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A Critical Consideration of the Corporate Rescue Culture; an Analysis from the Perspective of Complexity Economics

“The firm is dead: Hurrah for the failed firm”¹

Dr T.L.M. Verdoes and A.M. Verweij LL.M.²

Introduction

Over the past two decades substantial developments have taken place with regard to corporate insolvency laws and processes. On a supranational level the embracement of Corporate Rescue is exemplified by the presentation of the European Commission’s Recommendation on a new approach to business failure and insolvency in the spring of 2014³. The objective of this Recommendation is to enable viable companies in financial distress to restructure at the earliest stage possible in order to prevent insolvency, and therefore maximise the total value to their stakeholders and the economy as a whole. National legislators in various member states within the European Union on the other hand have been as well (re)designing insolvency systems in order to facilitate rescue and rehabilitation of companies in financial distress.

This shift throughout Europe towards more debtor-friendly insolvency procedures is motivated by a desire to aid distressed companies who have some justifiable perspective to continue and therefore to avert unnecessary failure of in essence ‘sound’ businesses. Successful rescue of companies in financial distress is first of all preferred in order to preserve going concern value instead of piece-meal liquidation of the estate. In addition the consequences of liquidating a company in financial distress instead of reorganizing its business operations are considered less

¹ A variation on A. A. Alchian and S. Woodward, Review: The Firm Is Dead; Long Live The Firm, a Review of Oliver E. Williamson’s ‘The Economic Institutions of Capitalism’, 1988, Journal of Economic Literature, Vol. 26, No. 1, pp. 65-79.

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³ European Commission, Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency (2014/135/EU).

and less desirable. Businesses are considered to be important drivers of growth, innovation, novelty, change, knowledge and wealth. Emphasis on rescue and rehabilitation of companies in financial distress is therefore deemed warranted. We label this trend as “Corporate Rescue Culture”.

However what kind of economic realities and forces need to be taken into account and which preconditions need to be dealt with if rescue and rehabilitation of a distressed company is facilitated? Rescuing businesses is embedded in the forces of capitalism. Capitalism’s focus is on creation of value. But how is value or wealth created? And how do markets and firms fit into this system? In this article we try to interpret the forces of capitalism and its impact on the corporate rescue culture. Our characterization of the economic forces is undoubtedly eclectic⁴ and dialectic.⁵ This is however the essence of capitalism. We shall start with economics in general, and look at two extremes, the Neoclassical vision and in particular the evolutionary-complexity vision. Following these considerations we further delve into the business, its resources and finally the failed business. Then the main objections with regard to corporate rescue will be discussed. Our main conclusion is that failure is much more structural than assumed. Businesses and competitive advantage are in general temporary and changed, failed and dissolved businesses are the essence of capitalism, reasons not to interfere and to facilitate business rescue. The main dogma of corporate rescue identical with the conventional theory of the firm is that a business is a stable, fixed, successful, continued, independent and worthwhile entity. However, (bundles of) resources “flow” through the economic cosmos; are attracted and repelled by firms, but they cross firm boundaries; particularly knowledge.

The essence of economics: how do societies create wealth or value?

Economics is about the quest for value. What are the drivers, central forces, stylized facts and laws of capitalism? What are the consequences for bankruptcy proceedings in general and in particular for the trend of Corporate Rescue Culture with regard to these forces?

The economy is represented by the dazzling array of activities such as acting, behaving, producing, buying and selling, deciding, investing, contracting,

⁴ The different terms to label an independent economic organization as “firm”, “business”, “enterprise”, “company”, or “corporation” resemble the fluent and eclectic nature of the firm. These terms are used interchangeably. “Methodologically it would seem that as a matter of form, we would start with a definition of what we are talking about (“the firm”). But this we fear, is the very nub of the whole problem. The defining characteristics of the firm to a large extent presupposes the economic framework within which the firm is to be analyzed.” (adapted from: M. Obrinski, *Profit Theory and Capitalism*, 1983, University of Pennsylvania Press, p. 7).

⁵ The firm is an agent on the market, is an alternative for the market, searches for opportunities in the market, is disciplined by the market and can be traded on the market. These different perspectives on different levels create a dialectic framework (T.L.M. Verdoes, *Towards a metaphorical composition of (business) economics; a quest through the economic cosmos* (in Dutch), 2005).

trusting and, last but not least, enterprising. In this web of dazzling and permanent economic activity businesses play an important role. They are the movers by combining, cooperating and connecting resources. Essentially the economy is a self-organized value chain supported by businesses and markets. This is strikingly illustrated by a quote from the Global Competitiveness Report: “Wealth is actually created in an economy at the micro-economic level – in the ability of firms to create valuable goods and services using efficient methods. Only firms can create wealth, not governments or other societal institutions. The productivity of a country is ultimately set by the productivity of its companies.”⁶ According to Handy organizations are the linchpins of our world: “(...) the wealth of our society will depend on them; ultimately, they will be the source of our well-being.”⁷

What exemplifies the Neoclassical vision? And how does this economic perspective differ from the complexity approach? The central pillars of the Neoclassical view are based upon the assumption that perfect and complete markets are in equilibrium. Agents are fully rational and have full access to free information. The world is deemed efficient and static because there are no frictions. Resources are mobile and can be, or have been, allocated to their best use. So the world is at rest. However Neoclassical scholars are aware that this composition does not represent the real world. It is however a useful description to derive testable hypotheses. In fact economists agree that the economy is very complex; is like our cosmos. However science is the search for simplicity. The question is how to simplify and whether or not these simplifications leave out important structural elements.

Complexity economists argue that the complexity problem must be placed in the center, from the beginning and at the deepest level. Complexity economics is dynamic, out-of-equilibrium, not-efficient, path dependent, non-linear and contains frictions and externalities. A key component in the complexity vision is that the individual creates the world simultaneously as he or she is influenced by that world.⁸ Beinhocker argues that complexity economics is a better approximation of economic reality surrounding the “new more knowledge based economy”.⁹ In fact it is not only a better reflection of the new, but also of the “old” economy.¹⁰

During the Industrial Revolution there was a climate of cooperation between scientific and practical knowledge. This created a positive feedback between propositional and prescriptive knowledge that accelerated the creation of

⁶ World Economic Forum, 2007, The Global Competitiveness Report 2007-2008, p. 53.

⁷ C. Handy, The age of paradox, 1994, Harvard Business School Press, p. 36.

⁸ D. Colander (ed.), The complexity vision and the teaching of economics, 2000, Edward Elgar, Cheltenham, pp. 6-7.

⁹ E.D. Beinhocker, The origin of wealth; Evolution, complexity and the radical remaking of economics, 2007, Random House Business Books p. 75.

¹⁰ The difference between the old and new economy is gradual: L. I. Nakamura, Economics and the new economy: the invisible hand meets creative destruction, 2000, Federal Reserve Bank of Philadelphia, pp. 15-30 and W.B. Arthur, Increasing returns and the new World of business, 1996, Harvard Business Review, pp. 100-109.

useful knowledge.¹¹ Engineers, mechanics, chemists, physicians, cooperated in small creative communities – like a small Silicon Valley – that experimented by means of trial and error (or tinkering - “bricolage” – how it is described in evolutionary theories). So the economy has always been not a division of labor but a division of knowledge. The economy is in essence a system of distributed knowledge. Knowledge is not a phenomenon of the presumed new economy but has been even a central force in the old economy. “In today’s economy, knowledge is coming to represent a larger fraction of the products and services we consume”.¹² However Marshall already recognized the importance of knowledge by stating that: “Knowledge is our most powerful engine of production; it enables us to subdue Nature and force her to satisfy our wants”.¹³ According to De Gregori the “Incomparably greatest among human resources is knowledge. It is because it is the mother of all other resources” – “resources they are not, they become”.¹⁴ In fact this is the essence of our changing economic ecology.¹⁵ We know that everything can be improved, so there are unlimited options, however it is unknown which option works and is useful.

Does wealth then comes from following improving existing recipes or creating entirely new recipes? According to Romer the last mechanism is the most important: “All increases in standards of living can be traced to discoveries of more valuable arrangements for the things in the earth’s crust and atmosphere. Sustained economic growth is accompanied by the countless large and small discoveries that are required to create more value from a fixed set of natural resources”.¹⁶ This process of improvements is however as old as the economy itself. Knowledge as compared with physical resources is a non-excludable and non-rival resource. Once it is revealed, everybody can use it; it is thus non-scarce. It can be added and combined with other knowledge and information. So knowledge (or software) begets knowledge, more software building blocks leads to bullish imaginable software combinations of which the vast majority is useless – “the number of business opportunities is fundamentally bullish in the aggregate, even if individual companies come and go ... new practice is implemented by

¹¹ J. Mokyr, *The Gifts of Athena: Historical Origins of the Knowledge Economy*, 2011, Princeton University Press.

¹² W.B. Arthur, *ibid.*, p. 101.

¹³ A. Marshall, *Principles of Economics*, 2000 (Orig. Pub. 1920), <<http://econlib.org>>, IV.1.2.

¹⁴ T.R. De Gregori, *Resources are not; they become: an institutional theory*, 1987, *Journal of Economic Issues*, p. 1243.

¹⁵ A. Marshall, *ibid.*, V. 5.13, compares the economy (of competing firms) with a forest of trees: “The representative firm is a long sustaining business”. This implicit (‘long sustaining’) idea shows up in many business sciences, the theory of the firm and the legal perspective of the firm. However this idea is contradicted by brutal facts: most things fail, P. Ormerod, *Why most things fail*, 2005, John Wiley & Sons.

¹⁶ P. Romer in J. Cortright, *New growth, technology and learning: a practitioner’s guide*, 2001, *Review of Economic Development Literature and Practice*, No. 4, p. 2.

letting inflexible firms collapse and die”.¹⁷ The larger the body of software (knowledge), the faster the growth potential. Our complex and adaptive system embodies an enormous potential. Digitalization, specialization, modularization, harmonization, globalization and democratization enlarges the efficiency, scale and scope and easiness of using this potential. On the other hand the risks are higher, and companies’ lifecycles become shorter. The enormous turnover in business activity is a (healthy) sign of a “restless capitalism”.¹⁸ However: “The survivors may appear to be those having adapted themselves to the environment whereas the truth may be that the environment has adopted them”.¹⁹

According to Beinhocker wealth creation is “the product of a simple, but profoundly powerful, three-step formula – differentiate, select and amplify the formula of evolution”. Evolution can be viewed as an algorithm or an all-purpose formula for innovation. Market’s “capability” is the computational efficiency as a distributed processing system. Businesses are interactors. “An interactor is a design that has been rendered from the possible designs and made real. (...). Businesses do the living and dying”.²⁰ Both businesses and markets are complex adaptive systems that co-evolve. Evolution is cleverer than presumed as nobody is truly able to find the highest peak on the fitness landscape. Evolution is essentially a knowledge process, while innovation is a change of knowledge in the system.

But what do markets select? According to Beinhocker it is not the company itself but the unit of selection is the underlying business module. Business modules are bits of the business plan that have provided in the past, or could provide in the future a basis for differential selection between businesses in a competitive environment.²¹ “Firms, industries and economies are all involved in producing and exchanging products. They do this in complex and interconnected ways, thus, the firm is only a very proximate unit of analysis. Connected systems produce a product and this may be a firm or it may be a firm plus other partner or subcontracting firms and a range of consultants and specialists in the service sector may be involved. Modern production systems are bewildering networks of connections”.²² In these mini-ecologies, or self-organized value chains – it is connections that count (and not if these connection are inter or intra connections). It may be that the factor of analysis – the given independent firm - is the wrong

¹⁷ P. Romer, *The Soft Revolution: Achieving Growth by Managing Intangibles*, 2003, in: *Intangible Assets*, J. Hand and B. Lev (eds), p. 90.

¹⁸ J. S. Metcalfe, *Restless Capitalism*, 2004, Momigliano Lecture, p. 188.

¹⁹ A.A. Alchian, *Uncertainty, evolution and economic theory*, 1950, *Journal of Political Economy*, p. 214.

²⁰ E.D. Beinhocker, *ibid.*, p. 11, 195 and 200.

²¹ E.D. Beinhocker, *ibid.*, p. 283, a rather circular definition he admits.

²² J. Foster, *From simplistic to complex systems in economics*, 2005, *Cambridge Journal of Economics*, Vol. 29, p. 889.

element.²³ The focus should be on the (whole) value chain, not on the individual firm.

Hanauer and Beinhocker stress that capitalism is not a mere system of making markets more efficient, but it is a system of finding new solutions to problems. This experimenting economy is not efficient but it is wasteful. Capitalism's great strength is its embracement of creativity which is a hugely inefficient and wasteful evolutionary process. Hanauer and Beinhocker call this "an emerging twenty-first century view of the economy"²⁴.

Yet one can wonder if this complex adaptive ecological system did not already exist in a perhaps more primordial form much earlier. The forces were always there, but not as explicit and visible as they are now due to the acceleration of the pace of just about everything.²⁵ "The economy like the biosphere, is about persistent creativity in ways of making a living"²⁶. The economy as a complex adaptive system was already recognized by Adam Smith – he is a "man of system", or a "complexity theorist with a Sante Fe Vision".²⁷ Emergence, serendipity, luck and coincidence were and still are important drivers for, increasing returns, nonlinearity and positive feedback and the rise, existence and fall of the firm.

The chances that knowledge will eventually be undermined by future developments are very high. Romer labels this with the term "combinatorial explosion of ideas" – an analogy of Cambrian explosion. "Converging technologies are causing industries to shift and blur, changing the very nature of products. The distinct identities of products, services, channels, industries and companies are rapidly changing".²⁸ Schumpeter already wrote about this tendency in the 1930's. "Capitalism, is by nature a form or method of economic change. (...). The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumer's goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. "... the problem that is usually ... visualized is how capitalism administers

²³ M. J. Taylor, *The Firm as a Connected, Temporary Coalition*, 2005, SPACES, and B. Nooteboom, *Innovation, learning and industrial organisation*, 1999, *Cambridge Journal of Economics*, Vol. 23, pp. 127-150. This resembles the (biological) view of Richard Dawkins that human bodies are vehicles of genes; of which only the latter are selected. The firm is just a vehicle of resources, but these resources – especially knowledge and information (or should we call them memes?) are ultimately selected – not firms, R. Dawkins, *The Selfish Gene*, Oxford University Press, 2006.

²⁴ N. Hanauer and E.D. Beinhocker, *Capitalism redefined*, 2014, *Democracyjournal.org*, p. 33.

²⁵ J. Gleick, *Faster: The Acceleration of Just about Everything*, 2000, Vintage Books USA.

²⁶ S. Kaufman in M.J. Mauboussin, A. Schay and S.G. Kawaja, *The triumph of bits*, 1999, *Credit Suisse/First Boston*, p. 2.

²⁷ R. Koppl in Colander, *ibid.*, p. 104.

²⁸ C.K. Prahalad and V. Ramaswamy, *The new frontier of experience innovation*, 2003, *MIT Sloan Management Review*, pp. 12-18.

existing structures whereas the relevant problem is how it creates and destroys them. This kind of competition disciplines before it attacks”²⁹.

A business is (usually considered to be) a successful and a value creating, capturing and sustaining organization within a value chain. The fluid and subjective nature of value is the essence of business. The essence of generating value is that it is by nature uncertain and cannot be foreseen nor taken for granted. Businesses are constructions to test value-creating propositions. The outcomes of this process are (a few) winners and (many) losers. The essential purpose of organizational law is to facilitate collective action. “Organizational law empowers firms to hold assets and enter contracts as entities that are legally distinct from their owners and managers. This is a kind of asset partitioning or asset or entity shielding”³⁰. Legal structures that enable evolutionary processes are important to the success and survival of any social structure. “Freedom to experiment is important in fostering this process. The point of evolutionary theory is that no one can determine a priori what is the best model, even for most firms, most of the time”³¹. Organizational law facilitates therefore the bundling of resources to experiment with the encompassing purpose of creating value. Creating value is the essence of economics; the self-organized value chains move, transform and reposition resources in order to create wealth (“a fit order”). Organizational law is only a facilitator in the quest for value, by shielding successful firms, but not unconditionally. The condition is that the combination creates value. This created value is essential to compensate stakeholders for their contributions.

The firm as a changing, moving and failing entity in the value chain

Specialization is not enough to let firms arise and succeed. In this situation all people could be an entrepreneur. Coordination could occur via the market or via a firm. Smith is rather vague about the ‘organizational consequences’ of specialization.³² Smith’s most famous business example is the pin factory; it is an example of how specialization and cooperation increase productivity. However: “There is more of a mystery to the origin of the pin factory. It makes little sense, and it helps our understanding not at all, to assign a high a priori fitness to the pin

²⁹ J. A. Schumpeter, *Capitalism, Socialism and Democracy*, 1975 (orig. pub. 1942), New York: Harper, pp. 82-85.

³⁰ H. Hansmann, R. Kraakman and R. Squire, *Law and the Rise of the Firm*, 2005, *Harvard Law Review*, Vol. 119, p. 1335.

³¹ D. McBride, *General Corporation laws: history and economics*, 2011, *Contemporary Problems*, Vol. 74, p. 12.

³² R.N. Langlois, *The vanishing hand: the changing dynamics of industrial capitalism*, 2001, Paper, University of Connecticut, p. 1.

factory. That fitness must emerge from the context.”³³ What are the underlying forces of the origin, existence and failure of firms? The theory of the firm is remarkably focussed on the existence of the firm, and silent about its origin and in particular its failure. No universal and single theory does justice to firm (and market) development and movement: “... the trends and developments related to it are one more example of how mind-bendingly and marvelously complex the world of capitalism can be, with not only constant churn in terms of entry and exit but also combinations, divestitures, cosmetic alterations (name changes), strategic shifts, break-ups, acquisitions, and so on. This reality goes far deeper than what we can glean from aggregate numbers, and in their work, economists do not always convey this complexity. Those in the midst of it—managers, executives, employees, consultants—either do not seek the big picture or are prone to breathless extrapolations of small samples into the latest trends. But, “this messiness is where prosperity is made”.³⁴

According to Coase³⁵ there are costs involved with using the price system: transaction costs. The firm is an institution that can economize on those costs. It is an alternative mechanism to the market with which the economy is naturally endowed. The market coordinates with the price signal, the firm with “her” hierarchy. After Coase other strands have been developed: the transaction and agency approaches, the resource based and knowledge based theories. However changes and the entrepreneurial, modular - linked in the value chain - and to some extent the cognitive function of the firm do not show up in these theories of the firm, besides the rise and fall. The market and the firm already exist – are given, the approaches focus on the (static) existence of the firm and the market, not on their genesis, and failure. However a lot of companies have failed or changed their activities, products, technologies, subsidiaries or organisation due to coincidental circumstances, the firm is an emergent (temporary) entity. This “picture” corresponds more with the firm in daily speech of the strategists and marketeers.

Pitelis and Teece³⁶ identify the nature, essence and objectives of a firm. They conclude that reconfiguration and market creation do not show up in the theory of the firm. The essence of the firm is in the diagnosis, configuration and leveraging of knowledge assets and organizational capabilities to allow the principals of these organizations to effectuate the capturing of value (profit) from both the creative and routine operations of the business. Accordingly, the diagnosis, upgrading, and integration (and disaggregating,) of intra-firm resources (as complementary to inter-firm resources) and organizational capabilities,

³³ J.H. Holland, *Hidden order, how adaptation builds complexity*, 1995, Basic Books, New York, pp. 97-98.

³⁴ D. Stangler and S. Arbesman, *What does Fortune 500 turnover mean?*, 2012, Ewing Marion Kauffman Foundation, p. 26.

³⁵ R.H. Coase, *The nature of the firm*, 1937, *Economica*, pp. 386-405.

³⁶ C. Pitelis and D. Teece, *The (new) nature and essence of the firm*, 2009, Munich Personal RePEc Archive.

especially dynamic capabilities, so as to achieve firm-level sustainable competitive advantage, can be regarded as “the essence of the firm”. Taylor concludes that the present (theoretical) conceptualization and stylization of the firm are not suitable for analyzing the process of enterprising and entrepreneuring that run through capitalist societies. The firm is invoked uncritically as the smallest unit of analysis – as a phenotype, a formative element in the economic-cum-social system. It is a “given”. It is necessary to get beneath the stylized fact of the firm as a legal entity (behind the legal landscape that has preoccupied economic theory). The firm is seen as key driver of change, innovation and knowledge transfer, but in the conceptualization the firm is effectively relegated to being a driver that does not drive but only is driven. The firm as a legal unit (a stylized shell) is given. This tends to obscure and deflect attention away from more organic, social processes of people being enterprising. Processes of enterprise are broader than the terrain of legally defined ‘firms’ and business enterprises that only weakly reflects them. “Business enterprises are (...) temporary expressions of the processes of enterprise: legal and operational entities that are temporary coalitions of networked venturers and entrepreneurial endeavour that are crystallised and dissolved as conditions (economic, social and regulatory) change and are modified” (...). “Corporations too are temporary coalitions of strategic decision-makers who assemble and disassemble structures of subsidiaries, associates, strategic alliances and joint ventures for the purposes of wealth creation.” (...). “The firm is temporary in the sense that business opportunities are time and place specific. Firm’s linkages and markets wax and wane.”³⁷

So the function, essence, objectives and raison d’être of a firm are embodied in the social processes (the inter and intra linkages of resources in the value chains) of finding new better solutions for problems. This changing context is time and place specific. Failure nonetheless does not show up in the theory of the firm, nor do movements with respect to (un)bundled assets, disinvestments, acquisitions, mergers, and the principle that markets always win and why most firms fail! This requires a deeper understanding of the underlying forces shaping the competitive landscape, namely the complexity of the self-organized value chains.

(Bundles of) Resources or business modules cross firm boundaries

Intangible resources are the underlying factors of the competitive advantage of a business and they are crucial for a successful, continuing business with superior performance. Dierickx and Cool³⁸ argue that the critical strategic resources are non-tradable as they can only be built and accumulated within a business. Strategic assets are nontradeable, nonimitable and nonsubstitutable; these assets are shielded

³⁷ M.J. Taylor, *ibid.*, p. 7 and 2.

³⁸ I. Dierickx and K. Cool, Asset stock accumulation and sustainability of competitive advantage, 1989, *Management Science*, Vol. 35, pp. 1504-1513.

from the market. Diericks and Cool point out that the idiosyncratic nature of firm specific assets precludes their tradeability on open markets.

The “triumph of bits” and the “age of modularity”³⁹ opens numerous opportunities and even more threats. Due to this trend knowledge can easily be copied, communicated, connected and coordinated. “When information (the ore) is carried by things – it goes where the things go and no further. But once everyone is connected electronically, information can travel by itself.”⁴⁰ Due to the “explosion of connectivity” (the universal application of bits) value chains can easily be subdivided into business modules. This opens opportunities to transform, reconfigure and even transplant or supersede (parts of) the value chain. “The links within the firm may be much weaker than in the past, and conversely links between firms, tied together for instance of complementary technologies, may be stronger (...). the economic organization may have boundaries that are very different from the legal entity known as the firm”⁴¹. The value chain pushes and pulls at the (critical) alienable resources of the firm. Knowledge is less bound to a business as it can be used elsewhere when there are better valuable opportunities.⁴² In case of failed firms valuable knowledge can easily flow to other useful opportunities. Why should the use of resources be constrained by the walls of the failed firms? In fact bundles of resources cross the boundaries of firms frequently, as it did in the past.

“An economy is a coordinated system of distributed knowledge (...) in economic evolution markets are actually information-processing-knowledge-structuring mechanisms.”⁴³ Value chains can self-organise. Useful knowledge will in general be absorbed by other links in the value chain. These knowledge diffusion and spill-overs are the essence of capitalism. Knowledge is a complex and slippery concept as it emerges through interactions and slips away through these same interactions. Knowledge is in a permanent state of flux and perishable.”⁴⁴ Knowledge is a non-rival and non-excludable resource which everybody can use. Knowledge flows even harder, via trivial, subtle and implicit mechanisms compared with tangible resources.

³⁹ C.Y. Baldwin and K.B. Clark, *Managing in the age of modularity*, 1997, Harvard Business Review, pp. 84-93.

⁴⁰ P. B. Evans and T.S. Würster, *Strategy and the new economics of information*, 1997, Harvard Business Review, pp. 71-82.

⁴¹ R.G. Rajan and L. Zingales, *The Influence of the Financial Revolution on the Nature of Firms*, 2001, Unpublished paper, p. 10.

⁴² R.G. Rajan and L. Zingales, *ibid.*, p. 5., report that “71% of the companies included in the INC 500 (a list of young, fast growing firms) were founded by people who exploited a growth opportunity created by the previous firm that employed them.

⁴³ J. Potts, *Knowledge and markets*, 2001, *Journal of Evolutionary Economics*, pp. 413-431.

⁴⁴ M.J. Bates, *Information and knowledge: an evolutionary framework for information science*, 2005, *Information Research*, Vol. 4, p. 16., stresses the fundamentally emergent evolutionary nature of what higher animals and human beings, in particular, experience as information and knowledge.

The firm: a changing and/or failing organization

The knowledge based firm is therefore a time and place dependent organization of resources embedded in the social organization of value chains surrounded by a membrane of trust, incentives or a dedicated hierarchy. In fact the firm is like a sub-economy with strong links and forces (that push and pulls to the firm's resources) within the value chain. In theories of the firm, business science and the legal conception of the firm however, the firm is a given. This assumes that every business is a worthwhile organization which continues to prosper and grow and shows persistent above-normal performance. It is of course impossible that all businesses persistently grow and show above average performance. There is lots of empirical evidence and theoretical insights that the existence of successful firms and the life time of firms is not perpetual. Failure is the norm, long-lasting success is exceptional. A firm is not only dismantled in case of failure, this bundling and unbundling is the essence of enterprising. To change the boundaries of a firm is not exceptional but a normal fact of business life. Both are essential symptoms of capitalism.

Ormerod notices that business failure does not show up in the theory of the firm. Yet the brutal truth is that most firms fail. The world of business is just too complex and it is therefore illusory to think that we can predict the successfulness of a business, idea, innovation or an investment. Ormerod characterizes business decision making as playing a game of chess where you do not know your opponent, the rules change and you do not know when you have won.⁴⁵ The world of business is full of mistakes but not all mistakes are lethal. However: ultimately markets win, because there are numerous and unlimited potential competitors who can buy, copy, imitate, substitute, steal, reveal and undermine the critical resources of an organization. Wiggins and Ruefli conclude that sustainable competitive advantage and superior performance is very rare; firms with long enduring competitive advantage are statistical outliers.⁴⁶ Stubbart and Knight focus on disappearing firms. They point at the core assumption that survival is the vital objective for a firm; it is the 'correct outcome'. Their conclusion from scrutinizing more than 240 documents is that the vast majority of firms, even large firms, survive relatively short periods. These findings are consistent with the vision of an environment full of uncertainties, surprising spurts of growth and dramatic reversals – an environment where long term survival is problematic." (...). "Long term survival might be better regarded as a purely random result of complex

⁴⁵ P. Ormerod, *ibid.*, pp. 111-117.

⁴⁶ R.R. Wiggins and T.W. Ruefli, Sustained Competitive Advantage: Temporal Dynamics and the Incidence and Persistence of Superior Economic Performance, 2002, *Organization Science*, Vol. 13, No. 1, pp. 82-105.

interactions among competing organizations”.⁴⁷ Failure of the firm also happened frequently in the past⁴⁸.

Businesses exist because they create limitations: they reduce the environment and focus on a limited number of products, processes or business activities. Yet the potential threats are unlimited. Success comes from limitations in different disguises but failure comes however from unlimited possibilities. Focus and specialization are reasons of existence in specific, but failure in general. Failure is far more pervasive than existence and survival. There are simply a lot of (unknown) unknowns. The only way of selecting firms is through testing by Smith’s ‘invisible hand’. The market extracts (in a biased but objective way) poor performing, wealth destroying firms out of a total business population.

Failed firms: should they be rescued?

Markets separate underperforming from well performing firms through an objective and neutral criterion (which can of course be biased): a firm that does not pay its debt. This criterion creates an objective equal level playing field on the capitalist landscape. It could be that insolvency proceedings have two pitfalls: the low debt coverage ratio and the low percentage of the failed firms that continue their business. From the perspective that the business is still viable and able to create and capture value, (static) efficiency is the encompassing norm, failure comes suddenly, reorganization is quick and easy, failure is a mere financial problem and the resources are less (or not) valuable in another alternative allocation, this statement could be right⁴⁹. But these requirements are very, very strict. Is this “wrongful determination failure selection bias” (the insolvency criterion) so strong that it destroys much going concern value on average? In fact none of these requirements shows up on average. A market’s primary function, based upon the complexity perspective, is to differentiate between valuable and non-valuable businesses. The reason why markets are so good at this is their computational efficiency as distributed processing systems: “Markets are almost pure evolutionary systems; evolution is cleverer than you are. Markets superiority in command and control is attributable not to their efficiency at resource allocation

⁴⁷ C.I. Stubbart and M.B. Knight, The case of the disappearing firms: Empirical evidence and implications, 2006, *Journal of Organizational Behavior*, Vol. 27, pp. 91 and 98.

⁴⁸ P. Ormerod, *ibid.*, p. 5, mentions that in 1469, twelve companies in Venice were engaged in the new activity of printing, but by 1472 nine of them had failed.

⁴⁹ D. G. Baird and R.K. Rasmussen, Reply: Chapter 11 at Twilight, 2003, *Stanford Law Review*, Vol. 56, pp. 673-699, identify three conditions for corporate reorganizations: the firm has substantial value as a going concern, its investors cannot sort out financial distress through ordinary bargaining and the business cannot readily be sold in the market as a going concern. Our more elaborate conditions in our view more reflect the fundamentals of capitalism and the *raison d’être* of firms; it focuses especially on the quest for value.

in equilibrium, but because of their effectiveness at innovation in disequilibrium.”⁵⁰

Can a failed firm then easily be transformed into a value creating entity? Based upon the assumption that static (efficiency allocative) markets selects poorly functioning firms in static industries then the selection is a signal to restructure the business. But this is the same as assuming that in principle businesses are always viable (because they have existed for a while). In essence every firm can be saved, but is it rational to do so? Markets select firms that cannot create and capture value or cannot transform it into cash. Only if the last part of this value-cycle is problematic restoring the business has a function. Entrepreneurs have a tendency to be too optimistic and keeping faith in the previously chosen direction (that used to be successful). Usually the symptoms of a downturn show up at an earlier instance. Yet entrepreneurs or company directors wait too long to reconfigure their businesses.⁵¹ Management usually want to turn the tide themselves, keep control over important decisions, believe in their success, want to retain trust, faith and reputation and are ignorant because of the required focus. Failure does not suddenly arise out of nowhere. Usually there has been a long(er) period of downward spiral consisting of a process of value destruction. “Bankruptcy is not the cause of the decline in value of the firm. It is the result.”⁵²

Attempting to make failed firms become more efficient, assuming a static context, is not much of help. “There is nothing so useless as doing efficiently that which should not be done at all”.⁵³ In a distressed financial situation the main focus, due to time pressure, is in general on the financial and not the much needed strategic restructuring. This leaves the essence of business failure intact and can be perhaps best described as merely rearranging the chairs on the deck of the Titanic. However a firm has less strict boundaries and ties than is recognized. The firm is a temporary coalition that attracts and repels resources. It is not necessary that (growth) opportunities should be executed under the current membrane of the corporate veil. The static, efficient and strict boundaries view on the legal and economic theory of the firm and business sciences do not correspond to the complex economic forces of capitalism. These theories do not correspond to the empirical and theoretical facts of firm turnover, mergers, failure, emergence, serendipity, luck, mistakes, divestures, alliances, that more resembles a(n evolving) complex economic ecology. Failure (and change) is endemic and structural, success is incidental.

The low debt recovery rate and the going concern rate of insolvent firms is simply the result of the fact that there is no value potential. Creditor friendly

⁵⁰ E.D. Beinhocker, *ibid.*, p. 294.

⁵¹ Roland Berger Strategy Consultants, 2005, Trojan horses of decline, study on strategic risk management, identify three kind of crisis: a strategic, profit and liquidity crisis. Usually a period of strategic and profit crisis precedes the liquidity crisis.

⁵² R.A. Brealey, S.C. Myers and A.J. Marcus, *Fundamentals of corporate finance*, 2012, 7th edition, p. 459.

⁵³ A famous quote of Peter Drucker.

insolvency proceedings are therefore not old fashioned but can be considered very modern. The focus should not be on sustaining failing firms, but on experimenting and rearranging the value chain in the most effective manner with consequences that cannot be foreseen. The essence of capitalism and economics is in the self-organized value chains, in which resources flow and value cannot be foreseen. The mere bundling through a business is temporary. In a complex environment only the market can assess value and whether or not the company may proceed.

Three problems of the corporate rescue culture

Failure and changing boundaries of the firm is the essence of economies and enterprising in capitalism. Legal as well as most economic theories of the firm are focussed on strict boundaries; corporate rescue is focussed on maintaining these boundaries. The changing links between the inter and intra value chains is the unknown outcome of a self-organized complex system. Sometimes resources can do better if they are freed from the yoke of the corporate veil. Failed firms are viewed as negative on the individual level, for the economy in general it is positive.⁵⁴ “Failed entrepreneurs may be as heroic as successful entrepreneurs”.⁵⁵ “Death hurts, but it isn’t fatal”.⁵⁶

A firm binds different kind of assets; it could be argued that nowadays the assets contain less tangible, and more intangible assets that cannot be sold easily. The difference between the going concern and liquidation value in the (more) knowledge-based economy is even higher. The probable loss of value is even bigger than it was in the past. Knowledge is a non-rival and non-excludable good, everybody can use it. Knowledge and information flow due to behavior, strategies, feedback and performance, learning, investing, buying, selling etc. - it is in a permanent state of flux. The essence is that useful knowledge, just like other resources, does not stay within the boundaries of the company, but it flows out and in, is used, created, transformed, copied, imitated, captured, sold and it perishes. By capturing the value (by using it) others notice it, and can use it themselves. Capturing the value of knowledge undermines its value. These flows are more intense and faster, but also more implicit, trivial,⁵⁷ subtle, unnoticed and unconscious than other tangible resources which are more explicitly exchanged. Knowledge flows is what economics is about, not only now, but also in the past. Knowledge flows in and out of organizations - especially out of failed firms. We

⁵⁴ According to E.D. Beinhocker, *ibid.*, P. Romer, *ibid.*, M.J. Mauboussin and B. Hiller, *ibid.*, J.S. Mectcalfe, *ibid.*

⁵⁵ A.M. Knott and H.E. Posen, *Is Failure good?*, 2005, *Strategic Management Journal*, Vol. 26, pp. 617–641.

⁵⁶ G. Hoetker and R. Agarwal, *Death isn’t fatal, the postexit diffusion of knowledge created by innovative companies*, 2007, *Academy of Management Journal*, Vol. 50, No. 2, pp. 446–467.

⁵⁷ Knowledge is also created often not explicitly, but implicitly as a byproduct of taking part in the economy.

doubt that knowledge of failed firms is highly valuable, that firms own it, that this value is easily captured in firms and that the value cannot be captured elsewhere. Because in essence knowledge already flows; useful knowledge is already absorbed by the market. Market evolutionary algorithm is capable of moving knowledge efficiently through the value chains.

Finally we summarize three main (overlapping) objections to business rescue culture:

1. Rescue comes too late

Enterprising is committing to an investment plan that is (partly) irreversible: “Truly strategic choices are difficult or costly to reverse once made”⁵⁸. Failure does not appear without reason. There are usually concrete signs of distress at the earliest stages of the downward spiral which go unnoticed and are neglected. However entrepreneurship is also about neglecting certain assumptions and creating new limitations. Recovery plans are usually developed and implemented at a very late stage when the competitive disadvantage cannot be turned. It is comprehensible that management does not want to start too early with disclosing and announcing that the firm has entered a downward spiral. This can accelerate this spiral due to stakeholders becoming more demanding and hesitant about supplying the business with their services on less attractive conditions. The holders of the critical (and valuable) resources can withdraw their support. Management furthermore may lose its independency in determining the policy of the firm. Empirical research reveals that management ignores early warning signals⁵⁹. This neglect of signals is called myopic behaviour, but in a successful context it is characterized as keeping focus). What’s the alternative, at what moment can and do we facilitate business rescue? The timing is extremely difficult and cannot be formulated in an objective way.

2. Rescue is too subjective

Default on debt is an objective norm to select value-destroying firms. (Legal) insolvency has to be replaced by another norm to start and proceed the restructuring. Which norm must be applied and furthermore at which moment? Does it provide wrong incentives: continuing a poor performing firm?⁶⁰, free

⁵⁸ E.D. Beinhocker, *ibid.*, p. 325.

⁵⁹ Z. Sheaffer, B. Richardson and Z. Rosenblatt, 1998, Early-warning signals management: a lesson from the Barings crisis, *Journal of Contingencies and Crisis Management*, Vol. 6, No. 1, pp. 1-22.

⁶⁰ Continuance of failed businesses show high rates of failure recidivism. E. I. Altman and B. Branch, *The Bankruptcy System’s Chapter 22 Recidivism Problem: How Serious is It?*, 2015, *The Financial Review*, Vol. 50, pp. 1-26, conclude that of debtors that emerge as continuing, independent entities under chapter 11, ultimately 18.25% file for bankruptcy protection again. These firms are called catch 22, 33 and 44 etc. firms.

riding on others and without worrying about the consequences of insolvency? Does it distort competition because facilitating rescue is just like subsidizing poor performance? This interferes with the co-evolution of markets and firms, which selects valuable resources and allocates them in the self-organized value chains.

3. Rescue is too complex

How can the viability of a company in distress be assessed? The viability can only be tested by markets. Furthermore who is to decide and who is able to recognize value? The insolvency practitioner has to be a true “magician” to pinpoint viability. The following rhetorical question can be asked: If they are so smart (at identifying viable firms), why are they still here? If they are so smart, why are they doing this job and why aren’t they rich? Is the insolvency practitioner well equipped to perform this task? Is he negligent when mistakes are made? How does he balance the conflicting purposes of maximization of value with employment (retaining jobs) and other social purposes?

Stangler and Arbesman paraphrase the economic business environment as “messiness where prosperity is made”. In this messiness where value is created, value chains are formed and transformed. The firm is a link in the value chain, the value it creates can only be known *ex post* (and in that case only partly and for a certain period). The viability of “this project” can and should not be assumed, it can only be tested via markets. The essence of value creation is that it cannot be predicted, if this is possible it cannot be created anymore! Evolution is more clever than us human beings. Are insolvency practitioners more clever than markets and evolution in recognizing sources of value?

Conclusion

A company has to specialize and to focus on something, it has to create its own limitations in order to be distinctive. A company cannot take into account everything: it would be impossible to be effective and efficient. It would paralyze the firm. Progress is obtained by trial and error, but this means most firms ultimately fail. This is the basic competitive force. Markets select poor performing (wealth destroying) firms. But this has positive consequences for the aggregate macro perspective; this is what Metcalfe calls “a restless capitalism”. Why should we interfere in this selection process in an environment where resources flow in the quest for value in the value chains? The task of the insolvency practitioner in a business rescue perspective is very complex and subjective in particular with regard to the assessment of the viability in light of the feasibility and desirability of rescuing failed businesses. With embracing the business rescue culture the neutral, objective equal level playing field of a business dissolution with a clear purpose has been replaced by a subjective and complex minefield with a mixed purpose. Does this create additional conflicts and bankruptcy costs? Interferences with the

market have to be justified, we see no clear advantage of business rescue interference, only a lot of disadvantages.

“The overuse of the survivor technique, distorting our understanding of the process that has led to the present state of things, has affected several disciplines besides business history. If we merely observe that many of the firms that now dominate the economy are of ancient lineage, or that some of today’s top firms were also at the top a century earlier, we might conclude that giant firms are generally long-lasting; yet the stated observation is equally compatible with the hypothesis that some initially small firms grow rapidly to become large, while corporate giants have, over reasonably long periods, a poor survival rate. Our current knowledge of survivors dominates our impression of the typical experience, and their triumphs are lionized, while the history of the failures is forgotten or considered untypical”.⁶¹

The companies that prevail and exist now have defeated a lot of other firms, have absorbed the remains of failed companies, have assembled and disassembled their resources. The dynamics of creation, adaptation, failure and dissolution of firms represent the forces of capitalism. We have to look behind the stylised legal shell and economic theory of the firm. Firms are movers and often choose the wrong policy and opportunity; “most things fail”. However failed firms are essential for capitalism. The focus should be on experimentation, not in preventing failed firms from collapsing. Progress is obtained not despite of failure, but due to failure! A more positive appraisal of failure is needed: “The firm is dead: Hurrah for the failed firm”.

⁶¹ L. Hannah, Marshall's “Trees” and the Global “Forest”: Were “Giant Redwoods” Different?, 1999, in *Learning by Doing in Markets, Firms, and Countries*, N.R. Lamoreaux, D.M.G. Raff and P. Temin (eds.), University of Chicago Press, pp. 254-255.