Course Overview:
Creating Value Through Corporate Restructuring

Harvard Business School

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Course Overview: Creating Value Through Corporate Restructuring

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I. Introduction

The Creating Value Through Corporate Restructuring (CVCR) course at the Harvard Business School explores how corporate managers create value by restructuring the firm's financial claims and contracts. The main pedagogic approach used in the course is the case method. Students study restructurings that address corporate underperformance, financial distress, changes in business strategy and corporate policy, and information gaps between the firm and the capital markets. Examples include financial reorganization and bankruptcy, equity restructuring through corporate spin-offs and targeted stock offerings, and restructuring of employees' claims through layoffs, downsizing, and negotiated wage give-backs. For most firms studied in the course, restructuring is a response to severe financial stress, following large declines in firms' profitability, market value, or competitive position.

This document describes the analytical and organizational framework of the course, discusses general course themes, and provides a session-by-session description of the course materials. Appendix A lists the cases and teaching notes. Appendix B provides assignment questions that are given to students to help them prepare the cases.

The course is offered as a second-year elective in the School's MBA program. Course materials have been successfully used as well in a number of the School's executive programs. CVCR runs for 20 classes, and students are required to submit a paper. Current course enrollment consists of two full sections of approximately 100 students apiece, and there is a waiting list.

The course was started by Steve Fenster and Ron Moore in 1992, when it was called Corporate Restructuring. I began teaching the course in 1994, and took full responsibility for its development in 1995. I have contributed 10 of the 17 cases included in the curriculum.[1] Eight of these cases comprise two new modules that I have developed to extend the conceptual reach of the course, on the restructuring of equity contracts and employee contracts.

Case studies in the course are almost all "field" cases. As such, they incorporate data and insights obtained directly from company management, giving students a unique "inside look" at the corporate restructuring process. Most of the cases come with comprehensive teaching notes. To give students a general context for analyzing the cases, case materials are supplemented with assigned readings from the academic literature on corporate restructuring. The case teaching notes, and this course overview, highlight some of the connections to this literature.

I teach the course from the perspective that corporate restructuring—far from being a rare or episodic event that happens to "someone else"—is a common and important event in the professional lives of many managers. Over the period 1981-1996, for example, public companies with combined assets of more than *half a trillion* dollars filed for Chapter 11 bankruptcy protection in the U.S. I estimate that assets of approximately equal value were restructured through consensual reorganizations outside of bankruptcy court. In 1996 alone there were more

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[1] The *Southland Corporation (C)* case study was written by Richard Ruback. Steve Fenster and Ron Moore developed the remaining cases. I co-developed the *National Convenience Stores* case study with Steve Fenster.

than 50,000 business bankruptcy filings in this country. Over the same 1980-1996 period, over 350 public companies underwent corporate spin-offs, divesting businesses with a total equity market capitalization of more than $200 billion. And by some estimates as many as 10 million employees were laid off in the U.S. under corporate downsizing programs.[2]

The "reach" of corporate restructuring is far greater than these statistics imply when one considers the web of relationships between restructured companies and their corporate customers, suppliers, and competitors. Through its impact on firms' market values, restructuring also impacts literally millions of investors, lenders and shareholders who provide capital to these firms. The course emphasizes that a basic understanding of corporate restructuring practices, and an appreciation for the important public policy issues raised by restructuring, belongs in every manager's "tool box."

The course also emphasizes that the scope of corporate restructuring has become increasingly global, as heightened competition in international product, capital, and labor markets puts tremendous pressure on companies worldwide to increase their competitiveness and maximize their market value. Recent developments in Europe, and more recently Asia, vividly illustrate the growth of restructuring opportunities outside the U.S.

The cases in CVCR contribute important new insights into the corporate restructuring process. Students learn how restructuring creates value; when it makes sense for a company to restructure; and what kind of restructuring is most appropriate for dealing with a given problem. Students also learn what issues and challenges managers have to deal with when implementing a restructuring, to ensure the goals of the restructuring are achieved.

II. Course Framework

The course examines how managers create value by restructuring the firm's financial contracts and claims. I have devised a general approach for thinking about restructuring, and developed cases studies that represent a broad range of important kinds of restructuring. Together, the course structure and the cases give students a general framework for analyzing and responding to the restructuring opportunities they will encounter in their careers.

The Purpose and Scope of Corporate Restructuring

Following Jensen and Meckling (1976), I view the firm as a collection of contracting relationships among individuals (Jensen and Meckling refer to this as a *nexus of contracts*). These contracts represent claims on the cash flows generated by the firm's assets and operations. In developing this course, I realized that this model of the firm provides a natural and useful way to think about corporate restructuring.

I define restructuring as the process by which the firm changes the terms of its contracts; restructuring is about *recontracting*.[3] Sometimes contracts are restructured through a process of negotiation; other times firms unilaterally restructure their contracts. Economically, restructuring affects the level and timing of the firm's cash flows; it also affects how these cash

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[2] All dollar figures have been converted into constant 1996 dollars, using the U.S. producer price index. Sources for these statistics include the Bankruptcy Yearbook & Almanac, Securities Data Corporation, and Downs (1995). The estimate of assets restructured through out-of-court reorganizations is based on research in my paper "Troubled Debt Restructurings" (Gilson, John, and Lang (1990)).

[3] There exists an extremely important set of activities like strategic alliances and redefinitions of corporate strategy that fall outside the definition of "restructuring" that I will use here.

flows are divided up and apportioned among the firm's claimholders. The list of claimholders who can be affected by restructuring is long; it includes shareholders, creditors, managers, employees, suppliers, and customers. The contractual relationship between these claimholders and the firm can either be explicit or implicit.[4]

The incentive to restructure often arises because the firm's market value falls significantly below its full potential or intrinsic value. Case materials highlight important causes of this "value gap," including poor corporate performance or financial distress, changes in corporate strategy, and mistakes by the capital markets in valuing corporate assets. Closing the value gap potentially benefits all the firm's claimholders and stakeholders, provided they can agree on how to share the gains.[5]

A number of the case studies that I developed for the course show that restructuring can have an enormous impact on shareholder value and stakeholder wealth—in the billions of dollars for larger companies. For example, when Scott Paper Company downsized its workforce from 34,000 to 11,000 employees in less than two years, the industry-adjusted market value of Scott's common stock increased by $3 billion—a gain of *207%*.[6] UAL (parent of United Airlines) realized a similar increase in its stock market value when its employees made large wage and benefit concessions in exchange for a controlling interest in UAL stock.

Corporate restructuring also often dramatically affects the *distribution* of value among the firm's various stakeholders. As a result, a key challenge facing managers in many restructurings is to resolve or bridge conflicts among the firm's stakeholders, so that a restructuring can take place. The cases show that these conflicts are often very intense. FAG Kugelfischer's announcement that it would lay off half of its 30,000 employees in Germany prompted massive public demonstrations and rioting. During National Convenience Stores' bankruptcy, senior creditors and stockholders became locked in heated litigation over the firm's enterprise value. Estimated values ranged from $200 million to more than $300 million.

Course Content and Organization

I have organized the course around modules that highlight important classes of contracts and restructurings. **Exhibit A** summarizes this organizing framework. The first module features financially distressed firms that restructure their **debt contracts**. The second module features firms that restructure their **equity contracts**, either by creating new classes of stock, or by giving managers a large claim on residual equity cash flows. The third module features firms that restructure their **employee contracts** to control labor costs.

Early versions of the course concentrated on debt restructuring. More recently I developed the second and third course modules to represent two other common kinds of restructuring undertaken

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[4] An example of an implicit contract is an informal unwritten promise by a company to its workers that it will employ them long-term, or grant them regular annual wage increases.

[5] The notion of a value gap used in this course builds on work by Bill Fruhan (1988), but focuses attention on the role that financial recontracting plays either in supporting value-enhancing business policies, or in independently creating value.

[6] This percentage appreciation is estimated as follows. At the beginning of Scott's restructuring, in April 1994, its common stock had a market value of $1.4 billion. At the end of the restructuring, marked by the acquisition of Scott by Kimberly-Clark in December 1995, the market value of Scott's common stock was $4.7 billion. This represents an increase of $3.3 billion (236%). Had Scott's common stock appreciated at the same rate as the S&P Paper and Forest Products Index, the increase in value would have been only $0.4 billion (29%). Note that this estimate represents the increase in the market value of Scott's common stock only; it does not factor in any gains or losses realized by other Scott claimholders and stakeholders, including employees, suppliers, customers, creditors, or the communities in which Scott's manufacturing facilities were located.

by companies. Future course development will add cases on the restructuring of other important contracts and claims, e.g., supplier contracts, joint venture agreements, employee pension plans, environmental liabilities, and tort claims (e.g., tobacco or breast implant liabilities). Over time, the reach of the course will also be increasingly broadened through the addition of more cases on international restructurings.[7]

In each module of the course, I have developed cases to represent the range of approaches available for restructuring a given type of contract. For example, the module on restructuring employee contracts features different approaches companies can take to reduce their labor costs: involuntary layoffs, voluntary early retirement programs, and negotiated wage and benefit concessions. Similarly, the module on restructuring equity contracts includes case studies on corporate spin-offs and targeted stock offerings as alternative approaches for dealing with undervalued common stock. In the module on restructuring debt contracts, firms deal with excess leverage and financial distress either by reorganizing in bankruptcy court, or by negotiating a consensual out of court restructuring with their creditors.

General Approach to Analyzing Restructuring

Through analysis of specific companies and transactions, students develop a general understanding of how restructuring creates value, and acquire a set of insights they can use to identify, analyze, and profit from restructuring opportunities more broadly.

Conceptually, I have framed the course in terms of the following general questions:

- When does it make sense to restructure a firm?
- What kind of restructuring is most appropriate for addressing the particular problems or challenges the firm faces?
- To implement a restructuring, what key decisions must managers make, and what barriers must they typically overcome?
- How much value will the restructuring create?
- What actions can managers take to ensure the capital markets fully credit the firm for the value created by restructuring?

Within this general context, students learn that restructuring often affects the firm's value because of various market frictions and institutional rigidities that make it costly for firms to recontract (**Exhibit A**). These factors include transactions costs, taxes, agency costs, and information gaps between firms and the capital markets. Although the specific parameters will differ from case to case, these factors often determine why restructuring "matters."

My case study of USX Corporation illustrates the usefulness of this perspective. The case describes the company's decision to create targeted stock in each of its two business divisions; the alternative was to completely separate the divisions through a spin-off. At the time, experience with targeted stock was extremely limited. "Fundamental analysis" of targeted stock in terms of the above factors provides insight into the relative valuation impact of the two restructuring alternatives. For example, a firm's corporate tax liability may be lower under a targeted stock structure because consolidating income across business segments allows the firm to use its accumulated net operating losses and other tax shields more efficiently. On the other hand, targeted stock may not address costly agency and incentive problems in the firm because management retains control over the firm's businesses.

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[7] An example of this initiative is my case study *FAG Kugelfischer—A German Restructuring*, in the third module of the course.

The case studies that I developed for this course also show that choosing the "right" restructuring approach often requires managers to understand the fundamental business and strategic problems facing their companies. Humana Inc. split its two main businesses apart through a corporate spin-off because management recognized the businesses were strategically incompatible; alternative restructuring options (including targeted stock) would not have addressed this problem. Chase Manhattan Corp. and Chemical Banking Corp. reduced their labor costs by merging and laying off redundant employees, rather than cutting jobs internally, because management of both banks perceived a long-term industry strategic advantage to being larger. Employee layoffs at Scott Paper Company were concentrated in a very short time frame to minimize workplace disruptions, but for some industries, strategic and business factors may warrant a more gradual approach to downsizing.

III. Major Course Themes

The course covers a wide range of restructuring transactions and techniques. Analysis of individual cases requires students to understand various complicated legal, accounting, regulatory, and other rules that affect restructuring outcomes. From this focused analysis, a number of important general themes emerge. These themes are revisited throughout the course in a variety of different restructuring and institutional contexts.

Triggers of Restructuring

An important focus of the course is understanding what drives the decision to restructure. For many of the firms studied, this decision is triggered by a financial crisis. In these cases management may have little choice but to restructure, to fend off a hostile takeover or avoid bankruptcy. For some other firms in the course, however, restructuring is done *preemptively.* In these cases managers either anticipate a crisis, or they seek to take advantage of a strategic opportunity.

Through analysis of these cases, students learn that significant value can be created by preemptive restructuring. This is consistent with Donaldson's (1994) claim that voluntary or preemptive restructuring can, for some firms, generate more value than restructuring done under the threat of a hostile takeover or bankruptcy.

The cases also highlight reasons why it can be difficult to preemptively restructure, however. Absent a crisis, it can be more difficult for managers to persuade corporate stakeholders to make concessions or otherwise agree to alter their claims. Management of UAL Corporation effectively had to create an "artificial" crisis to motivate employees to participate in the buyout. It is also unclear whether the factors that encourage firms to preemptively restructure can be widely replicated at other firms. For the cases studied in the course, these factors are often idiosyncratic, e.g., a strong or visionary CEO, a corporate culture that encourages experimentation and change, etc.

Challenges in Implementing a Restructuring

Corporate restructuring can have a variety of goals, such as making the firm more cost competitive, abandoning a flawed corporate strategy, or taking other measures to increase the firm's market value. The course shows that achieving these goals can be extremely difficult because of various barriers to *implementing* a restructuring. These barriers reflect market frictions and institutional rigidities that make it costly for firms to recontract. For example,

financially distressed firms that try to reduce their debt, or replace it with new equity, are taxed on the amount of forgiven debt. Labor laws and union rules make it costly for firms to lay off employees. Breaking up a conglomerate firm through a spin-off can generate a large tax liability. Information gaps can limit a troubled firm's access to new outside financing, forcing it to sell off assets for less than they would be worth if retained by the firm.

Managers' ability to deal with these constraints, and implement a restructuring, can have a huge impact on how much value restructuring creates. Managers also need to be aware of these constraints so they will not have unrealistic expectations about what can be achieved by restructuring their firms.

The cases also provide students with practical information about what key decisions managers must make when implementing a restructuring. These decisions often present managers with difficult tradeoffs. For example: How should shared corporate assets and liabilities be allocated among the firm's business units prior to splitting them apart in a corporate spin-off? How should the terms of an exchange offer for public bonds in a debt restructuring be structured to ensure a high tender rate? In a corporate downsizing program, how should the number and location of layoffs be determined, and how quickly should the layoffs be made? What features should a debt restructuring plan include to ensure preservation of the firm's net operating loss carryforwards and other tax attributes? How should layoffs of redundant employees following a corporate merger be distributed between the merging companies?

Managers who understand the economic tradeoffs behind these decisions can create significantly more value for their companies in a restructuring.

Public Policy on Restructuring

The case studies in the course raise important and controversial public policy questions relating to corporate restructuring, questions which have no easy answers: Do shareholder wealth gains from restructuring reflect the creation of new value, or do they reflect *transfers* of value from other corporate claimholders and stakeholders, such as creditors, employees, and suppliers? How should the interests of communities adversely affected by corporate restructuring be viewed? Should managers be well-paid for ordering the layoffs of many thousands of employees? Does bankruptcy law in the U.S. keep inefficient firms from being shut down, or give such firms an unfair competitive advantage over their non-bankrupt competitors? Do the capital markets myopically give firms too much credit for cutting short-term costs, and ignore the negative long-run consequences of corporate downsizing? Can "U.S.-style" restructuring, with its emphasis on shareholder value maximization, work in other countries where firms are managed more for the benefit of other stakeholders? In a world with global capital flows and diminished trade barriers, do managers have an ethical *responsibility* to restructure their firms, if the alternative is loss of competitiveness and even more severe hardship for corporate stakeholders in the long run?[8]

Recontracting and Information Gaps

An important recurring theme in the case studies that I have developed for the course is that corporate restructuring can produce large information gaps between managers and the capital

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[8] One might go even farther and ask whether managers have a responsibility to *continuously* restructure their firms, to avoid the cost and hardship associated with large one-time restructurings. Putting controls and incentives in place to ensure such continuous monitoring occurs involves certain tradeoffs, however (Simons (1989)).

markets. As a result, the benefits and costs of a restructuring may not be accurately reflected in the market value of the firm's securities, and corporate assets may end up significantly undervalued or overvalued.

The case studies illustrate a variety of ways in which large information gaps can arise. For outside investors and analysts, assessing the likely financial impact of a restructuring can be extraordinarily difficult. Restructuring often materially changes the firm's business. An innovative restructuring may have few or no historical precedents. Public trading in the firm's securities may be temporarily suspended. And managers may be limited in how much helpful information about the restructuring they can disclose publicly. For example, the information may be competitively sensitive (e.g., detailed data on the location of employee layoffs in a firm could be useful to the firm's competitors, by revealing its strengths and weaknesses in specific product and geographic markets). Further, disclosing information about the financial concessions made in a restructuring could antagonize key stakeholders.

The risk that a restructuring could be significantly misvalued has important implications for corporate resource allocation, and for the wealth of managers, shareholders, and other stakeholders. If managers do not believe that the financial benefits of a restructuring will be fully credited in the firm's stock price (or only credited with a lag), they may rationally decide not to restructure the firm, and real value will be lost. If the capital markets award too much credit for restructuring, on the other hand, too many firms will restructure, and real value will also be lost (this argument is often made by critics of corporate downsizing). Information gaps can also make it more difficult to achieve negotiated restructurings (e.g., in bankruptcy), because the recontracting parties cannot agree on the firm's value.

Analysis of the case studies examines possible strategies and approaches managers can take to close information gaps. Students learn that it is often necessary to actively "market" a restructuring to the investment community—that it is not always enough simply to create value "on the inside," and trust the capital markets to see this value.[9] The cases provide examples of firms that attempted to address this problem through innovative accounting and disclosure policies, and proactive communications with investors and analysts. Investor relations executives played key roles in several of the restructurings studied in the course. Students also learn how firms can create new innovative securities to help resolve valuation discrepancies in negotiated bankruptcy restructurings.

Practical and Cross-Disciplinary Course Focus

The course has both an academic and a practical focus. Students are given an analytical framework for thinking about restructuring that includes strong links to academic research. Students also acquire knowledge and tools that will enable them to take advantage of the restructuring opportunities they will encounter in their careers. While the course pedagogy emphasizes how managers can use financial analysis and valuation techniques to solve restructuring problems, analysis of the cases generally requires students to draw on their training in other disciplines, including negotiation, organizations and markets, corporate strategy, and accounting. The course has a term paper requirement, and I encourage students to explore linkages across disciplines in their analysis.

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[9] Some academic research shows how discretionary corporate disclosures can increase firm market value (Healy and Palepu (1995)). Note that the idea of helping the market "better understand" the firm's value is not inconsistent with academic theory and evidence on efficient stock markets. The "efficient markets hypothesis" states only that traded financial assets are correctly priced *on average*; it does not imply that every asset is always priced correctly.

IV. Course Content

In this section I summarize the course modules and case studies, and describe the key themes and issues addressed in the cases. As summarized in **Exhibit A**, the course is organized around three modules. Each focuses on the restructuring of one important set of contracts: (1) debt contracts, (2) equity contracts, and (3) employee contracts.

Module 1: Restructuring Debt Contracts

- Federated Department Stores
- Sunbeam-Oster Company
- National Convenience Stores Incorporated
- Continental Airlines—1992 (Abridged)
- Southland Corporation (C)
- Brent Walker PLC
- Olympia & York
- Cumberland Worldwide Corporation

Overview

The first module of the course studies restructuring of debt contracts by firms that are unprofitable or over-leveraged. Options for restructuring troubled debt include legal bankruptcy reorganization, consensual out-of-court restructuring, and liquidation. Finding a permanent solution to the firm's debt repayment problems often requires restructuring both its capital structure and its business.

The cases in this module highlight different approaches for restructuring troubled debt. Students learn that the manner in which financial distress is resolved depends on a variety of economic and institutional factors. For example, whether a business is more likely to be reorganized or liquidated depends importantly on the country's bankruptcy law (across countries, bankruptcy laws divide into those that encourage reorganization of troubled companies, as in the U.S., and those that favor liquidation). Similarly, the choice between in-court and out-of-court reorganization depends on the nature of the firm's assets, characteristics of its capital structure, tax factors, and provisions in bankruptcy law that potentially benefit a bankrupt firm's business.

Students are asked to assume the perspective of the senior managers, and design and negotiate restructuring plans for their firms. Ideally, management's goal in a restructuring should be to pick a restructuring method, and design a plan, that maximizes the value of the firm's assets and produces a sensible new capital structure. Students quickly learn, however, that achieving this goal can be very difficult. Institutional rigidities and market frictions can frustrate managers' efforts to eliminate excess debt and negotiate a settlement with creditors. (For academic research on these issues, see Gilson (1990, 1995, 1997) and Gilson, Hotchkiss and Ruback (1998).) The class discussion gets students to think about how managers should deal with such impediments to restructuring.

Materials in this module also expose students to the special challenges that managers of distressed firms face in trying to balance the competing interests of the firm's different constituencies. When a firm is insolvent, and creditors are essentially "shareholders in waiting," it is often unclear whether managers should be accountable to current shareholders, or to creditors who will become future shareholders (or both). Such uncertainty can paralyze management decision-making at a critical time for the company. It can also exacerbate costly agency conflicts between shareholders and creditors, as each group seeks to maximize the value of its own claims at the expense of the other (see Gilson (1989, 1990) and Gilson and Vetsuypens (1993, 1994b)).

This module consists of eight cases. When teaching these cases, effective links can be made to the growing body of academic research on corporate bankruptcy and financial distress (see the list of references at the end of this document). Placing the cases in a broader research context helps students better understand how financial distress affects corporate resource allocation and firm value. By documenting patterns and regularities in restructuring practices, this research also gives students general guidelines for how they should respond financial distress as managers.

Description of Cases

Federated Department Stores

The module begins with Steve Fenster's case on **Federated Department Stores**. I use the case to examine how managers and creditors of financially distressed firms choose between restructuring firms' debt in bankruptcy court and restructuring it out of court. In the U.S., bankruptcy reorganization takes place under Chapter 11 of the U.S. Bankruptcy Code. Research shows that approximately half of all U.S. debt restructurings occur out of court (Gilson, John, and Lang (1990), Gilson (1991)).

In the context of debt restructuring, this research suggests claimholders can often collectively be made better off by restructuring out of court. Out of court restructuring is generally less costly than formal Chapter 11, because it takes less time, generates lower professional fees, and causes less disruption to the firm's business. Attempts to restructure out of court can break down, however, when claimholders cannot agree on how to share these cost savings. Gilson, John, and Lang (1990) show that consensus is harder to achieve when the firm's capital structure is more complex, and debt is owed to a larger number of creditors. (For additional research on out of court restructuring, see Asquith, Gertner, and Scharfstein (1994), and Brown, James, and Mooradian (1993).)

Academic research also provides insight into two other reasons distressed firms might file for bankruptcy. First, managers could benefit personally from bankruptcy. Chapter 11 suspends creditors' legal rights to seize collateral and take control of the firm's operations. However, the evidence shows that managers of bankrupt firms frequently lose their jobs or suffer large pay cuts (Gilson (1989, 1990, 1993)).

A second reason firms could file for bankruptcy is to realize certain financial benefits available only to bankrupt firms. Under Chapter 11, firms do not have to pay or accrue interest on their unsecured debt, and they can break unfavorable lease contracts. Chapter 11 also gives troubled firms easier access to new capital, by giving new lenders priority over existing lenders. Chapter 11 also provides important tax benefits to some firms, and facilitates debt reduction (Gilson (1997)). My case study of Continental Airlines (see below) presents opportunities to discuss these benefits.

Sunbeam-Oster Company

The next three cases in the module focus on techniques and strategies for valuing financially distressed companies. This series of cases begins with Steve Fenster's case study of the 1989 bankruptcy of **Sunbeam-Oster Company**. This case requires students to estimate the enterprise value of a bankrupt company, providing a review of basic valuation techniques described in my technical note with Steve, **The Adjusted Present Value Method For Capital Assets**. Although similar techniques can be used to value distressed and healthy firms, research suggests that applying these techniques presents special challenges in the case of distressed firms (Gilson, Hotchkiss, and Ruback (1998)).[10]

The next two cases in this series examine how estimated values are *used* in a bankruptcy negotiation. The firm's estimated market value is a key component of every reorganization plan. This value determines the extent to which the firm's various claimholders get to participate in the plan. Estimating the market value of a bankrupt firm is generally very difficult, however, due to large information gaps between managers and outsiders. As a result, the parties in a bankruptcy negotiation often disagree strongly over value. In larger cases, differences in value can be in the *billions* of dollars.

Such disagreement can also reflect the parties' incentives to *misrepresent* the firm's value to increase their recoveries under the reorganization plan (Gilson (1995)). This strategic behavior can generate severe distrust and conflict, thereby prolonging the negotiations and increasing the costs of reorganizing troubled firms.

National Convenience Stores

These issues are further explored in the case study of **National Convenience Stores**, which I developed with Steve Fenster. The company was a $900 million (by annual sales) operator of convenience stores when it filed for Chapter 11 in 1991. The case shows how standard valuation models can be used to justify a wide range of values in bankruptcy, greatly exacerbating claimholder conflicts. The case is also a powerful vehicle for showing how incentives to misrepresent value arise in bankruptcy.

Using management's own financial projections, it is straightforward to estimate the company's value. Students' initial estimates of value are generally too low to support any distribution to the company's junior claimholders. Changing management's assumptions only slightly, however, produces a dramatic increase in the company's estimated value, and puts junior claimholders back "in the money." This result is a complete surprise to most students, and effectively highlights the critical role that valuation plays in restructuring.[11]

The case provides a company-specific context for discussing research on strategic behavior in the use of bankruptcy valuations (Gilson, Hotchkiss, Ruback (1997)). This research shows that

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[10] In particular, distressed firms typically have large net operating loss carryforwards (NOLs). Estimating the value of NOLs can be extremely difficult. Distressed firms' ability to use NOLs depends on various complicated contingencies, and it is unclear what discount rate is appropriate for valuing the NOLs. An additional tax complication facing distressed firms is that cancellation of debt is taxable income. Treatment of NOLs and debt cancellation income creates an incentive for distressed firms to remain highly leveraged, making it much more difficult to forecast firms' future financial performance and estimate value. Gilson, Hotchkiss and Ruback (1997) develop a valuation method that properly adjusts for these tax factors.

[11] In the actual case, estimates of National Convenience Stores' enterprise value ranged from $210 million to over $300 million. At one point in the case, within the space of only a few days, management lowered its own estimate of value from the high end to the low end of this range.

values proposed in bankruptcy restructurings are often significantly biased. In the sample of companies studied, firm values estimated using management's financial projections range from 20% to 250% of firms' actual market values observed after Chapter 11. Consistent with events in the National Convenience Stores case, the direction of the bias depends on the benefits that various parties in bankruptcy realize from overstating or understating value. (For example, senior creditors tend to propose abnormally low values because this entitles them to a larger fraction of the reorganized firm's equity, "squeezing out" junior creditors.)

The National Convenience Stores case also raises some interesting ethical issues relating to valuation. Bankruptcy rules encourage the parties in a bankruptcy negotiation to "lie" about value. Managers may have incentives to misrepresent value to keep their jobs, or increase their compensation.[12] Because there is generally no market or auction for a bankrupt firm's assets, opportunities to misrepresent value are much greater in bankruptcy than in most other negotiated corporate transactions like mergers. Discussion of these issues is very lively.

Continental Airlines—1992

My case study **Continental Airlines—1992** continues the discussion of bankruptcy valuation issues, with a fascinating twist. Continental filed for Chapter 11 in late 1990, in the wake of the Gulf War and the worst U.S. airline industry recession in history. In the second year of Continental's bankruptcy, *five* outside investor groups made bids to purchase a controlling stake in the airline. Competition among the groups produced an effective auction for Continental's assets. In addition, Continental's common stock was publicly traded throughout the bankruptcy.

The case illustrates how valuation discrepancies in bankruptcy can be reduced by allowing outsiders to value the firm's securities and assets. Whether done in a market or by competitive auction, such third-party appraisals potentially limit insiders' ability to opportunistically misrepresent value. Eliminating such behavior should enable the firm to reorganize more quickly, at lower cost.[13] In practice, auctions in bankruptcy are relatively rare. The case provides an opportunity to discuss what factors limit outside interest in acquiring a bankrupt company, and what measures managers can take to encourage such interest.[14]

I also use the Continental case as a vehicle for discussing investment strategies used by so-called "vulture investors," who specialize in trading in the claims and securities of financially distressed firms. Events in the case illustrate one approach used by "vulture" investors to acquire control of a distressed firm's assets. Students are introduced to other investment strategies practiced by vultures, and are asked to evaluate whether vultures add value in a reorganization. Although the activities of vultures are controversial, research suggests they

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[12] For example, if during bankruptcy it appears that senior creditors will acquire the majority of the reorganized firm's equity, managers may be tempted to disclose false negative information about the firm (or withhold positive information), to artificially depress the firm's market value and increase senior creditors' eventual recovery. Managers may have a similar incentive to low-ball the firm's value if they are to receive stock options under the reorganization plan, since the options will be issued at an artificially low exercise price. Gilson, Hotchkiss, and Ruback (1997) find that management's financial projections are more likely to be low-balled when senior creditors are more powerful in the bankruptcy negotiations, and when managers receive stock options in the bankruptcy reorganization plan.

[13] In the actual case, Continental's post-bankruptcy common stock price was very close to the value estimated by management in the reorganization plan, despite the size and complexity of the airline's business and capital structure. In addition, the entire auction process was completed in only a few months, accelerating Continental's exit from bankruptcy.

[14] Such measures include the use of over-bid provisions and break-up fees to overcome "free-rider" problems, and the use of contingent-payment securities to insure bidders against overpaying.

can significantly reduce the costs of restructuring troubled companies(Gilson (1995), Hotchkiss and Mooradian (1997)).

Finally, I use the Continental case to discuss important public policy issues on bankruptcy. Recent events in Asia and Europe make this discussion extremely timely. One frequent criticism of U.S. bankruptcy law is that it is overly biased towards reorganization, allowing unprofitable companies that should be shut down to stay in business. A related concern is that Chapter 11 confers an unfair advantage on bankrupt firms relative to their non-bankrupt competitors (e.g., by allowing them to break unfavorable lease contracts).

The U.S. airline industry is a natural focal point for discussing these issues. At the time of the case almost a third of U.S. airline industry capacity was in Chapter 11. Several major airlines, including Pan Am and Eastern, had recently tried to reorganize, but had failed and subsequently were liquidated. An important question is whether such cases are evidence of a badly designed bankruptcy system (Weiss and Wruck (1997)). The debate is complicated, because bankruptcy systems that favor liquidation will err in closing down businesses that have more value as going concerns. The resulting opportunity losses cannot be measured, making comparisons difficult (Gilson (1994)).

Southland Corporation (C)

The next case in this module is Richard Ruback's case study **Southland Corporation (C)**, which I use to discuss special issues in restructuring widely-held public debt. Getting small public bondholders to agree to restructure their claims can be difficult because they have a strong incentive to "hold out." To overcome this problem, firms generally restructure such debt through coercive exchange offers, or through a relatively recent innovation in bankruptcy practice called "prepackaged Chapter 11."

Brent Walker PLC and Olympia & York Developments

The next two cases in the course were written by Steve Fenster, and deal with non-U.S. debt restructurings. **Brent Walker PLC** features the out of court restructuring of a troubled British entertainment conglomerate. The case shows how harsh treatment of managers under U.K. bankruptcy law gives them an especially strong incentive to restructure out of court. **Olympia & York Developments** features a large privately-held Canadian real estate company that underwent simultaneous restructurings in Canada, the U.K., and the U.S. These cases allow students to contrast alternative bankruptcy systems in different countries. The cases provide an opportunity to revisit the public policy issues introduced in my Continental Airlines case.

Cumberland Worldwide Corporation (A)

The final two sessions of the module feature Ron Moore's case study **Cumberland Worldwide Corporation (A)**. The case features a large financially distressed consumer products manufacturer that is attempting to restructure its debt out of court. The first day is spent analyzing the case, as preparation for an elaborate in-class negotiation exercise held in the second day. The exercise is a simulation of a Chapter 11 reorganization, based on the case, where students are placed into teams representing the firm's principal claimholders. The exercise was developed jointly by Ron, André Perold, and Tim Luehrman at Harvard Business School. Each year I invite three practicing bankruptcy attorneys to participate in the exercise as bankruptcy judges. The exercise is an extremely effective pedagogic tool.

Module 2: Restructuring Equity Contracts

- Humana Inc.—Managing in a Changing Industry
- USX Corporation
- Donald Salter Communications Inc.
- Transportation Displays Inc.

Overview

The second course module studies how firms can create value by restructuring their equity contracts. Half of the case studies in this module feature firms that restructure their equity by creating new classes of common stock. Methods for creating new stock classes include corporate spin-offs, equity carve-outs, and targeted stock offerings—collectively, stock "break-ups." The other case studies in this module feature firms that restructure their equity by giving senior managers a significant claim on the firm's residual equity cash flows. Senior managers of troubled companies often receive large equity grants, in stock or stock options, as part of their compensation.

Equity restructurings change how total cash flows payable to the firm's stockholders are divided up and "packaged." In a stock break-up, each newly-created class of stock represents a distinct claim on the cash flows generated by a separate operating division or subsidiary. Following the break-up, each new class of stock trades publicly, and the subsidiary publishes its own detailed financial statements. Equity restructurings that establish significant new stock-based compensation for managers also repackage the firm's equity cash flows, and may or may not create new securities.

The cases in this module highlight different approaches for restructuring equity contracts. Students learn what economic and institutional factors managers should consider when deciding whether and how to restructure these contracts. The cases illustrate important ways in which firms can benefit from equity restructuring. Stock break-ups help investors recognize hidden value in a firm by making its assets and operations more "transparent." Break-ups allow diversified firms to divest businesses that no longer fit well with their corporate strategy. Finally, break-ups and stock-based management compensation plans improve managers' incentives and reduce agency costs, by giving managers a larger stake in future corporate profits. Understanding which, if any, of these benefits applies in a given situation can be difficult. Empirical evidence on stock break-ups suggests they significantly increase the market value of firms' assets, on average (Schipper and Smith (1983), Hite and Owers (1983), Berger and Ofek (1995)).

The cases expose students to the special challenges that managers face when trying to implement an equity restructuring. Investors may underestimate the benefits of a stock break-up because competitive or other concerns limit what information managers can disclose publicly about the transaction. Under certain circumstances break-ups can be heavily taxed. Break-ups can impose financial losses on key corporate stakeholders such as employees and creditors. Finally, awarding large equity grants to managers can be politically difficult, if stakeholders are asked to make large financial concessions under the restructuring.

Description of Cases

A. Stock Break-ups

Humana Inc.

The module begins with my case study of **Humana Inc.**, which focuses on corporate spin-offs. In a spin-off the firm distributes all of the common stock in a subsidiary company to its existing shareholders, allowing the subsidiary to trade as an independent company.

At the time of the case, Humana was the nation's largest integrated health care provider, operating a chain of hospitals and health plans (mainly HMOs). The hospital industry was struggling with severe over-capacity and low hospital occupancy rates. Humana's strategy had been to use its health plans to supply patients to its hospitals, producing higher occupancy rates. Although the company had historically grown at double-digit rates, lately both of its businesses had experienced problems. Occupancy rates in its hospitals were very low, and its common stock was trading at a lower multiple to earnings than either of its industry peer groups. Management considered various restructuring options, including a spin-off.

The case shows how restructuring can be used to support value-enhancing changes in corporate strategy. A spin-off made sense for Humana because its integrated strategy was fundamentally flawed. Health plans that competed against Humana's HMOs had no incentive to send their enrollees to Humana hospitals. Physicians who were not under contract with Humana had been increasingly referring their patients to non-Humana hospitals to protest the reimbursement policies of its health plans. Finally, there was a fundamental conflict between the two businesses: HMOs profit by *reducing* the frequency and length of hospital stays.

The problems in Humana's strategy could only be addressed by completely and permanently separating its hospital and health plan businesses. A spin-off achieves this goal, but a number of other restructuring alternatives that Humana considered—issuing targeted stock, undertaking a leveraged buyout, and repurchasing company stock—do not.[15] The case is extremely effective in highlighting important differences between restructuring alternatives which on the surface appear to achieve the same end.

The case provides opportunities to discuss other important benefits of spin-offs. Spin-offs can reduce agency conflicts between managers and shareholders (Collis and Montgomery (1998)). Spin-offs allow firms to tie managers' compensation more closely to the performance of firms' individual business units. Spin-offs also facilitate greater management focus.

The case highlights a benefit of spin-offs that has not been studied in the academic literature. Before a company's businesses can be separated, it is necessary to allocate corporate overhead between them. The allocation process can reveal significant waste and inefficiency. Historically, with its focus on high growth, Humana management had "lost track" of overhead expenditures. It had overspent on computer systems, and hired too many IT and corporate development personnel. Implementing the spin-off forced the company to deal with its inefficient cost structure, producing significant savings.

The case exposes students to important challenges managers face when implementing a spin-off. One such challenge arises in the overhead allocation process. This process can generate costly agency conflicts. Managers who are given the task of allocating overhead may assign the best people and resources to the business segment they expect to work for after the spin-off. To

[15] Recent spin-offs by AT&T and Pepsi Co. were partly motivated by similar problems.

eliminate this problem, Humana told these managers their future job assignments would be determined by a coin toss, after the allocations were made.

Another key challenge managers face when implementing a spin-off is setting the terms of any future transactions between the company's separated business segments. Each of Humana's segments had historically derived a large share of its business from the other, through transactions conducted at non-market prices. Undoing these business relationships presented management with some difficult tradeoffs. Completely severing all inter-segment business ties would have advanced the primary business objective of the restructuring, but it would also have destabilized both businesses.

This case presents opportunities to discuss how restructurings are valued by the capital markets. The case effectively shows how significant information gaps can arise in a restructuring. For competitive reasons, Humana's managers were limited in how much information about the anticipated financial impact of the spin-off they could disclose publicly. Internally, management prepared detailed financial projections showing how profitability would improve after the transaction. Publicly, none of this analysis was disclosed. Students are given the same limited information that investors were given.

Absent detailed cash flow projections, students are forced to value the spin-off using market price-earnings multiples or other more creative approaches.[16] Valuing the spin-off using market multiples is difficult because varying the overhead allocation between Humana's two segments materially affects the estimated value. Estimated value can be increased by allocating more (less) overhead to the segment with the lower (higher) multiple. The case shows how varying overhead allocations changes Humana's estimated stock market value by $1.3 billion (40% of its market value before the spin-off). This illustrates an important limitation of using market multiples to value spin-offs, and reinforces the notion that managers should not trust capital markets to always value a restructuring correctly.

Finally, the Humana case provides an opportunity to discuss the merits of "voluntary" restructuring (Donaldson (1994)). The company was not facing an immediate financial crisis or outside takeover threat. The impetus to restructure had its roots in the company's corporate culture, which encouraged experimentation and change (Humana had abruptly changed its core business at various times throughout its thirty-year history). Whether such preemptive restructuring can or should be encouraged in companies more widely is an interesting topic for discussion.

USX Corporation

The second case study on stock break-ups is my case study of **USX Corporation**, which focuses on targeted stock. In a targeted stock structure, the firm replaces its existing stock with two or more new classes of stock that represent distinct claims against the firm's individual business segments. The structure differs from a spin-off, in that the firm remains a single legal entity, and there is no physical separation of its assets.

At the time of the case, USX operated a steel business and an energy business. The company produced consolidated financial statements. Senior managers of USX believed the company's common stock was significantly undervalued, because investors and analysts were unable to

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[16] For example, Humana's post-spin-off market value can be estimated using comparable company market value multiples of the number of hospital beds or the number of HMO enrollees. Similar approaches are often used to value IPOs, whose future financial performance is also extremely hard to forecast.

assess the separate financial performance of each business. Corporate raider Carl Icahn also believed that USX stock was undervalued, but because of mismanagement.

For several years Icahn had pressured the company to separate the two businesses through a corporate spin-off. USX management argued there were important reasons for keeping the businesses together, and proposed issuing targeted stock in the steel business and the energy business. In management's view, targeted stock had several important advantages over a spin-off. Like a spin-off, it would enable investors to more accurately value the company. However, it would also preserve operating synergies between the two segments. And the firm would remain diversified, thus benefiting corporate stakeholders like creditors and employees. USX management felt it was responsible to these stakeholders as well as to stockholders.

The case demonstrates how break-ups can be used to increase firms' market value by reducing information gaps between firms and the capital markets. Targeted stock and other kinds of break-ups make a firm's assets more "transparent" to investors and financial analysts. This will increase value by reducing the firm's cost of capital (Kim and Verrecchia (1994)). Merton (1987) shows that a firm's market value will increase when investors are more "familiar" with the company, and a break-up increases investor familiarity by creating new traded equity claims in the firm's business segments. Finally, analysts may have stronger incentives to cover a firm following a break-up. My study of break-ups with Paul Healy, Christopher Noe, and Krishna Palepu shows that break-ups result in significantly larger analyst following, and significantly more accurate analyst earnings forecasts (Gilson, Healy, Noe, and Palepu (1997)).

The case also gives students an opportunity to discuss how the terms of targeted stock should be set to maximize the market value created. The issues are complicated. For example, it may be desirable to limit management's discretion to allocate corporate overhead expenses, which will affect how the firm's earnings are distributed between different targeted stock classes. The relative voting power of different targeted stock classes will also have to be adjusted by some formula when the relative market values of the shares change. And shareholders may wish to give management the option to undo the targeted stock structure at some future date if circumstances warrant.

The case challenges students to critically assess the merits of targeted stock, and discuss whether pure financial restructuring can create value when a firm has fundamental business problems. One can question how much targeted stock truly helps investors value a firm's business segments, since segment earnings and dividends will be affected by how management allocates corporate overhead and sets transfer prices for inter-segment transactions. In addition, targeted stock may not completely address the firm's agency problems, because managers' control over corporate assets is unchanged.

The case deliberately leaves unresolved the question of whether USX was truly undervalued. Firms can have a low market value either because they are undervalued or because they are mismanaged. Discriminating between these two alternatives is obviously difficult. In trying to ascertain the source of USX's problems, students experience the same uncertainty that outside investors actually face in these situations.

The USX case also raises important general issues regarding the ability of capital markets to support economically efficient investment decisions. Some academic research questions whether capital markets adequately reward firms for making investments with long-term payoffs (Porter (1992)). The case encourages students to consider the interesting possibility that financial restructuring may be able help capital markets better recognize the creation of value inside companies, producing more efficient resource allocation.

B. Restructuring Management Incentives

The last two cases in the module on restructuring equity contracts feature troubled companies that hired new senior managers to lead operating and financial turnarounds. In both cases, the new managers were given a significant claim on the firm's equity cash flows. Both cases feature relatively smaller, non-public companies.

These cases provide a context for understanding the critical role that management compensation and incentives play in facilitating turnarounds of troubled businesses. The cases focus on the role that equity incentives play in motivating managers to maximize value in a restructuring. Academic research shows publicly-traded distressed companies routinely give new managers significant financial incentives to maximize stock market values and firm profitability (Gilson and Vetsuypens (1993, 1994a)).

The cases also highlight the special problems and challenges that smaller, non-public companies face in trying to establish appropriate incentives for managers. The value in studying such companies is that they are more constrained in how they can compensate their managers. The lessons from studying these cases are broadly applicable to larger public companies.

Donald Salter Communications

The first case, **Donald Salter Communications**, features a private family-owned company that ran into serious financial difficulty and hired a professional turnaround manager as CEO. Historically the company had measured its performance using accounting profit rates. The new CEO demanded an incentive bonus plan where the bonus award was based on appreciation in the *estimated* market value of the company's stock, as determined by an outside appraiser. The case reproduces the CEO's compensation contract, so students can evaluate the payoffs and incentives created under the bonus plan. Analysis of the plan shows the schedule of bonus payments approximates a public company executive stock option, with some important differences.

The Donald Salter case highlights the difficulty of establishing appropriate incentives for senior managers in the restructuring of smaller, non-public companies. Private companies by definition do not have publicly traded stock, so is more difficult to explicitly reward managers for value created in the restructuring. Smaller companies are also more likely to be controlled by the founder or members of the founder's family. Since founders likely hold most of their personal wealth in company stock, they may favor goals (e.g., reducing the firm's risk, or maximizing near-term cash flows) which are inconsistent with maximizing the firm's market value. They may also be reluctant to share their equity with an outside manager.

Transportation Displays Incorporated

The next case is Steve Fenster's case study of **Transportation Displays Incorporated** (TDI). At the time of the case, TDI faced possible bankruptcy three years after going private in a leveraged buyout. As at Donald Salter, the directors of TDI hired an outsider as new CEO. He also demanded a large claim on the firm's equity cash flows, and was awarded 45% of TDI's common stock. Most students find this percentage surprisingly high.

Comparisons between Donald Salter and TDI provide rich insights into the determinants of management incentives and compensation in troubled companies. The cases show how managers have significantly more power to negotiate their compensation when they have no prior ties to

the company. Research on management compensation in troubled companies finds outside turnaround managers are paid significantly more than incumbent managers (Gilson and Vetsuypens (1993, 1994a)). These issues are revisited in the next module in my case study of Scott Paper Company.

Module 3: Restructuring Employee Contracts

- Scott Paper Company
- FAG Kugelfischer—A German Restructuring
- Chase Manhattan Corporation—The Making of America's Largest Bank
- UAL Corporation
- Navistar International

Overview

The third course module studies how firms can control their labor costs by restructuring their contracts with employees. The case studies in this module highlight alternative approaches for controlling these costs, including layoffs, negotiated wage give-backs, and voluntary early retirement programs. Cases also address restructuring of obligations to retired employees under medical and pension benefit plans.

Labor costs represent the largest single expense category for most companies. Relatively small reductions in these costs can generate large increases in firms' profits and market equity values. Senior managers of underperforming firms can therefore be under considerable pressure to reduce firms' labor costs, especially when there is an active market for corporate control.

A simple example illustrates the "leveraging" effect of labor costs on profits and stock values. Consider an all-equity financed manufacturing firm that has annual revenues of $100 million, employee expenses of $70 million, and other expenses of $20 million, all in perpetuity. In relative terms this breakdown is fairly representative of U.S. manufacturing sector. If the firm's weighted average cost of capital is 12.5%, its common stock will have a market value of $80 million. If annual employee expenses are reduced by only 5% ($3.5 million), the market value of the firm's common stock will increase by fully *35%* ($28 million = $3.5 million ÷ 12.5%). If the firm is financed with debt, shareholders' gain is even higher.

Employee contracts differ from other contracts studied in the course in important ways. First, employee contracts are more often informal and unwritten. A firm may implicitly promise its workers job security and regular pay raises. Implicit contracts are easier to break than explicit contracts (although breaking implicit contracts may have significant long-run reputational costs for firms). Second, employees are a factor of production. Layoffs and wage/benefit reductions can indirectly impact company profits through changes in employee productivity and morale. Finally, employees cannot sell their claims on the firm. Hence, relative to other claimholders, they are less well diversified and a larger proportion of their personal wealth is firm-specific.

The cases take the perspective of senior managers. Students are asked to evaluate different approaches for reducing labor costs, and assess how employee restructuring impacts firms' financial performance and market value. The cases highlight the significant challenges that senior managers face when restructuring employee claims. Determining an appropriate level of

layoffs or wage/benefit reductions can be extremely difficult (compared to, e.g., choosing a new level of debt in bankruptcy). The restructuring can damage employee morale, loyalty and goodwill, undermining the direct cost savings. And managers can face severe media and public criticism for cutting employee jobs and benefits, especially when their compensation increases as a result of the restructuring.

Managers can also face severe limitations on how much information about the financial benefits of an employee restructuring they can disclose publicly to analysts and investors. Limitations on disclosure exist in other kinds of restructurings studied in the course, but they are especially severe when employees are involved. Data on layoffs are competitively very sensitive. Disclosing the exact number and location of layoffs in a firm could reveal the firm's strengths and weaknesses in specific geographic and product markets, benefiting competitors. Analogous information that might be revealed about a debt restructuring—e.g., the identity of creditors, or the size of their claims—is much less valuable competitively, and is mostly public knowledge. Disclosing detailed data on projected labor cost savings could also damage employee relations, making the restructuring more difficult to implement.

Limited disclosure could produce large information gaps between firms and the capital markets, causing a restructuring to be significantly overvalued or undervalued. The cases in this module provide opportunities to discuss what measures, if any, managers can take to address this problem.

The cases also encourage students to think about how employee restructuring affects the firm's "top" line. Managers who order large-scale layoffs often argue that downsizing helps the firm grow revenues and market share, thus creating *more* jobs in the long run. This argument may have economic merit, or it may reflect managers' desire not to be perceived as "mere" cost-cutters. Anecdotal evidence, and the experience of the firms studied in this module, suggest investors and analysts are often skeptical of management's revenue-growth claims.

The cases provide rich opportunities to discuss important public policy issues related to employee restructuring and corporate downsizing. Students take up these issues in the context of the following questions: Do observed shareholder gains from employee layoffs represent pure value creation, or do these gains represent transfers of value from employees? Does the stock market myopically put too much weight on short-run cost savings generated by employee layoffs, and discount the long-run harm layoffs can visit on a firm's business? Should firms be managed for the benefit of stockholders exclusively, or should managers also factor in the welfare of employees and other corporate stakeholders? And can a more "benign" approach be found for controlling labor costs, as an alternative to layoffs?

Description of Cases

Scott Paper Company

The first case in the module, **Scott Paper Company**, provides an inside look at a major corporate downsizing program, led by the controversial turnaround manager "Chainsaw" Al Dunlap. In less than a year, Dunlap oversaw the elimination of almost one-third of the company's 34,000 hourly and salaried employees, through layoffs and asset sales. By the end of the restructuring in late 1995, when Scott was acquired by Kimberly-Clark, the market value of Scott's common stock had increased by more than $3 billion (over 200%). Dunlap's personal wealth increased over this period by nearly $100 million, reflecting his compensation and appreciation in the value of his Scott stock holdings and executive stock options.

The Scott case highlights the key challenges that senior managers face when overseeing a corporate downsizing program. One of the most important challenges is determining the extent of layoffs. The employee layoff decision is conceptually similar to the decision facing managers in a debt restructuring as to how much the firm's debt should be reduced. The analytics of the layoff decision are usually much more complicated, however.

Scott's layoff targets were the product of an intensive "work redesign" analysis that took place over a period of several years. The purpose of this analysis is to identify opportunities to *permanently* eliminate jobs, without hurting the firm's business. In Scott's case, the analysis involved tracking the physical movement of people and resources on the factory floor, to determine whether manufacturing processes could be physically reconfigured to enable the same amount of work to be done using fewer people. By changing the location of a paper-making machine and a plant loading dock, for example, it was possible to operate at the same level of capacity, while employing three fewer people on shift.

The main advantage of this approach is that job cuts are driven by fundamental business considerations, and should be relatively permanent. Anecdotal evidence, and my own field research, suggests that companies that arbitrarily reduce their workforces as a "quick fix" for high payroll expense may later be forced to re-hire people.

The main cost of this analysis is that it is relatively more expensive and time consuming to implement. In addition, it requires the cooperation of employees, who have valuable specific knowledge about factory workflows and manufacturing processes. This method is therefore ill-suited to companies that have poor labor relations and/or that have to restructure more quickly.

The Scott case effectively illustrates the problems in using "benchmarking analysis" to determine layoff targets. This approach, which is often used by consultants, sets the target level of layoffs at a company by reference to various productivity and expense ratios calculated for other comparable companies chosen to represent "best practice." One commonly-used benchmark is the ratio of sales-to-employees. If a firm's whole industry suffers from excess capacity, however, benchmarking against the industry will underestimate the required number of layoffs. Comparisons of productivity ratios across firms will also be less informative when firms differ in their capital intensities, use of outsourcing, pricing policies, etc.

The Scott case allows students to discuss what factors managers should consider in setting a timetable for layoffs. Dunlap believes strongly that layoffs must be enacted quickly, ideally in less than a year. His predecessor at Scott had planned to lay off somewhat fewer employees over a three-year period. An accelerated timetable for layoffs is potentially less disruptive to employee morale, and helps establish credibility with investors. For certain kinds of firms and industries, however, a more gradual approach to downsizing may be warranted.[17]

The Scott case allows students to discuss the relative merits of forced layoffs versus voluntary early retirement programs. Voluntary programs involve less labor disruption, and generate less negative publicity for the firm. On the other hand, they tend to attract the firm's most productive employees (i.e., those with better job prospects outside the firm), leaving the firm with a less productive workforce after the restructuring.

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[17] In the computer industry, for example, companies that once manufactured only proprietary mainframe computers have been forced to downsize their workforces as user demand has shifted towards open architecture PC-based systems. Manufacture of the latter systems involves greater outsourcing, necessitating a smaller workforce. Some mainframe users lack the financial means or the incentive to switch to the new technology, however, so downsizing in this industry has generally been more gradual and incremental than practiced at Scott Paper. Dunlap's "fast track" approach would arguably be inappropriate for this industry.

The Scott case illustrates the challenge managers face in communicating the benefits of a restructuring to the capital markets. Scott's downsizing program was supported by extensive internal financial analysis. For competitive reasons, however, this analysis could not be disclosed publicly. Students estimate the value of Scott's cost savings using internal company data that investors and analysts did not have in the actual case. This exercise dramatically illustrates how information gaps can arise in a restructuring. Students evaluate various actions Dunlap took in an attempt to increase analysts' and investors' assessment of the value created by Scott's restructuring.

Dunlap's compensation at Scott generated significant public controversy. Critics of corporate downsizing argue managers should not be well-paid for ordering massive layoffs. Students' position on this issue depends on whether they view shareholder wealth gains from layoff announcements as pure wealth creation, as opposed to wealth transfers from employees. Some students consider Dunlap's $100 million windfall excessive, but others recognize that as a percentage of total shareholder wealth gains it is quite small (roughly 2%). Interestingly, initial student reaction to his compensation generally depends on students' age and nationality; students who are older and of European origin are typically much more critical.

FAG Kugelfischer—A German Restructuring

My case study **FAG Kugelfischer—A German Restructuring** studies employee restructuring outside the U.S. There are a number of fascinating parallels between this case and the Scott Paper case. Kugelfischer is a German ball-bearings manufacturer that faced possible bankruptcy in 1993, following a severe downturn in its markets and an ill-advised acquisition in former East Germany. Like most German firms, Kugelfischer had historically been managed for the benefit of employees and other corporate stakeholders. The company had an extremely high labor cost structure. The company hired the German professional turnaround manager Kajo Neukirschen. Within a few months, Neukirschen undertook a series of restructuring initiatives which were remarkably similar to those later taken by Dunlap at Scott Paper. These included cutting Kugelfischer's workforce of 40,000 by more than half. Like Dunlap, Neukirschen's primary objective was to increase shareholder value.

Kugelfischer's restructuring is remarkable when viewed within the context of the German system. Laying off employees in Germany is extraordinarily costly and difficult, compared to the U.S. German labor laws give employees far more rights and protections than exist in the U.S. Kugelfischer's layoff announcement prompted mass public demonstrations and rioting. German managers have also historically had less incentive to restructure because stock-based incentive compensation is rarely used in Germany. Neukirschen held no stock or stock options in Kugelfischer.

The Kugelfischer case dramatically illustrates how increasing competition in international product, capital, and labor markets is exerting tremendous pressure on companies worldwide to restructure and reduce labor costs. The case provides an opportunity to discuss the broader social implications of increased corporate downsizing in countries where historically firms have been managed for the benefit of employees and other corporate stakeholders. Discussion of these issues is typically very lively, given the international mix of students.

Finally, the Kugelfischer case provides an international context for assessing the stock market's ability to value a restructuring. Assessing company performance is arguably more difficult in Germany because German accounting rules permit firms to maintain large reserves which can be used to manage reported earnings. German companies in general expend fewer resources on communicating with analysts and investors. Evaluating Kugelfischer's downsizing

is additionally complicated because it had few domestic competitors (none that were publicly traded), so valuations using comparable company market multiples are much "noisier."

Chase Manhattan Corporation

My case study of **Chase Manhattan Corporation** studies another approach companies take to deal with excess capacity and high labor costs. In late 1995, Chase Manhattan and Chemical Bank merged to form the largest bank in the U.S. (fourth largest in the world). In addition to producing significant scale economies, the merger created significant cost cutting opportunities in the form of large overlaps and redundancies in the merged bank's operations. Management forecasted that annual pretax cost savings from the merger would be $1.7 billion. Savings would be achieved by laying off 12,000 of the banks' 74,000 employees, closing hundreds of retail bank branches, and other measures.

Students analyze cost cutting at Chase within the broader context of the economic forces which are pressuring commercial banks and other financial service firms to rationalize their cost structures. The framework for this analysis is the "functional perspective" developed in the Harvard Business School's Global Financial Systems (GFS) project (see Merton (1990), Crane and Bodie (1996), and Crane *et al.* (1996)). The functional perspective recognizes that deregulation of the financial services industry and changes in technology have made it increasingly possible for non-bank institutions to compete against banks in their traditional markets—and that powerful economic forces make such changes inevitable.

Another reason for the merger was management's belief that being larger is a significant competitive advantage in the banking business. Management saw the merger as an opportunity to grow revenues as well as cut costs. It believed the revenue benefits were substantial. A larger bank that offered multiple services and products could more easily attract large corporate clients, and penetrate new markets. A larger bank could also invest more heavily in important new technology, and realize significant benefits of scale and scope. Many banks and non-banks do not share this view, however, and have successfully specialized in particular product lines (e.g., mortgage servicing or wholesale commercial banking). Whether the revenue-growth story makes sense is an important public policy issue, and makes for a lively classroom debate.

Informative comparisons can be made with the Scott Paper case. Scott's CEO also argued publicly that downsizing would generate higher revenue growth, by creating a leaner organization that could develop and market new products more quickly. In both cases, however, the stock market appears to have discounted management's claims.[18]

The Chase case provides another example of preemptive or voluntary restructuring (see the above discussion of my Humana case). The merger was not undertaken in response to an immediate financial crisis or outside takeover threat. Rather, management conceived the merger as a strategic response to the dramatic changes taking place in the financial services industry.

Implementation issues are very important in the Chase case. One concerns the determination of the merger premium paid by the acquiring bank for the shares of the target bank. Setting the

[18] The analysis of Scott, for example, shows that the market value of Scott's common stock appreciated roughly by the present value of the cost savings. No value appears to have been awarded for higher growth potential. Consistent with this analysis, the company's price-earnings multiple and market-to-book multiple (both are approximate measures of growth potential) were unchanged by the restructuring, despite various actions the CEO took to gain higher multiples (e.g., selling off low-growth businesses). Chase's multiples also did not noticeably increase following its restructuring, even though management believed the revenue growth potential created by the merger was significant.

premium is complicated, in that it can send a signal about which bank's employees are to bear most of the planned job cuts; it can also make management of one bank appear weak, undermining its authority in the post-merger integration period. The merger terms were chosen to advance the goals of the restructuring. To better implement the planned cost savings, management devised an elaborate computer model to monitor the thousands of actions contemplated under the restructuring plan. Anecdotal evidence suggests many mergers do not succeed because of problems in implemention. The Chase case provides students with a framework for understanding how implementation should work.

The Chase case also illustrates another reason managers can be constrained in how they communicate with the capital markets during a restructuring. In an earlier merger, Chase management found that when it gave analysts extremely detailed financial projections about the merger (e.g., for individual business segments or product lines), it was harshly criticized if it failed to meet a particular sub-target. Management found itself having to respond "defensively" to analysts—even when the bank's *aggregate* financial performance exceeded projections. Based on this experience, management made a deliberate decision in the second merger to disclose only aggregate, company-wide financial projections.

As discussed in the second module, the capital market's ability to accurately assess the valuation consequences of a restructuring will depend on the relative "transparency" or "opaqueness" of the firm's assets. Comparison of the Scott Paper and Chase cases provides an interesting perspective on this issue. Under its restructuring, Scott greatly simplified its asset structure, selling off all assets and properties other than its core consumer tissue product business. This made the firm much easier to value. The merger of Chase and Chemical, in contrast, produced a larger bank with a broader set of businesses, making the benefits of restructuring potentially more difficult to value. Reinforcing this point, prior to the merger a major activist shareholder lobbied one of the banks to break itself apart so its businesses would be easier to value.

UAL Corporation

The next case, **UAL Corporation**, examines an alternative, more "benign," approach for controlling labor costs versus straight layoffs. In 1994, UAL (parent holding company of United Air Lines) gave employees a 55% equity stake in the company, in return for wage, benefit, and work rule concessions worth an estimated $5 billion. The new equity was placed in an employee stock ownership plan, making it the largest such plan in history. In addition to becoming the majority shareholders, participating employees received three seats on the board of directors, and a veto over layoffs, mergers, and asset sales. UAL employees thus exchanged compensation for job security. During this time other major airlines were laying off tens of thousands of employees. The UAL employee buyout was hailed by politicians as a new model for corporate restructuring and labor-management relations.

UAL's restructuring appears to have been hugely successful in financial terms. Over the three years following the buyout, UAL's common stock has appreciated by approximately 250%, compared to 150% appreciation in the S&P 500 and an index of other major airlines. In light of this outcome, students are asked whether UAL's restructuring represents a desirable alternative to conventional downsizing, and whether a similar approach would work at other companies.

The buyout represents another example of preemptive or voluntary restructuring. The company was not facing an immediate financial crisis; it had leading market share; although it had reported several years worth of losses, it had a huge cash reserve. Two factors provided the impetus for the deal. First, the then-CEO threatened to break apart the company through a

complicated spin-off transaction that would have effectively "de-unionized" the airline and produced massive layoffs. Second, UAL's pilots had, for several years, attempted to take control of the airline, and so were highly predisposed to the idea of a buyout. Students debate whether a buyout on the same scale would be possible at another company where there was no crisis to motivate employees. An interesting contrast can be drawn between UAL and two other airlines where employees own a large equity stake: Northwest and TWA. Both of the latter airlines were in or near bankruptcy when employees exchanged wages for stock. Discussion of these issues is very lively.

The case demonstrates the special challenges managers face in making a restructuring like UAL's work. Although the buyout was subject to the majority approval of participating employees, many had the view they had overpaid for their UAL stock. Getting UAL's stock price up quickly was therefore critical to making the deal succeed. Most financial analysts who covered UAL viewed the buyout quite negatively, however. The analysts had a variety of concerns, including the complexity of the deal, and the potential conflicts that would be created by giving employees control of the company.

Management's ability to change analysts' attitudes was limited. Estimating the net financial benefits of the buyout is extraordinarily difficult. Although the employee concessions significantly increased UAL's cash flows, emphasizing the size of these concessions in an attempt to boost the stock price would have alienated employees. In addition, GAAP accounting for the ESOP was extremely confusing: perversely, as UAL's stock price increased, the company was required to take a larger deduction for the stock given to employees, causing reported earnings to *fall*. (These issues are discussed in a clinical study of the UAL buyout; see Gilson (1998)).

Students are asked to devise a strategy for dealing with UAL's analysts and investors, given the constraints management was operating under. UAL's own innovative solution was to invent a new method for reporting earnings that more accurately reflected the financial benefits of the restructuring. The new earnings measure excluded the ESOP charge, providing a better approximation of UAL's cash flows. Because UAL was legally required to continue reporting traditional GAAP earnings in addition to this new measure, however, there was initially substantial confusion among employees, analysts, and the news media. An important lesson from this analysis is that the financial benefits of a restructuring may not be reflected in the firm's stock price for a long time.

Navistar International

The module concludes with my case study of **Navistar International**, which analyzes the restructuring of retiree health and medical benefits. Many companies have significant outstanding obligations to their employees through retiree health and medical benefit plans. Since 1990, the size of this liability for all U.S. companies has, by some estimates, been as high as $2 trillion. Growth in this liability has been fueled by the aging of the workforce, skyrocketing medical costs, and the widespread use of generous voluntary early retirement packages in corporate downsizing programs.

For many companies the liability has been large enough to threaten their solvency, prompting Congress to enact a special amendment to the Bankruptcy Code to deal specifically with these claims. And since 1992, public companies have been required to fully accrue this liability on their balance sheets, forcing many to take massive writeoffs and report significantly lower earnings.

Navistar had to restructure a huge ($2.6 billion) liability for retiree medical benefits. The liability had become this large for two reasons. First, the company had promised (in writing) its retirees and their families full lifetime medical coverage. Second, the population of Navistar retirees had exploded following an earlier massive downsizing program that cut its workforce by two-thirds. Under an impending accounting rule change, Navistar would have to book this liability on its balance sheet for the first time, resulting in negative shareholders' equity and a large loss.

The case requires students to design a restructuring plan that balances the interests of Navistar shareholders and retirees (represented by the UAW). In general, restructuring liabilities under retiree health and medical benefit plans presents major challenges to corporate managers. As with other accrued or contingent liabilities (e.g., defined benefit pension plan obligations, environmental liabilities, tort claims, etc.), estimating the value of the these claims can be extremely difficult, relative to more "conventional" balance sheet liabilities (e.g., bank loans and bonds). In addition, retirees' legal rights, and companies' legal obligations, under these plans are often unclear, and subject to judicial interpretation. This uncertainty can greatly complicate the negotiations. Media and political criticism of companies that attempt to reduce promised medical benefits to retirees can be severe. Finally, in negotiations to restructure retiree medical benefits, retirees are often represented by labor unions, producing possible jurisdictional disputes (when more than one union is involved) and conflicts of interest (when a union is representing retirees in similar negotiations at another company).

The case also provides an opportunity to discuss important ethical and public policy issues that arise in restructuring. Navistar's promise to retirees was made in writing (a copy of the document appears as an exhibit in the case). Breaching this contract benefits shareholders at the expense of current and future retirees. It is not clear whether Navistar's underlying business is sound, however, or whether large employee concessions would do more than transfer wealth to shareholders.

The case presents an interesting contrast with UAL Corporation's restructuring, since Navistar's eventual settlement with the UAW involved giving employees two-thirds of the company stock and guaranteed representation on the board of directors. The corporate governance structures put in place under the two restructurings were therefore similar, although the companies' circumstances were quite different. Comparing these cases highlights the conditions under which it makes sense to control high labor costs by giving employees ownership in the company.

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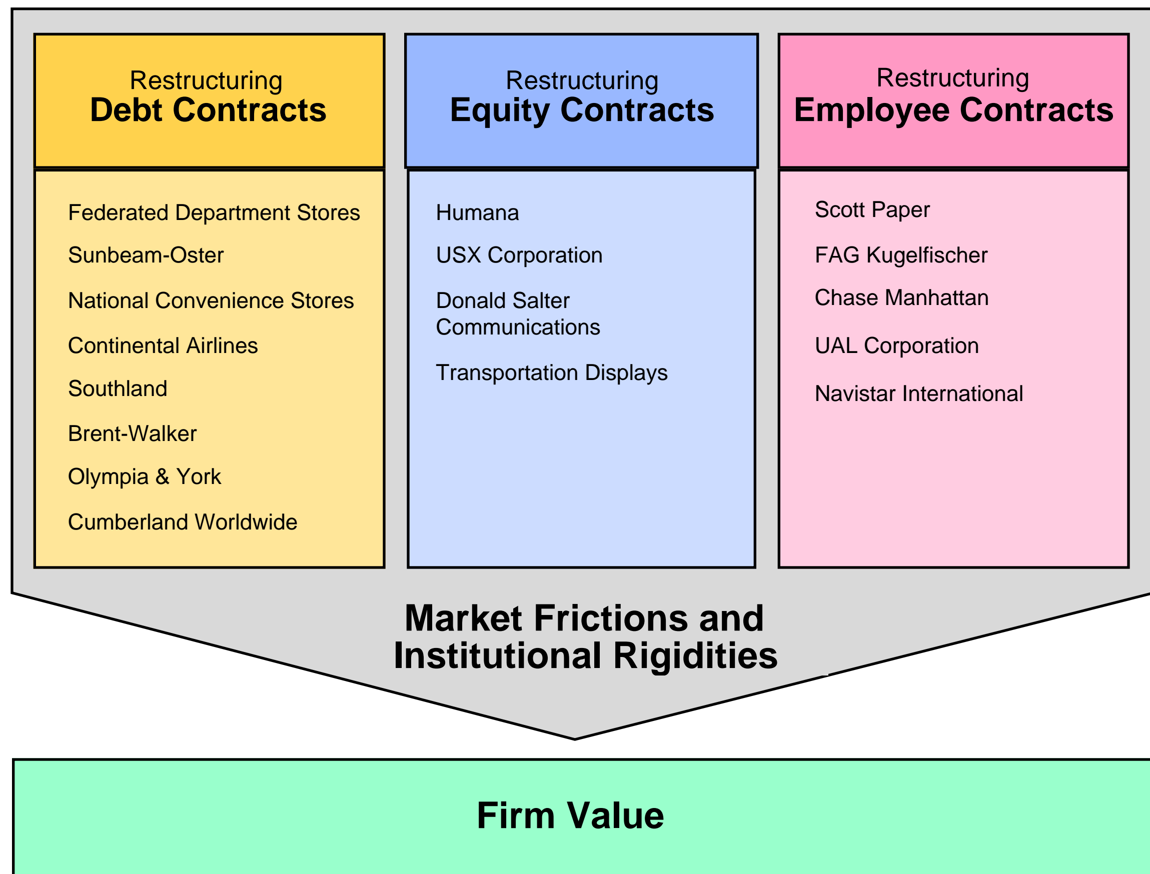
Exhibit A Course Framework for *Creating Value Through Corporate Restructuring*



APPENDIX A

List of Cases

(T = Teaching Note)

Cases	Faculty Author(s)	HBS Publishing Order #	Subjects
MODULE 1: RESTRUCTURING DEBT CONTRACTS			
Federated Department Stores, Inc.	S. Fenster	9-292-079 5-294-016 (T)	Bankruptcy, benefits and costs of Chapter 11
Sunbeam-Oster Company, Inc.	S. Fenster	9-291-052 5-293-046 (T)	Bankruptcy, valuation, vulture investing
National Convenience Stores, Inc.	S. Fenster/ S. Gilson	9-294-068 5-294-135 (T)	Bankruptcy, valuation, negotiation strategies
Continental Airlines - 1992	S. Gilson	9-294-058 5-294-127 (T)	Acquisition of firms in Chapter 11, valuation
Southland Corporation (C)	R. Ruback	9-292-004	Prepackaged Chapter 11, public debt exchange offers
Brent Walker PLC	S. Fenster	9-293-078 5-294-080 (T)	Debt restructuring in the U.K.
Olympia & York Developments	S. Fenster	9-293-115 5-294-081 (T)	Transnational bankruptcies (U.S., U.K., Canada)
Cumberland Worldwide Corp. (A)	R. Moore	9-291-081	Bankruptcy vs. out-of-court workouts
MODULE 2: RESTRUCTURING EQUITY CONTRACTS			
Humana Inc.	S. Gilson	9-294-062 5-294-130 (T)	Corporate spin-offs, valuation, corporate strategy
USX Corporation	S. Gilson	9-296-050 5-298-085 (T)	Targeted stock, information benefits of corporate restructuring
Donald Salter Communications Inc.	S. Gilson	9-295-114 5-298-089 (T)	Turnaround management, executive compensation, small private co. workouts
Transportation Displays Inc.	S. Fenster	9-291-064 5-293-050 (T)	Turnaround management, executive compensation, troubled LBOs
MODULE 3: RESTRUCTURING EMPLOYEE CONTRACTS			
Scott Paper Company	S. Gilson	9-296-048 5-298-088 (T)	Downsizing, employee layoffs, executive compensation
FAG Kugelfischer	S. Gilson	9-298-046 5-298-128 (T)	Downsizing and layoffs in Germany, international accounting comparisons
Chase Manhattan Corp.	S. Gilson	9-298-016 5-298-127 (T)	Downsizing through merger, restructuring of financial services industry
UAL Corporation	S. Gilson	9-295-130 5-298-126 (T)	Negotiated wage concessions, employee ownership, investor communications
Navistar International	S. Gilson	9-295-030 5-298-086 (T)	Restructuring retiree medical liabilities, bankruptcy, negotiation strategies

OTHER RELATED CASES

First Executive Corporation	H. DeAngelo/ L. DeAngelo/ S. Gilson	9-294-105 5-294-136 (T)	Junk bonds, insurance company insolvencies, bank runs, the "politics of finance," mark-to-market accounting
First Capital Holdings Corp.	H. DeAngelo/ L. DeAngelo/ S. Gilson	9-296-032 5-296-095 (T)	Junk bonds, insurance company insolvencies, bank runs, the "politics of finance," vulture investing

APPENDIX B
Assignment Questions

Please note: See Appendix A for a list of faculty authors and case order numbers. Assignment questions for each case have been prepared by the respective faculty case author(s).

MODULE 1: RESTRUCTURING DEBT CONTRACTS

Federated Department Stores, Inc.

1. What problems does Federated face following the completion of the Olympia & York Loan?

2. What would be your strategy to deal with the vendors and factors?

3. What should Jim Zimmerman do with respect to customers and employees in this period?

4. Was Chapter 11 foreordained when the buyout was done? Could Federated have avoided Chapter 11 in September 1989?

5. If Chapter 11 was inevitable, what preparatory steps should Jim Zimmerman and Karen Hoguet take?

Sunbeam-Oster Company, Inc.

1. How does Smith Barney seem to calculate (i) Enterprise Value, (ii) Equity Value, and based on their numbers, what would be the (iii) Total Value of Consideration paid to creditors? Do you agree with Smith Barney's valuation of the new common shares to be issued by Sunbeam-Oster in the "Debtors Plan of Arrangement"?

2. How much additional "enterprise value" does Japonica see in Sunbeam-Oster as you contrast Exhibits 8 and 9? What are the sources of this additional value? So you see value beyond that?

3. Does the "allocation of consideration" in the debtor's plan look reasonable from the perspective of the creditor classes?

4. As Japonica what would you do? If you choose to go ahead, how would you implement your approach? Can Japonica reasonably expect to get financing?

National Convenience Stores, Inc.

You should prepare your analysis of this case by imagining yourself to be a member of one of the following claimholder classes in National Convenience Stores' (NCS's) bankruptcy, based on

the following assignments (the claims are described more fully in Exhibit 3 and on pages 9-10 of the case):

If your last name begins with the letters:	You are a member of the following claimholder class:
A to C	Secured claims
D to J	12.5% senior subordinated debentures
K to M	9% convertible subordinated debentures
N to R	Equity (common and preferred stock)
S to Z	Management

Each of you should come to class prepared to propose a simplified Chapter 11 "reorganization plan." Your plan should contain the following three elements: (1) an estimate of NCS's enterprise value, (2) a proposed level of debt for the firm's post-bankruptcy capital structure, and (3) a schedule of proposed total dollar payouts/distributions for each of the above five classes (including management).

NOTE: Regarding plan element (2), recall CEO Van Horn's comments that "... Chapter 11 was enough of a nightmare that he had no intention of landing there a second time," and his belief that "a reorganized NCS could handle debt in an amount between 3.5x and 4.5x the Company's projected 1993 EBITDA." For the sake of comparability, use a multiple of 4.0x EBITDA (the mid-point) for setting the amount of debt in a reorganized NCS.

Regarding (3), don't worry too much about what kind of claims or consideration (e.g., debt, cash, common stock, etc.) should be given to each claimholder class; rather, focus on the total dollar value of what each class is to receive under your proposed reorganization plan.

You should be prepared to defend your analysis before representatives of the other claimholder classes (or even members of your own class).

Continental Airlines - 1992

1. Does the amount being offered for the company's equity by the various outside investors represent a fair price? In answering the question, note the following:

   (a) The financial projections contained in Exhibits 8 and 9 are premised on an outside investment of $325 million in new debt securities and $25 million in new common stock and warrants, representing a 46% equity stake in a reorganized Continental Airlines Holdings (before exercise of the warrants). Under their final bids, *Maxair* and *Air Canada/Air Partners* would each end up owning approximately 54% of the equity (also before exercise of the warrants) .

   (b) At the time of the case the FAA had forecast that total revenue passenger-miles (RPMs) for the U.S. airline industry would grow at approximately 4.6% a year over the next decade. Inflation was expected to be 2.5% per year over the same period.

(c) The forecasts shown in Exhibits 8 and 9 of the case were *formed* on September 15, 1992, but refer to fiscal years that end December 31.

2. Which of the proposed investments are the best from the standpoint of Continental Airline Holdings? In your judgement, is the structure created satisfactory to sustain the airline over the foreseeable future?

3. As Bob Ferguson, what would you recommend to the board?

4. What operating and financial measures would you envision taking over the next few years after leaving Chapter 11?

5. Has the bankruptcy process served the stakeholders and national policy well in this case?

Southland Corporation (C)

1. Why have prior plans to restructure Southland failed?

2. As a claimholder, do you prefer the exchange restructuring to the prepackaged bankruptcy?

3. Why would Senior bondholders ever accept less than full payment when junior debt and equity receive partial payout?

4. Why would the prepackaged plan work better than the exchange offer?

5. Evaluate the settlement with the Thompsons, and the behavior of management throughout the LBO, restructuring, and bankruptcy process.

Brent Walker PLC

1. What is your sense of the quality of the Company's business? Do you agree with the company's proposed business strategy?

2. How do you assess the strengths and weaknesses of the Company and its creditors as they approach an out of court restructuring?

3. As Lord Kindersley, what is your proposal for an out of court restructuring of Brent Walker? Can you propose a permanent out of court restructuring? If not, what sort of interim restructuring can be concluded? (By "permanent restructuring" I mean a restructuring that, based on the projections, should provide a stable structure not requiring additional negotiations.)

4. Can shareholder values be safeguarded in an out of court restructuring in the United Kingdom? Would Insolvency Proceedings be more advantageous for the equity holders?

Olympia & York Developments

1. Assess the financial condition of O&Y. Are there important differences when you look at the Canadian properties, the U.S. properties, the Corporate Investments, the U.K. assets (Canary Wharf), and Olympia & York Developments Limited (Parent Company)?

2. How did O&Y get into such difficulties?

3. How do you assess the bargaining power of O&Y and the various creditors? In light of your conclusions, what sort of negotiating strategy would you undertake? As Paul Reichmann and Gerald Greenwald, what kind of restructuring proposal would you seek to achieve?

4. If you do not anticipate a happy outcome, think of when earlier action might have saved the O&Y empire, what earlier action might have been, and whether it was reasonable to expect the Reichmanns to have perceived this possibility.

Cumberland Worldwide Corp. (A)

1. What are the principal financial problems confronting the management of CW at the time of the case? Were these problems brought about primarily by bad luck, or did poor decisions play a major role?

2. Are the financial markets, as reflected in the trading prices of CW's securities, accurately assessing the Company's prospects? Is there money to be made by investing in CW's securities? Specifically, does the market value of the right hand side of the holding company's balance sheet fully reflect the liquidating value of its assets? If not, why not?

3. Senior management seems to be convinced that the best way to build value for CW's claimants is to invest significant amounts in the rejuvenation of CR. What are the value implications for the claimants if the rejuvenation plan is successfully implemented? Would you support management's plan for CR as a bank lender, as Sam Adams, as a preferred stockholder, as a common stockholder? (At the time of the case, the yield on long-term Treasury securities was 8%; CR's long-term borrowing rate, as an independent company, would have been 10%, and its beta would have been 1.1)

4. Evaluate Morton's recapitalization plan. Would it, if implemented, result in a capital structure that meets the ongoing needs of the business? Which claimants would find it appealing, which unappealing? As a bank lender, would you subscribe to Morton's premise that all of the claimants must share the pain of the restructuring?

MODULE 2: RESTRUCTURING EQUITY CONTRACTS

Humana Inc.

1. Do you think Humana's problems were serious enough to warrant some form of restructuring?

2. How much extra value would be created by separating the hospital and health plan segments through a spinoff? What are the sources of this additional value, and how should the spinoff be structured for Humana to realize maximum benefits from the spinoff?

3. Kaiser Permanente has employed an integrated strategy of owning both hospitals and health plans for many years, some would argue with great apparent success. This suggests that Humana's problems are not the fault of its integrated strategy per se, and that breaking apart the hospital and health plan segments may not enhance shareholder value in the long run. So you agree or disagree?

4. Do any of the other options considered by management represent a more sensible solution to Humana's problems that the spinoff?

USX Corporation

1. In 1986, then-chairman and CEO David Roderick described USX as possibly one of “the most restructured corporations in America.” Even so, Carl Icahn believed that further restructuring of the company was still necessary. In late 1990, what operating and/or strategic problems, if any, do USX’s two main businesses still face that would warrant some form of additional restructuring?

2. Do you think there is any merit in Carl Icahn’s claim that problems in USX’s steel business are depressing the value of its energy business? As a USX stockholder, how credible a spokesperson do you consider Icahn to be on this issue?

3. Which restructuring optionIcahn’s spinoff proposal or the company’s targeted stock proposalwill create the most value for shareholders? For creditors? For the firm’s other stakeholders?

4. For what kinds of companies is targeted stock most appropriate? Least appropriate?

5. Should the company seriously consider any other options besides doing a spinoff or issuing targeted stock?

6. If the company decides to go ahead with the targeted stock issue, what specific provisions or features should the stock include to ensure maximum value creation? How closely would you model USX’s targeted stock on GM’s alphabet stock?

Donald Salter Communications Inc.

1. What are the principal challenges facing Jim Myers, and what actions is he taking to address them? What special challenges does Myers face as a result of the company's Subchapter S status and the fact that it is a family-owned business?

2. If you were a compensation consultant hired by the stockholders of Donald Salter Communications to design the executive incentive plan, what values for the Target Award and the Percentage Cap would you recommend? Is there anything about the incentive plan that you would change? How would you design the rest of Jim Myers' compensation package?

3. Does the executive incentive plan meet Myers' stated goal of increasing the link between pay and market-value based performance in the company? Please be specific.

4. How should the company's enterprise value be calculated for purposes of determining the incentive compensation of Jim Myers and other senior managers? Can the same value also be used for purposes of repurchasing company stock from shareholders who wish to "cash out"?

5. Evaluate the other elements of Myers' proposed turnaround plan. Do you think his plan will be successful? Would you do anything differently?

Transportation Displays Inc.

1. What were the management challenges that Bill Apfelbaum faced as the new CEO of TDI? What actions does he appear to be taking? If you were the new CEO, what would you do either differently, or in addition?

2. Analyze to what extent Chapter 11 is an alternative for the Company, the banks, or the Subordinated debt. How does the Chapter 11 alternative affect the bargaining power among the groups?

3. As CEO you and your investment banker have prepared a negotiating strategy for the restructuring as well as a guess where the process will come out, i.e., what a final agreed upon Plan would look like. The Board of Directors has asked you to present your thoughts on these subjects. Please do so.

4. What criteria should Pat Durkin, Managing Partner of Saratoga Partners, use to decide whether to invest new equity in TDI as part of an overall restructuring? Would you make a new equity investment as part of an overall restructuring?

5. If you are Bill Apfelbaum, how do you deal with your personal objectives? Are the requests Apfelbaum made in the case reasonable and are they likely to be achieved? If you were a creditor, how would you react?

MODULE 3: RESTRUCTURING EMPLOYEE CONTRACTS

Scott Paper Company

1. As a director of Scott Paper Company, would you have hired Al Dunlap in April 1994?

2. What other options besides downsizing should Dunlap consider for restructuring Scott Paper?

3. Which parts of Scott Paper's business should Dunlap let go as part of the downsizing, and which parts should be retained and/or grown to sustain the company going forward?

4. Is the magnitude of the proposed employee layoffs at Scott Paper reasonable? What about Dunlap's accelerated timetable for the layoffs?

5. How should Dunlap's restructuring program affect Scott Paper's common stock price? Given the information available at the time of the case, would you have invested your money in Scott Paper common stock?

6. Dunlap's clear agenda is to maximize Scott Paper's stock price. Given the terms of the proposed restructuring, to what extent will gains to Scott's stockholders come at the expense of Scott's employees or other stakeholders? As a manager, how much weight should you give to the interests of stakeholders other than the stockholers?

7. What do you think about Al Dunlap's compensation package?

FAG Kugelfischer

1. Does Kugelfischer need to be restructured at the present time? Is Kugelfischer performing significantly worse than its competitors? What would happen if Kugelfischer simply "did nothing"?

2. What measures should Kajo Neukirchen take to address the company's financial problems? Can Kugelfischer be restructured without resorting to large-scale layoffs?

3. How will your proposed restructuring plan affect Kugelfischer's market value?

4. What are the main impediments to introducing "U.S.-style" shareholder-oriented restructuring in Germany? Does Kugelfischer's restructuring represent an approach that could be adopted by other German companies?

5. What weight should managers give the interests of employees and other stakeholders in setting corporate policy?

Chase Manhattan Corp.

1. Recently a growing number of US companies have tried to cut their operating costs through various kinds of restructuring. AT&T has tried to accomplish this by spinning off several of its businesses, and Scott Paper accomplished this by selling off assets and downsizing its operations. Chemical and Chase, on the other hand, are attempting to reduce their costs by merging. This approach ("bigger is better") represents a sharp contrast to the refocussing and downsizing which has characterized most US restructuring in recent years. Do you think the interest of the banks' shareholders and other constituencies would be better served by some alternative form of restructuring that emphasizes increased focus?

2. What are the strategic benefits, if any, of combining Chase and Chemical? What is the most significant benefit that the banks will realize from this merger?

3. Should Chemical reconsider any of its other prospective merger partners?

4. Assuming that all the anticipated benefits from the merger are realized, what is the likely dollar impact of the merger on the combined wealth of Chase and Chemical common stockholders? How will the merger affect the banks' financial performance (e.g., as measured by return on equity)? As a banking industry financial analyst, how would you measure the success of this transaction?

5. To what extent, if any, do the prospective financial gains of the banks' shareholders represent transfers of value from other claimholders, such as bank customers, employees, and communities in which the banks do business?

6. If you were Chemical management, what exchange ratio would you seek for the merger? What if you were Chase management?

7. Critically evaluate the analysis that Chemical and Chase performed for determining the level of employee layoffs and branch closings. How should a company determine what level of downsizing is appropriate for its circumstances? Over what time period should the layoffs and branch closing be scheduled?

8. As a general manager, when a company undertakes a complex or controversial restructuring program, what issues should management be concerned about in designing the company's disclosure strategy? In the context of the Chemical-Chase merger, how much and what kind of information about this deal should management disclose to Wall Street and the media?

UAL Corporation

1. What problems and challenges does UAL face that warrant some form of restructuring at the present time?

2. Does the proposed restructuring plan described in Exhibit 7 fairly treat both UAL's employees and its non-employee stockholders? Relative to the "Status Quo" (described on p. 5 of the case) how much does each group gain or lose in financial terms? (In answering this question, think carefully about how one should value the employee

concessions, and note that whether the restructuring benefits UAL's non-employee stockholders depends on what UAL's stock price is *after* the restructuring.)

3. As a stockholder who is being asked to vote on the restructuring plan, what aspects of the plan, if any, trouble you? If you don't intend to vote for the current plan, what changes to the plan terms would the company have to make to win your vote?

4. As an employee who is being asked to make concessions under the restructuring plan, what aspects of the plan, if any, trouble you? If you object to the plan, how would the plan terms have to be changed to win your support?

5. As a Wall Street analyst who follows UAL, what recommendation would you give regarding UAL's common stock if the restructuring plan is consummated?

6. Should UAL seriously consider pursuing some of its other restructuring options (the Enhanced Status Quo and the Radical Restructuring), or consider some other, altogether new option?

7. Do you think the restructuring plan proposed by UAL could serve as a model for restructuring by other firms or industries that are also faced with severe excess capacity?

8. Is the benign, “kinder and gentler” version of employee restructuring practiced by UAL workable at other companies like Scott Paper?

9. When companies like Scott Paper downsize and lay off their workers, companies’ stock prices typically rise. Do the gains thus realized by stockholders represent growth in the total size of the corporate pie, or the enlargement of stockholders’ slice at the expense of the employees’ slice?

Navistar International

1. How bad off is Navistar in fact? Do you believe management's claim that if the company does not obtain significant concessions on employee health care benefits, it will have to file for Chapter 11?

2. How would Navistar's various constituencies fare in Chapter 11?

3. What are the motivations of the UAW, and how do they affect Navistar management's strategy in dealing with this problem?

4. How much of a liability for post-retirement benefits can Navistar afford on its balance sheet? What settlement would you propose as fair for both the company and the workers?

5. How should Navistar fund its liability for post-retirement benefits, once restructured?

OTHER RELATED CASES

First Executive Corporation

1. Should regulators have seized First Executive's insurance subsidiaries? Since the major "run" occurred a year before seizure, couldn't one argue that seizure, even if justified, occurred too late to benefit the firm's policyholders?

2. What, if anything, did Fred Carr do wrong? What lessons should other life insurance companies (or other financial institutions) draw from the experience of First Executive?

3. Should life insurance companies (or other financial institutions) be forced to mark their assets to market?

4. What should the regulators do, if anything, about First Executive's junk bond holdings?

First Capital Holdings Corp.

1. What should Carolyn Shepard's recommendation be regarding the proposed investment in First Capital Holdings?

2. What risks would such an investment entail? What are the potential returns to such an investment?

3. In view of what had just happened to First Executive, should Shepard reject the proposed investment in First Capital as too risky? What is the likelihood that California regulators will also seize First Capital's California insurance subsidiary, FCLIC? Do you think this risk is any greater for FCLIC than for other insurers licensed to do business in California?

4. If you were the California State Insurance Commissioner, what evidence could you present to your constituents that would justify seizing FCLIC?

5. Should Shepard consider making a direct, control-oriented investment in First Capital, possibly in partnership with Shearson Lehman Brothers?

6. How much confidence should Shepard have in First Capital's management?