilization, it is possible to observe an improvement of the Net Working Capital, due mainly to a higher increase of the account receivables in respect of the account payables; it is a positive signal for the financial stability of the company, since it means that the investment in fixed assets is not financed by short term sources. However, this high Net Working Capital level can be a threat for the liquidity of the company; thus, the managers shall control this aspect in order to avoid incurring in the same mistake made by the Distressed Company managers.

Secondly, in the balance sheet is evident the effect of the purchase of the Distressed Company business branch occurred on the 2016. Indeed, in that year it is possible to see a significant increase of the fixed assets (in particular due to the recording of the goodwill), together with the account receivables and account payables. This increase is due to the change of the property of the assets and liabilities part of the business branch.

Finally, another aspect which is possible to see from Table 5.15 is represented by the adjustments of the capital structure. In particular, the Net Financial Position increases – signaling a growth of the debt obtained by the financial institutions – but at the same time the Equity value rises at a higher pace, because of both a capital increase of € 100.000 occurred in the 2014 and the conservation of the profits created during those years. The efficient balance of the capital structure can be represented by the Net Financial Position-to-Equity ratio, as shown in Figure 5.17, which compares the ratio between the Distressed Company and the Newco. Indeed, apart from the Newco cost structure, another Distressed Company reason for distress was linked to the capital structure, in particular its high degree of indebtedness. Thus, it is useful to compare the financial performance of the Distressed Company and the Newco. Figure 5.17 compares the Net Financial Position-to-Equity ratio of the two companies¹⁹¹; it is clear that the current scenario is better than the Distressed Company one. Moreover, the composition of the total debt is more balanced, with an equilibrate presence of both bank debt and commercial debt, as it is possible to see in Table 5.16.

¹⁹¹ For the Distressed Company the figure includes only the years 2010 and 2011 because they are the only years where the company had positive earnings. For the Newco only the last two years (2016 and 2017) have been considered because they represent the post-business branch acquisition period.

NFP/EQUITY COMPARISON

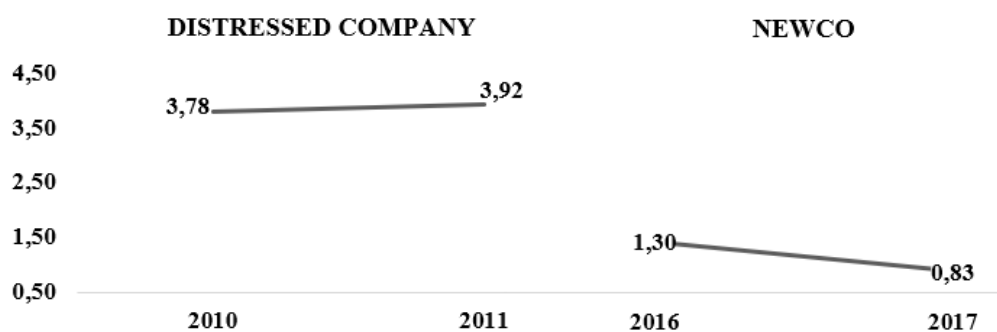


Figure 5.17 The Net Financial Position-to-Equity ratio: a comparison between Distressed Company and Newco.

(€/000)	2013	2014	2015	2016	2017
Total debts	2.094	2.576	3.022	5.046	4.420
Due to banks	0	334	503	1.010	808
Advanced payments	901	1.450	1.479	1.806	1.670
Account Payables	239	347	513	817	547
Tax debts	241	86	108	192	128
Due to social security	80	77	64	104	76
Other debts	634	283	354	1.117	1.190

Table 5.16 The Newco debt composition (2013-2017).

Moreover, it is interesting to observe the difference among the two companies about others index.

Table 5.17 includes a selection of other interesting ratios or measures.

	2010	2011	2016	2017
NFP/EBITDA	2.79	2.54	1.34	1.33
EBITDA Margin	12.2%	15.1%	15.4%	10.4%
FCF/Financial expenses	8.13	2.22	9.65	11.43
Net Income Margin	1%	1.3%	7.2%	2.9%
Interest Coverage Ratio	6.3x	6.3x	24x	17.1x
Current Ratio	2.02	1.96	1.51	1.65
Quick ratio	1.44	1.38	0.82	0.82

Table 5.17 Distressed Company and Newco: other ratios/measures.

First of all, it is important to notice that the ratio between the Net Financial Position and the EBITDA is lower in the Newco case, signaling a lower impact of the financial debt on the company operations. Similarly, the Free Cash Flow-to-Financial expenses ratio shows a better situation for the Newco. Moreover, as explained before, the profitability of the Newco – represented by the EBITDA Margin on revenues – is aligned with the one of the Distressed Company when the operative performance was positive. However, the Net Income Margin shows an improvement in respect of the same index when the Distressed Company was in its distress period. This difference may be explained by the fact that the Newco performance of the financial area is better (i.e. the interests on the debt is lower). This fact is confirmed by the Interest Coverage Ratio trend; indeed, the Newco EBITDA covers the interest expenses about 20 times, while the ratio for the Distressed Company in the years considered was about 6x.

As precised before, a negative aspect of the Newco is its high Net Working Capital; indeed, a too high Net Working Capital can lead to cash problems in the long term. Those potential problems are represented by the Current Ratio and the Quick Ratio, which show a decrease of the index in respect of the Distressed Company performance during the years observed.

In conclusion, the performance of the Newco is positive: the operative performance shows a high potential; in particular, the Newco is growing organically and the growth in revenues is due both to the maintenance of the old customers and to relationships with new clients. Moreover, the capital structure is well balanced. By contrast, there could be some potential problems for the Newco liquidity since the Net Working Capital is increasing significantly; however, the Free Cash Flow is tendentially positive (€ 392.000 in the 2017).

However, according to a fund insider, the 2018 Newco performance will increase materially, leading to an increase of the total revenues of about 20%. Thus, the future of the Newco seems prosperous: all the Distressed Company strengths has been isolated and transferred to the Newco in an efficient way.

5.4 A focus on the Fund strategy

At this point, it is important to review the whole timeline of the procedure considering the point of view of the Fund, in order to analyse in detail the strategy selected and why it has decided to perform that strategy instead of other ones.

As mentioned above, the Fund started to be interested in the Distressed Company in the 2013. How did the Fund find out about the presence of the Distressed Company? Indeed, the Distressed Company was private and probably the managers did not want that the fact that the company was in troubles was leaked out. However, a certain level of information about the company situation is necessary in order to find someone willing to rescue the company. This trade-off can be solved by letting know to the right advisory companies or legal offices the fact that the company is looking for an investor that could save the company performance. This is what effectively happened: the Fund used its information network – composed by advisory companies, legal offices and other insiders – for knowing about the presence of the Distressed Company.

Once the Fund has discovered the presence of the Distressed Company, it analysed the Distressed Company financial statement, its business model and its environment (i.e. clients, suppliers and industry), in order to be confident about the idea to have the right skills necessary to turn the company around. In particular, the Fund observed whether it had the right knowledge of the design industry and the local territory where the Distressed Company was embedded. In this phase, the Fund managers recognized that the investment might enter the “strategic” component of its business, i.e. the one which includes the acquisition of distressed companies with a high “made in Italy” component.

After having decided to go on with the analysis, the Fund analysed – also talking with the Distressed Company management – the reasons for distress. In this phase, the Fund recognized that there was a “real business” behind the decreasing performance of the Distressed Company, signalling that it could be one of the so called “good companies with bad balance sheets”.

At this point, the Fund had to consider whether it had the possibility to take the right decisions quickly, i.e. to take the control of the company without particular problems and to see the extent to which it might inject capital in order to ease the recovery of the Distressed Company performance. In practise, in this moment the Fund combined its skills and financial resources with the characteristics of the Distressed Company and the opportunity available. Moreover, during this activity it was very important to negotiate properly with the Distressed Company owners and managers; indeed, for the owners (i.e. the designers) the decision was very delicate and might involve a loss of the company control and a change of their lifestyle because of the strict rules imposed by the Fund.

As a consequence of this thorough analysis, the Fund decided to implement – in concert with the Distressed Company management – the first part of the strategy, performed in the 2013. It consisted in the implementation of four operations:

- creation – together with the Distressed Company owners – of the Newco aimed at incorporating the positive part of the Distressed Company;
- conclusion of a company rent contract between the Distressed Company and the Newco related to the Distressed Company business branch representing the profitable component of it;
- presentation – made by the Distressed Company managers but practically in concert with the Fund – of the demand for admission in the composition with creditors “*in bianco*” procedure;
- conclusion of an agreement – the “*Accordo Quadro*” – between the Fund and the two designers where the designers commit to collaborate exclusively with the Fund itself for 5 years and to not compete with the Fund for the 3 years which follow the conclusion of the collaboration.

In this way, the Fund on one side created all the bases for purchasing the profitable part of the Distressed Company, while on the other side it obtained a period of time (i.e. the 120 days granted by the court) during which it might perform a due diligence in order to create a reasonable and convenient plan.

As for the selection of the legal tool, the Fund might choose a different tool, such as the certificate plan or the agreement for debt restructuring (see Chapter 3). However, it chose the composition with creditors tool for different reasons:

- *the need of short-term liquidity*: in order to pay the unsecured creditors, there was the necessity for the Fund to inject cash. Differently than the certificate plan, the composition with creditors procedure protects the financing provided to the distressed company in execution of the plan. In fact, the financing provided by the Fund would have had a *prededucibile* claim in case of future bankruptcy procedure (*art. 182 quarter l.f.*);
- *the complexity of the creditors' composition*: the Distressed Company had a complex diversification of its creditors. Indeed, on one side they were highly differentiated geographically, because of the historical international orientation of the Distressed Company vision; on the other side, the average “core” contract is about 20 months long, signalling a dynamic and variable portfolio of clients. For this reason, the Fund selected a structured procedure as the composition with creditors one in order to avoid being subject to the 60% voting rule present in the agreement for debt restructuring procedure;
- *the risk to be subject to actions addressed at diminishing the debtor assets*: in that period, the Distressed Company was facing several legal disputes – in particular with some creditors, a former external designer and a leasing company – where it might both recover or lose money. Accordingly, the Fund might have preferred the composition with creditors procedure to the other ones in order to avoid being involved in other disputes. Indeed, it is important to precise that in the 2012 the Distressed Company dismissed 9 employees, who might start some actions against the company itself;
- *the severity of the crisis*: even though the literature does not confirm this aspect (see Chapter 3), the Fund might have chosen the composition with creditors legal tool because the stage of the Distressed Company distress was too serious for a completely out-of-court agreement (as demonstrated by the two failed attempts) but not so serious to justify a bankruptcy procedure.

When presenting the demand for the admission to the composition with creditors “*in bianco*” procedure, the Fund was not sure that the court would have rejected it for the VAT claims issue. In that period, the Fund decided to select that legal tool because the Fund managers thought that it was the best solution available to execute the strategy planned. However – since the Fund is specialized in the adoption of the bankruptcy buy-out procedure – it prepared an alternative plan which involved the bankruptcy buy-out tool for sure, but this does not mean that in that period they used the composition with creditors “*in bianco*” simply to take more time to execute the due diligence. Indeed, the court could approve the composition with creditors plan following the

orientation which did not treat the *art. 182 ter l.f.* as a special rule directly applicable to the composition with creditors procedure. Accordingly, if the court approved the composition with creditors plan, the Fund would have been satisfied.

However, the court did not approve the composition with creditors plan because it followed the orientation provided by the Court of Cassation where it was not possible to give to the party which files for the procedure the freedom to choose whether to pay the VAT claims in full or only partially. As a consequence, the Distressed Company managers were obliged to file for bankruptcy.

After this event, the Fund decided to implement the second part of the strategy, preparing the demand for the bankruptcy buy-out procedure. As precised before, the plan homologated by the court included only a part of the total Distressed Company claims. For example, a significant part of the tax claims stayed out of the agreement because usually the tax authorities spend more time to compute the amount of the taxes that the companies must pay; thus, the tax authorities have not been able to enter the bankruptcy buy-out procedure in time.

The effects of this limitation of the creditors' perimeter are clear in Table 5.18 and Table 5.19.

(€/000)	Bankruptcy Buy-out	Bankruptcy	
		A	B
<i>Prededucibili</i> creditors	169.771	169.771	169.771
Secured creditors	1.059.487	3.489.553	3.489.553
Unsecured creditors	1.080.311	1.892.716	1.892.716
Total liabilities	2.309.569	5.552.040	5.552.040

Table 5.18 The composition of the claims according to the different alternatives.

(€/000)	Bankruptcy buy-out		Bankruptcy			
			A		B	
		%		%		%
<i>Prededucibili</i> creditors	169.771	100%	169.771	100%	169.771	100%
Saving in <i>prededucibili</i> claims	10.229	100%				
Secured creditors	1.059.487	100%	2.910.841	83%	2.110.841	60%
Unsecured creditors	216.062	20%	0	0%	0	0%
Total	1.455.549		3.080.612		2.280.612	

Table 5.19 The fulfilment of the Distressed Company creditors according to the different alternatives.

The tables summarize the analysis performed by the official receiver when preparing the opinion to the Fund bankruptcy buy-out proposal *ex art. 125 l.f.* The bankruptcy alternative includes two scenarios, which difference is related only to the result of a legal dispute with a leasing company.

It is evident from the tables that the bankruptcy buy-out proposal:

- on one side, includes a lower amount of total debts to satisfy, i.e. only the 41,6% (€ 2.309.569 against € 5.552.040 in the bankruptcy case);
- on the other side, includes a better fulfilment of the creditors admitted to the procedure claims. Indeed, if for the *prededucibili* creditors the outcome is the same in both the alternatives, for the other creditors the outcome is better in case of bankruptcy buy-out. In particular:
 - the secured creditors are paid in full under the proposal, while in the best bankruptcy scenario they would get the 83% of their total claims;
 - the unsecured creditors receive the 20% of the total claims, while in case of bankruptcy they would receive nothing.

In sum, since under the bankruptcy buy-out procedure the Fund could pay only the creditors admitted to the procedure, it had the possibility to offer a better condition to all of them. However, on the other side there is a significant part of creditors which stayed out of the procedure, in particular the tax claimants mentioned above. In particular, the Fund paid € 551.542 in order to execute the plan, while in case the plan would have been homologated considering the definitive list of creditors the Fund would have paid a significantly higher amount for sure.

However, since the law permitted this type of behaviour by the Fund, and since the plan satisfied the creditors admitted to the procedure in a better way than the bankruptcy case, the official receiver gave a positive opinion and finally the court homologated the plan. After the plan has been homologated, the Fund – through the Newco – obtained the control of the Distressed Company business branch, definitely purchased in the 2016.

From a structural point of view, the whole transaction can be divided in two phases (i.e. the 2013 company rent contract and the 2016 business branch acquisition), as represented in Figure 5.18 and 5.19.

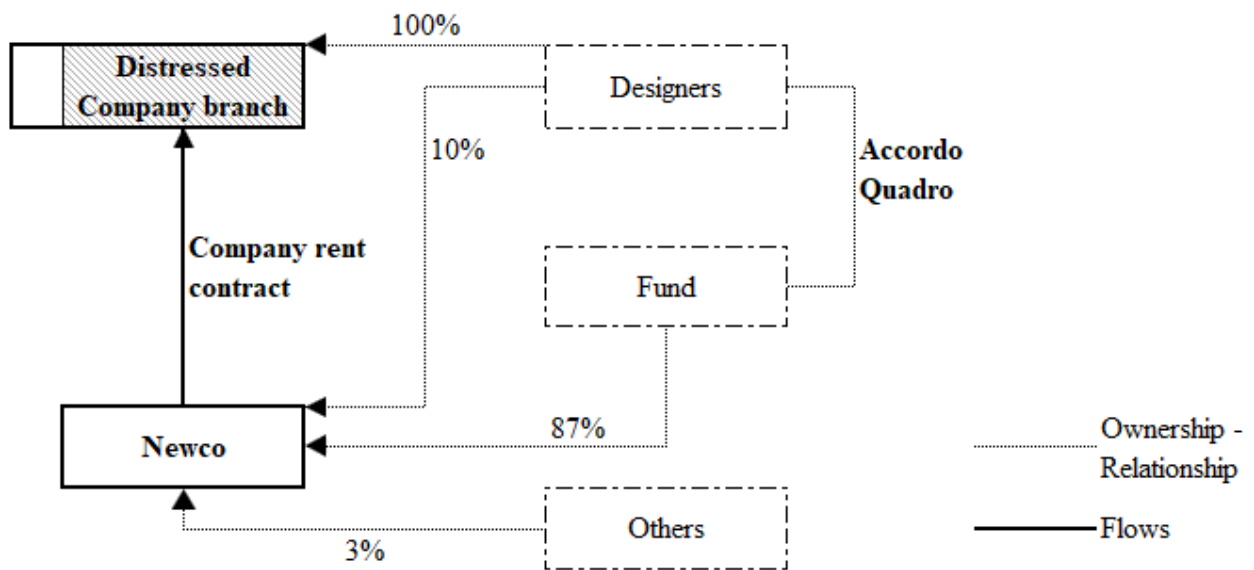


Figure 5.18 The first phase of the operation: the company rent contract and the “Accordo Quadro” (2013).

Figure 5.18 shows the first phase of the transaction, occurred in the 2014. As shown by the Figure, this phase is characterized by the conclusion of a company rent contract between the Distressed Company and the Newco (founded by the Fund and the designers for this reason, in order to continue the operations) and the conclusion of the “Accordo Quadro” aimed at maintaining the designers’ expertise inside the operations. Thus, in this phase there is not any change of ownership, since the only legal change is related to the company rent contract.

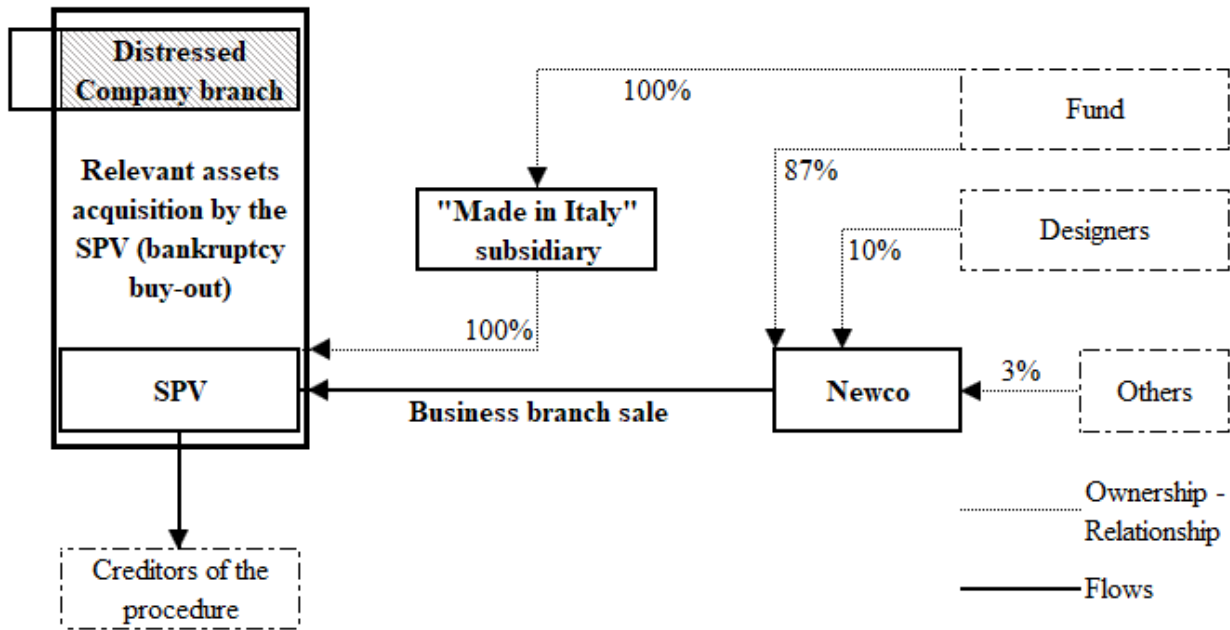


Figure 5.19 The second phase of the transaction: the purchase of the business branch (2016).

Figure 5.19 shows the second part of the transaction, occurred in the 2016 (i.e. after the homologation of the bankruptcy buy-out plan by the court). In this phase, the Fund obtained legally the control of the Distressed Company business branch representing the company operations. In order to perform this operation, the Fund created a Special Purpose Vehicle (SPV) aimed at participating in the bankruptcy buy-out procedures as a contractor (*assuntore*)¹⁹². After having purchased the Distressed Company business branch, the SPV sold it to the Newco, controlled by the Fund (87%). The Figure includes also the presence of the “Made in Italy” subsidiary owned completely by the Fund; the subsidiary corresponds to the legal entity which manages all the high “made in Italy” component distressed companies purchased in those years.

As for the profitability of the operation, if the performance of the Newco will be positive, the returns for the Fund can be very high, in particular if we think that it spent only € 551.542 for the business branch. For example, applying a multiple of 6x (quite prudential for the design industry) to the 2017 Newco EBITDA, and decreasing the amount obtained by the 2017 Net Financial Position, it is possible to observe that the Enterprise Value is about 5 times higher than the initial expense performed in execution of the bankruptcy buy-out plan. According to a Fund insider, if

¹⁹² Legally, the SPV has been created with this specific business purpose (*oggetto sociale*).

the Fund decided to sell its participation on the Newco (i.e. the 87% of the total shares) in the 2018, its IRR would have been equal to about 35%. However, since the Newco is growing at a significant rate, there is a good possibility that the returns in case of divestment can be very high.

Once the Fund strategy has been analysed, it is interesting to try to classify it according to what described in the literature and analysed in Chapter 4.

In practise, thanks to the bankruptcy buy-out rules, the Fund has been able to purchase the Distressed Company business branch paying a low amount of money if we consider the total amounts of claims that the Distressed Company had. Moreover, the positive component of the Distressed Company – i.e. the business branch – has been sold to a Newco owned by the Fund. Finally, currently the capital structure is healthier, mainly because of the transaction performed by the Fund.

For those reasons – if we consider the deleveraging as an operation aimed at adjusting the capital structure of a good company by transferring its ownership to a Newco –, it is possible to relate the transaction as a *deleveraging* operation combined with the *business unit purchase*. In sum, the strategy can be called *legal deleveraging with acquisition of the business unit*. Table 5.20 combines the different stages with a classic deleveraging transaction with the one performed by the Fund.

Deleveraging**Legal deleveraging with acquisition
of the business unit**

Purchase by the Fund of the distressed company debt from a forced seller at a discount	The Fund commits to pay only the claims of the creditors admitted to the procedure
Creation of the newco aimed at controlling the distressed company	Creation of the Newco aimed at incorporating the profitable part of the Distressed Company
Payment of the claims by the Newco and conversion of the credit into a participation on the distressed company	Payment of the claims by the Fund in exchange of the ownership of the business branch, and sale of the business branch to the Newco
Partial elimination of the distressed company level of debt	The level of debt of the Newco is significantly lower
Positive performance of the financially healthier distressed company	Positive performance of the financially healthier Newco (which incorporates the former Distressed Company)

Table 5.20 A comparison between the classic deleveraging operation and the strategy performed by the Fund.

In sum, the main common points are:

- in both the operations a Newco is created;
- in both the operations the fund purchases a lower amount of debt than the total value;
- in all the cases the final outcome is a significant reduction of the debt.

By contrast, the differences are the following:

- in the classic deleveraging operation, the Newco is created in order to exchange the nominal value of the Distressed Company claims with a participation in the Distressed Company; on the other side, the aim of the Newco is to incorporate the business unit of the Distressed Company;
- in the classic deleveraging operation, the debt is purchased at a discount after a negotiation with a forced seller (such as a bank) which has the incentive to sell the claim almost immediately; in the *legal deleveraging* case, the Fund pays a lower amount of debt because the bankruptcy buy-out rule provides for it;

- in the classic deleveraging case, the distressed company continues to operate under a new ownership, i.e. the distress investor one; in the other case, the Distressed Company is failed and will not exist anymore;
- in the classic case, the distress investor can have a double return (the sale of the claims to the newco at its nominal value and the capital gain obtained by the future performance of the distressed company); in the *legal deleveraging* case, the return is related only to the future performance of the Newco.

Chapter 6: Summary and Conclusions

6.1 Summary

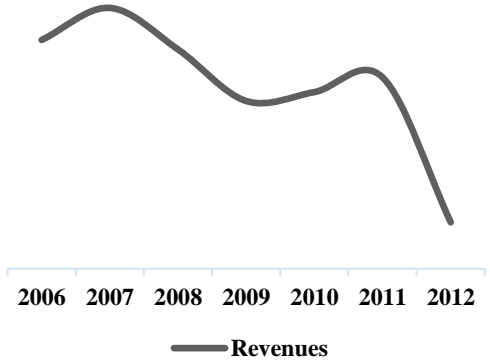
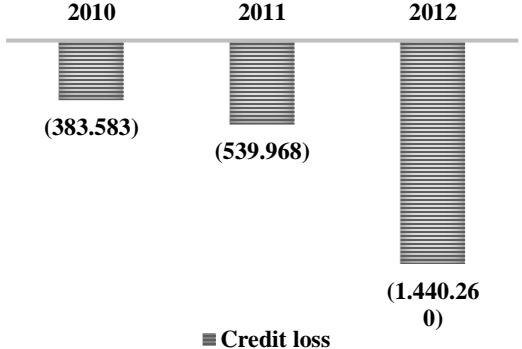
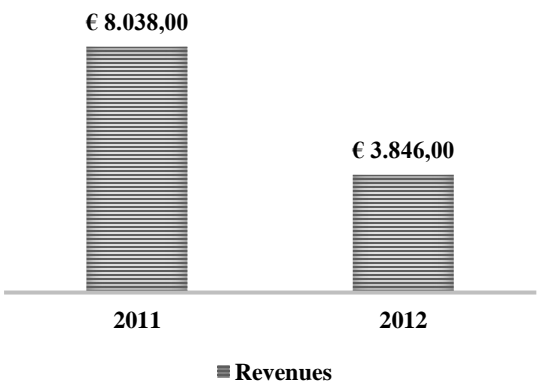
Investing in distressed companies is a very difficult task, which requires a broad set of advanced skills and competences. As explained clearly by the D'Aveni (1989) distress stage model, the distress period may have different paths and a different timing; in other words, the performance of a distressed company can pass from a slight distress to insolvency in a very short term or in a large period of time. As a consequence, to have strong business, finance, legal and communicative skills is not sufficient; a distress investor shall also have a clear view of the timing of the distress period in order to know which are the strategies that it can realistically implement. Thus, all the technical competences mentioned in the last Chapters must be considered adding a further variable – i.e. the time –, since sometimes the best strategy for a particular distressed company cannot be available.

Moreover, it is important to have a clear definition of distress: if on one side the quantitative aspect (i.e. the threshold of a ratio in order to consider it as a signal of distress) changes case by case, on the other side the definitions of “distress”, “crisis” and “failure” must be distinguished clearly, in order to have the right starting point when deciding the turnaround strategy. Complementary to this aspect is the perfect knowledge of the reasons for distress; in particular, it is important to consider the fact that the reasons that lead a company to distress can be multiple. Likewise, it is critical to detect the trigger event which starts the distress period, since some reasons for distress can be simply the consequence of one main circumstance. The analysis of the reasons for distress requires a strong knowledge of the business of the distressed company; in particular, it is important to examine the industry composition and the characteristics of the market. Moreover, this analysis requires also advanced accounting skills, for example in order to find structural problems in the cost structure or capital structure.

Another important skill that a distress investor must have is related to the legal aspect. Indeed, this type of investors cannot overlook the knowledge of the legal tools that the insolvency law provides. In practise, every strategy a distress fund projects includes – at least potentially – the possibility to apply one of the legal procedures provided by the law. Accordingly, the distress investors must be able to use all the legal tools perfectly, in order to know how to use the law for maximising their own returns.

The case study presented in Chapter 5 examines a significant part of those themes. The Distressed Company was an Italian medium company located in the North-Eastern part of Italy. Mainly, the company provided design services for the footwear industry, supporting the clients throughout the whole shoes creation process, from the preliminary discussion of the market trends and the idea of the final product to the production of the prototypes related to the final product. The company was owned by two designers who had founded it during the Eighties, and the company was embedded into an industrial district specialized in the footwear industry. Recently, the designers started to offer their design services also to other sectors such as interior design, packaging and digital design. During the Nineties the company grew significantly, so that during the first decade of the new century the managers decided to move the headquarter to a bigger building. In that period, the company had a dominant position in the local industry and significant relationships with some of the most important international clients. The aim of the company was to become an “industry of design”, covering not only the footwear sector but other markets as well.

However, at the end of the first decade of the Noughties the company started to show the first signals of distress; the trigger event was the 2008 global financial crisis, but the first signs were present also in the previous years. Table 6.1 summarizes the main reasons for distress.

<p>Financial crisis</p>	<p>The world financial meltdown led to a change of the behaviour of all the economic agents. As a consequence, the worse financial condition of the consumers has decreased the possibilities for the companies to sell their products or services; obviously, this situation has been translated also to the B2B companies, as the Distressed Company.</p>	 <p>2006 2007 2008 2009 2010 2011 2012</p> <p>— Revenues</p>
<p>Bankruptcy of some old clients</p>	<p>During the distress period, some Distressed Company clients were not able to pay the company anymore, mainly because of the financial crisis. This fact has contributed significantly to the dramatic fall of the 2012 performance because the managers had to account for a huge credit loss.</p>	 <p>2010 2011 2012</p> <p>(383.583) (539.968) (1.440.260)</p> <p>■ Credit loss</p>
<p>Cancellation of orders</p>	<p>Since some clients entered a distress scenario mainly because of the financial crisis, the Distressed Company has not been able to conclude some of the contracts regarding the related services. In particular, some clients decided to conclude unilaterally the contract; this event implicated a huge decrease of the total revenues, contributing significantly to the 2012 performance disaster.</p>	 <p>€ 8.038,00 € 3.846,00</p> <p>2011 2012</p> <p>■ Revenues</p>

<p>Fixed costs incidence</p>	<p>The negative effects of the past decision to purchase a huge amount of assets with leasing contracts started to show immediately after the distress has begun. Moreover, the intrinsic characteristic of the business (labour intensive) implied a huge amount of personnel and service costs. Accordingly, when the distress started to become serious, the company could not try to absorb the negative contingency by employing an efficient cost cutting strategy because of those high fixed costs.</p>	<table border="1"> <caption>Percentage Composition of Costs and Revenues (2008-2012)</caption> <thead> <tr> <th>Year</th> <th>Services (%)</th> <th>Leasing (%)</th> <th>Personnel (%)</th> <th>Sales revenues (%)</th> </tr> </thead> <tbody> <tr> <td>2008</td> <td>33%</td> <td>18%</td> <td>49%</td> <td>-</td> </tr> <tr> <td>2009</td> <td>35%</td> <td>17%</td> <td>43%</td> <td>-</td> </tr> <tr> <td>2010</td> <td>36%</td> <td>13%</td> <td>42%</td> <td>-</td> </tr> <tr> <td>2011</td> <td>36%</td> <td>10%</td> <td>34%</td> <td>-</td> </tr> <tr> <td>2012</td> <td>91%</td> <td>20%</td> <td>57%</td> <td>-</td> </tr> </tbody> </table>	Year	Services (%)	Leasing (%)	Personnel (%)	Sales revenues (%)	2008	33%	18%	49%	-	2009	35%	17%	43%	-	2010	36%	13%	42%	-	2011	36%	10%	34%	-	2012	91%	20%	57%	-
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<p>Bad capital structure</p>	<p>The Distressed Company capital structure was unbalanced, with a too high level of financial debt, in particular if we combine it with the performance of the working capital. In particular, if the relationship with the banks could be considered stable, the Distressed Company was facing some difficulties in respecting the payment of the commercial and tax debt.</p>	<table border="1"> <caption>Net Financial Position/Equity (2008-2011)</caption> <thead> <tr> <th>Year</th> <th>Net Financial Position/Equity</th> </tr> </thead> <tbody> <tr> <td>2008</td> <td>4,14</td> </tr> <tr> <td>2009</td> <td>4,71</td> </tr> <tr> <td>2010</td> <td>3,78</td> </tr> <tr> <td>2011</td> <td>3,92</td> </tr> </tbody> </table>	Year	Net Financial Position/Equity	2008	4,14	2009	4,71	2010	3,78	2011	3,92																				
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<p>Clients' integration strategy</p>	<p>It consists in the clients' decision to integrate inside the company the design process. This strategy – which can be partially due to the financial crisis – has decreased the potential number of orders for the Distressed Company, affecting negatively the revenues.</p>	<table border="1"> <caption>Revenues (2006-2012)</caption> <thead> <tr> <th>Year</th> <th>Revenues (€)</th> </tr> </thead> <tbody> <tr> <td>2006</td> <td>€ 9.119</td> </tr> <tr> <td>2007</td> <td>€ 10.046</td> </tr> <tr> <td>2008</td> <td>€ 8.845</td> </tr> <tr> <td>2009</td> <td>€ 7.353</td> </tr> <tr> <td>2010</td> <td>€ 7.611</td> </tr> <tr> <td>2011</td> <td>€ 8.038</td> </tr> <tr> <td>2012</td> <td>€ 3.846</td> </tr> </tbody> </table>	Year	Revenues (€)	2006	€ 9.119	2007	€ 10.046	2008	€ 8.845	2009	€ 7.353	2010	€ 7.611	2011	€ 8.038	2012	€ 3.846														
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Table 6.1 The Distressed Company reasons for distress.

The distress period can be divided into two stages. The first stage comprehends the period 2008-2011; in those years, the company performance declined continuously, even though the revenues performance was slightly positive (apart from the 2008 fall due to the financial crisis). The second phase corresponds to the year 2012; in that year, a combination of material decrease of the total revenues and the accounting for huge credit losses led the company in a serious situation.

In order to find a solution, the Distressed Company managers tried to prepare – with the support of two advisory companies – two business plans, that unfortunately did not represent the real situation of the company. As a consequence, a distress investor (the Fund) entered in negotiation with the Distressed Company managers – in particular with the two designers – in order to help the company to exit the distress stage in exchange for the ownership on it. Indeed, the aim of the Fund was to integrate the Distressed Company – characterized by a strong “made in Italy” component – in a group of similar “made in Italy” companies already owned by the Fund itself.

For this purpose, the Fund founded – together with the two designers – a Newco and concluded a company rent contract in favor to the Newco regarding the Distressed Company business branch related to the operative component of it. Then – in order to have the exclusivity on the positive part of the Distressed Company – the Fund concluded with the two designers an agreement where the designers committed to collaborate only with the Fund for a certain amount of years. In this period, the Distressed Company (in concert with the Fund) applied for the admission to the composition with creditors (*concordato preventivo*) “*in bianco*” procedure; however, the plan proposed by the managers has not been approved by the court because of the presence of a conflict of law regarding the treatment of the VAT claims. As a consequence – after the Distressed Company managers had filed for bankruptcy –, the Fund created a bankruptcy buy-out (*concordato fallimentare*) proposal with a content similar to the composition with creditors plan one. Because of the bankruptcy buy-out rules, the VAT claims issue was not a problem anymore and the Fund had the possibility to assume only a part of the claims (i.e. the ones present in the temporary list of creditors prepared by the official receiver). As a consequence of the bankruptcy buy-out plan – which has been homologated by the court –, the Fund acquired the positive component of the Distressed Company by incorporating it in the Newco, which currently has a positive performance.

In this way, the Fund has been able to perform a sort of deleveraging operation, in this paper called *legal deleveraging with acquisition of the business unit*, where it has been able to purchase the positive component of the Distressed Company investing a low amount of money (€ 551.542)

if we consider that only the 42% of the total Distressed Company debt has been paid¹⁹³. According to internal sources, if the Fund sold the Newco in the 2018, its IRR would have been about 35%: a significant rate considering a 3 years investment period.

6.2 Conclusions

The case study presented in Chapter 5 demonstrates various aspects about the way in which a distress investor can act and the distress investing process in general.

Complexity of the distress investing requirements

The Distressed Company case study shows clearly the level of knowledge that a distress investor must have in order to select the proper strategy in order to turn the company around and maximizing its return at the same time. In particular, generally the fund must possess advanced skills in the following areas:

- *business*: before deciding to invest into the Distressed Company, the Fund had to perform a thorough and pervasive analysis of the company situation and its reasons for distress. Indeed, an investment in a distressed company is by definition a risky operation; thus, it is important to be totally confident about the fact that there is a “real business” behind the dangerous situation. Accordingly, for example it has been an important factor to know about the Distressed Company predominance in the local industry; similarly, another important information that the Fund may have obtained regards the composition of the clientele and the characteristics of the most important contracts. Moreover, the information related to the presence of two business units, the design process and the involvement of the two designers-owners provided significant insight about the diversification of the revenues and the importance of the presence of the two designers inside the company. An exhaustive knowledge about the Distressed Company and its environment is important also in order to detect and understand in detail the reasons for distress. Indeed, in the case study (and in Table 6.1) it is possible to observe the variety of

¹⁹³ Moreover, it is important to precise that the majority of the creditors has been paid using the cash owned by the bankruptcy procedure itself.

the reason for distress; they were both internal and external and both operative and strategic.

In order to perform a high-quality business analysis, a distress investor shall also have skills and an organization peculiar of a strategic investor; in other words, since a distress fund must act quickly, it should already have a certain level of specialization in the industry it is going to invest. In the case study, the Fund already had a project specialized in “made in Italy” distressed companies. Thus, it could move quicker than the other distress funds which are not specialized; this fact can be seen as a key competitive advantage since it gives the possibility for the Fund to be more flexible when preparing a purchasing offer;

- *accounting*: in order to find the so called “good companies with bad balance sheet”, the distress investors have to master the financial statements analysis techniques. Indeed, it is as important as the business analysis to be able to recognize quickly every capital structure unbalance and situation of cost rigidity. In particular, a good financial statement analysis should show whether the reasons for distress are simply related to recoverable bad past decisions, suggesting that there is a “real business” behind the current state of difficulty.

Strong accounting skills are necessary also when preparing the turnaround plan, since every line item of the plan must be prepared in detail. For example, in the specific case it was important to have a good knowledge of the accounting treatment of the company rent contract in order to estimate the effects on the performance of the Newco in the first years which followed the transaction. Another critical accounting point was related to the definitive purchase of the business branch assets, i.e. the transition from a company rent regime to the acquisition one;

- *finance*: to have strong finance skills is important for two reasons. Firstly, in order to see whether the investment is reasonable, it is important to perform a correct valuation of the distressed company. Thus, the distress fund must know the most used valuation techniques. Secondly, a distress investor shall be expert in the functioning of the capital markets and the main financial instruments available. For example, in the case analyzed the Fund may have tried to adopt a debt-equity swap strategy; in order to perform such strategy, it would have been important to have an advanced knowledge of the securities the Fund was going to convert. Moreover, basically a distress investor operates as an asset

management company; thus, it is important to know how to balance and hedge its portfolio of investments;

- *legal*: the most important difference between the distress funds and the other investors is related to the strong expertise in the bankruptcy law. Indeed, the probability that a distress investor enters a procedure regulated by the insolvency law is materially high. The Fund described in the case study is specialized in the use of the bankruptcy buy-out legal tool but for sure it is expert also in all the other procedures provided by the law. In the case study, the Fund had to understand perfectly the way in which the composition with creditor, the bankruptcy and the bankruptcy buy-out work.

As a prove of the fact that to have a legal expertise is critical in the distress investing world, it is important to recall the use made by the Fund of the bankruptcy buy-out procedure. Indeed, the Fund used this procedure – and the opportunity created in that moment – to pay a lower amount of cash taking advantage of the *art. 124 l.f.*, which gave the possibility to rely on a temporary list of creditors;

- *network of contacts and communication*: finally, for a distress investor it is critical to have the proper network of contacts and strong communication skills.

The network of contacts is essential in order to be informed quickly about the presence of a company which is in a distress stage. Indeed, this type of information is private since a public disclosure can alter the relationships of the distressed company with its main stakeholders. Accordingly, the distress fund must be able to create a reliable network of insiders in order to have the tip before the other funds get it. In the case study, the Fund obtained the information from a local advisory company, confirming the importance of the network aforementioned.

Furthermore, the distress investor needs advanced communication skills in order to negotiate properly with all the stakeholders of the distressed company. This aspect is even more important when dealing with private companies owned by families or an entrepreneur. Indeed, often to communicate to an entrepreneur that its company is entering a distress scenario is a delicate aspect; moreover, usually the entrepreneur is not willing to give up the control of the firm he founded. Moreover, the distress investor must be at the same time a good negotiator and a good mediator; to find an equilibrium between the purposes of the stakeholders and the own ones is a very complex task.

Mistakes and failures

Another important lesson that the case study provides consists in the fact that often the right solution is not automatic.

Indeed, the first attempts undertaken by the Distressed Company managers consisted in the preparation of two business plans which were based on assumptions – provided by the managers – too optimistic, especially for the revenues. This fact explains well the complexity of the distress investing world, since often the scenario changes so rapidly that the managers are not able to provide a stable estimate of the main financial statement line items. Moreover, in this phase the distressed company managers may be incentivized to prepare optimistic plan in order to obtain large financings by the banks; thus, another theme is related to the reliability of the players of the procedure during the distress period.

After the failure of the business plans, the Distressed Company managers selected the composition with creditors tool. As happened in the previous attempts, the result has been a failure since the court did not approve the composition with creditors plan. The reasons are related to legal issues, i.e. the impossibility – according to the court – to include in the composition with creditors plan the partial payments of the VAT claims. This event provides a further insight about the complexity of the issue, since sometimes the distress funds themselves do not know how the court will decide.

In conclusion, the distress investing is an intricate field, where the decisions must be taken quickly. Accordingly, to make mistakes (or to not reach the best solution available) is a very common event in those cases, in particular when the availability of information is not complete, and the results depends strongly on the way in which the court interprets the law.

The information difficulties

As already mentioned, in the case study the Fund has been able to identify the Distressed Company thanks to its network of insiders that it has created during the last decades. However, in the same period also other funds might have been interested in the Distressed Company. This fact has helped the Fund to avoid a competition among distress investors which might have increased the acquisition cost of the Distressed Company.

In other cases, however, the Fund may suffer the fact that the information about other distressed companies is collected only by another fund. The general result is that it never happens that a high number of distress funds know about a particular distressed company. This fact represents a high information barrier which can potentially reduce significantly the probability to rescue a distressed company.

However, on one side the distressed company managers would prefer to not disclose to the market the situation since the main stakeholders (such as the banks and the suppliers) can decide to stop any relationships with the company, but on the other side without a certain level of information nobody would seek to help the managers to save the company. How to solve this information trade-off? On one side, it may be possible to conclude that the distress investing is inefficient by definition, and its inherent complexity includes also this information gap; but on the other side, the distress funds should be able to contrast this difficulty by creating a proper network of contacts. Effectively, this last point is one of the main competitive advantages of the distress investors, since they deal with private information only.

A new strategy: the legal deleveraging

As explained in the last part of the previous Chapter, the strategy performed by the Fund can be classified as a *legal deleveraging with acquisition of the business unit*. The main differences with the normal deleveraging operation are two:

- the payment of a lower amount of debt than the total (common to the classic deleveraging case) is due to the application of the bankruptcy buy-out rules instead of a negotiation process with a forced seller;
- the distressed company (or a business unit of it) ownership is transferred to the Newco instead of having a change of the ownership directly inside the distressed company.

The identification of this new type of distress investing operation can provide addition insight about the activity of the distress investors, in particular about the application of a similar strategy in other cases. In particular, interesting is the use of the bankruptcy buy-out procedure made by the Fund in this case.

Particularity of the bankruptcy buy-out procedure

The strategy performed by the Fund in the case study focused the attention on the bankruptcy buy-out procedure. Indeed, if used appropriately, this instrument can be used in order to take advantage of the possibility, ex. *art. 124 l.f.*, of creating a plan addressed only to the creditors which are included in the temporary list of creditors prepared by the official receiver under the bankruptcy procedure. In other words, this legal tool gives to the proponent of the plan the power to decide not to pay the creditors which are not included in the temporary list of creditors. However, when planning the strategy, the distress fund has to consider the totality of the distressed company claims, since it is ever possible that a creditor which stayed out from the temporary list of creditors asks to be admitted to the procedure at a later stage. In particular, in the Distressed Company case the tax authority lost a significant part of their claims simply because this type of entities employs more time to assess the real value of their claim. Accordingly, a good distress investor must be aware that under certain circumstances there may be the possibility to obtain those advantages which affect directly – and positively – its return.

6.3 Insight for future research

In addition to some conclusions, the Distressed Company case leaves some basis for future research.

First of all, in Italy the distress investing is an industry which is still young, in particular if we consider that in the USA the distress investing was already developed in the Eighties as a consequence of the development of the junk bonds market. Accordingly – also considering the fact that the most important legal changes related to the legal procedures aimed at continuing the company operations are recent –, it would be important to encourage the economic agents to enter this niche, since the effects for the economy may be significantly positive in the long term.

Secondly, a further analysis should be performed about the information asymmetry issue. In particular, it would be useful to find the main drivers which affect the right balance between the necessity to keep private the information in order to avoid a further decrease of the distressed company value and the importance to let know to the distress investors about the existence of the companies which are looking for help. A hypothetical possibility could be the creation of a sort of

protected information flow which matches companies and funds, aimed at linking the distressed companies' necessity to communicate their distress status and the interest that the funds have on this type of information. On the other side, it is understandable that this solution may enter in conflict with the goals of the distress funds which are already operative, since the information asymmetry is one of their main competitive advantage.

Finally, the strategies performed by the distress investors shall be reanalysed as soon as the Italian bankruptcy law reform will be completed¹⁹⁴.

In particular, it will be interesting to analyse the effect of the “alert procedure” that the Italian legislator is going to introduce; thanks to the alert procedure, the probability of detecting in advance a corporate distress status should be higher. Moreover, the alert procedure will anticipate further the period of protection of the distressed company assets; thus, the approach of the distress investors may change.

On the other side, the reform would like to reduce significantly the number of claims that are possible to classify as *prededucibili*; this fact can have a material impact on the distress funds strategies.

¹⁹⁴ The reform should be completed in the 2019.

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