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MANAGERS AS AGENTS VERSUS ANGELS: AN AGENCY THEORY PARADOX OF CORPORATE SOCIAL RESPONSIBILITY, BANKRUPTCY, AND RECOVERY

Luis E. Davila P.

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The dissertation of Luis E. Davila P. has been approved by:

Dr. Noushi Rahman

Dr. Imran Chowdhury

Dr. Myo Jung Cho

Dr. Vijay Sampath

Dr. Birgit Elchoueri

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Abstract

This dissertation focuses on the effects of corporate social responsibility (CSR) on bankruptcy outcomes and on the length of time it takes a firm to exit from Chapter 11 bankruptcy. Bankruptcy is a critical stage for any firm that has not been able to minimize the effects of financial distress and, consequently, has elected to seek protection under Chapter 11 of the bankruptcy laws. I not only analyze the effects of CSR on financial failure but also examine the effects of the level of a firm's CSR commitment on its survival and liquidation probabilities after filing for reorganization under Chapter 11. I also explore the moderation and mediation effects of available slack on the relationship between CSR and bankruptcy given that slack resources are needed for a firm's sustained CSR efforts. Further, I examine the association between a firm's commitment to CSR and the length of the recovery process.

Filing for bankruptcy is a response to the critical deterioration of a firm's financial performance and asset values, which can result from either financial or economic distress (Bhattacharjee, Higson, Holly & Kattuman, 2009). While the former results from management's actions in running the internal operations of the firm, the latter is entirely external, as it depends on market conditions and the overall external economic environment (Oxelheim and Wihlborg, 2009).

Bankruptcy, whether due to financial or economic factors, or both, is a critical situation—with which managers are typically not familiar—that negatively influences the normal development of business. Bankruptcy adversely affects not only the financial performance and

the economic value of the firm but also the relationships among the firm's internal and external stakeholders. Moreover, a firm's financial and operational deterioration, eventual bankruptcy filing, and the unsuccessful termination of bankruptcy proceedings (in the case of a liquidation of the firm) destroys value not only for the owners but also for all parties with an interest in the firm's business. Even in the case of a successful recovery, bankruptcy has long-lasting negative effects on the reputation of the firm and the responsible managers.

When a firm is under financial distress, managers appear to do "wrong" if they divert critical resources or restricted levels of organizational slack away from the core business in order to continue the firm's CSR activities. However, in an agency theory paradox, these "bad" managers' wrongful pre-bankruptcy CSR commitments become "good" deeds in hindsight because of the delayed "angel" or "steward" effect they have during the process of the firm's recovery from Chapter 11. Rupp, Williams and Aguilera (2006) describe this relationship in their paper where they theorize that "stakeholders not only react to how they see the firm treating *them* but also hold organizations accountable for the treatment of other stakeholder groups." Thus, the "bad but selfless" pre-bankruptcy manager's behavior prepares the firm for the subsequent financial turnaround because the commitment to CSR, even during periods of critical financial distress, helps the firm to retain the support of key stakeholders for the positive resolution of a Chapter 11 filing.

I found that a firm's continued commitment to CSR while going through periods of financial distress is an accelerator of financial failure or Chapter 11 filing and, simultaneously, a facilitator of a firm's eventual recovery from bankruptcy. Further, I found that CSR decreases a firm's likelihood of liquidation and increases its likelihood of recovery from Chapter 11 bankruptcy. Lastly, I found that there is a positive association between commitment to CSR and

the length time from a firm's filing for bankruptcy to the court's approval of a reorganization plan.

Dedication

I dedicate this dissertation with a special feeling of gratitude to my loving wife, Yajaira, who shared my commitment to earn a doctoral degree, endured throughout the long hours of study and work required of me, and provided support and encouragement throughout this amazing and enjoyable journey; to our exuberant, sweet, and precious little girl, Eleanor V., whose blessed arrival provided the final incentive for completion of this work; to my son, Vicente E.; to my grandmother Maria Juana Hernandez H., an omnipresent moral and ethical pillar who provided me with the will and strength necessary to take on and complete this challenging task; to my mother, Raffaella C. Puente Hernandez, who first taught me the value of education, critical thought, and perseverance in achieving my goals; and to my father, Luis E. Davila Balza.

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Contents

CHAPTER 1 - INTRODUCTION

1.1 Introduction

During and after the 2008 financial crisis, many firms continued their corporate social responsibility (CSR) activities when faced with competing choices to cut costs (Strugatch, 2011). A striking example is that of Intel, which committed to continuing its investment in CSR programs in spite of its stock price falling 42% in 2008 (Delvingne, 2009). In the words of Craig Barrett, Intel's chairperson, "You can't save your way out of a recession—you have to invest your way out. We look at our CSR activities the same way: you can't just do them in good times and then forget about them in bad times and hope to get any results" (2009: BU4). I take this philosophy a step further by examining the relationship among CSR commitments within firms that face financial distress, bankruptcy outcomes, and post-bankruptcy recovery. Under dire financial conditions, a firm's primary objective is to survive by allocating its resources to core activities. Therefore, in the context of financial distress, it is ironic that a firm would redirect its slack resources to 'non-essential' investments such as CSR investments. Thus, I pose the following research question in order to reconcile this paradox: *Why* do managers of financially distressed firms persist in using slack resources to maintain their commitment to CSR instead of conserving those precious and scarce resources?

Financial distress of a firm is a process of organizational decline manifested in a substantial reduction in the availability of resources, a suboptimal financial structure (Denis & Rodgers, 2007), managerial imbalances, centralization, strategic paralysis, conflicting strategic directions, and decreasing financial performance (D'Aveni, 1989a). Market changes and industry factors may contribute to the distress by applying extra pressure and stretching the resource base

of the firm (Asquith, Gertner, & Scharfstein, 1994; Bhattacharjee et al., 2009). For purposes of this study, I conceptualize financial distress as a process involving sustained deterioration of a firm's liquidity (Ooghe & De Prijcker, 2008). As financial distress is a prologue to failure, it leads firms to take actions to survive that may include retrenchment, downsizing, liquidation of assets, or the filing for bankruptcy. The severity of outcomes emanating from a financial distress situation depends on the nature of the specific demands and power positions of owners, managers, and other stakeholders (Pfeffer & Salancik, 1978).

I add to the discussion on CSR and financial performance by analyzing the relationship between CSR commitments and bankruptcy outcomes. In this regard, a firm's commitment to CSR is beneficial in some specific contexts in which it has a positive association with financial performance and risk reduction (Luo & Bhattacharya, 2009; Margolis, Elfenbein, & Walsh, 2007; Orlitzky, Schmidt, & Rynes, 2003; Sun & Cui, 2014). Nonetheless, a firm's investment in CSR can be disadvantageous as well given that the added costs associated with CSR increase a firm's idiosyncratic and financial risks, particularly when a firm is in financial distress (Koh, Qian, & Wang, 2013). In this study, I do not consider the controversial debate on the 'goods' and 'bads' of CSR in terms of financial performance. Instead, I have developed a theoretical framework that can assist in understanding the links between a firm's survival or failure, CSR, organizational slack, corporate restructuring, and time to recovery in a bankruptcy proceeding. Until now, these relationships have remained untested (Aguinis & Glavas, 2012).

Additionally, given the criticality of the availability of slack in a firm's resources for CSR engagements, I analyze the role of available slack as an operating mechanism in the relationship between CSR and bankruptcy outcomes. In this study, I used moderation and mediation analyses to assist in an understanding of the influence of slack on bankruptcy outcomes. In particular, I use

these analyses to determine how slack affects the relationship between CSR and bankruptcy, how slack transmits the effect of CSR on bankruptcy outcomes, and how slack as a mediator explains why CSR has a relationship with bankruptcy. Bankruptcy research places particular attention on the development of a variety of prediction models (Altman, 1968; Merton, 1974; Ohlson, 1980; Shumway, 2001a) that use various statistical techniques (e.g., multiple discriminatory, univariate, logistic, and probit analysis; hazard models, genetic algorithms, and neural network and theoretical modeling).

There is also the legal perspective of bankruptcy, which emphasizes the legal nature of the reorganization process, the variations in the legal framework, and the relationship between governance of a firm and a firm's liquidation and recovery processes (Balcaen, Manigart, & Ooghe, 2011; Lee, Peng, & Barney, 2007; LoPucki, 2003; Senbet & Wang, 2010).

The financial perspective on bankruptcy research presents two distinct areas of focus: a) the design of analytical models to be used to estimate distance to default (i.e., the length of time between the determination of a critical financial indicator of risk (Altman score models) and failure to pay creditors, triggering a firm's default) and probabilities of bankruptcy, and b) the evaluation and comparison of a variety of prediction models. With estimation modeling, research focuses on three sets of studies: a) financial ratio-based models (Altman, 1968; Bhandari & Iyer, 2013a; Ohlson, 1980); b) market-driven factor models (Bharath & Shumway, 2008; Merton, 1974); and c) a combination of both modeling techniques within hazard models (Podobnik, Horvatic, Petersen, Urošević, & Stanley, 2010; Shumway, 2001a).

A wide variety of modeling techniques have been used to estimate bankruptcy risk or failure, including: Balance Sheet Decomposition Measure (Entropy Theory), Cumulative Sums Model (Time Series), Financial Ratios, Genetic Algorithms, Gambler's Ruin Theory, Linear

Probability Model, Multiple Discriminant Analysis, Neural Networks, Partial Adjustment Model (Time Series), Recursive Partitioning (Decision Tree) Analysis, and Rough Sets Model.

1.2 Research Purpose

This study seeks to bridge the financial and management literature on bankruptcy and CSR. It combines the analysis of firms under financial distress in varying contexts, management's motivations (Ariely, Bracha, & Meier, 2009; Devinney, 2009) and risk-averse behaviors (Wiseman & Bromiley, 1996) with CSR commitment. Breaking new ground in this line of research, I assert that CSR commitment for firms under the particular context of financial distress reflects managers' individual motivations and those of management's dominant coalition (Cyert & March, 1963), the firm's top senior executives. The senior executives interpret stakeholders' signals about the firm's environment and consider the firm's various contract relationships in making decisions to acquire, develop, use, dispose of, or enhance available resources (Williamson, 1981; Williamson, 1989). Although CSR is neither a revenue nor cost optimizer, it plays a strategic role within the firm (McWilliams, Siegel, & Wright, 2006). CSR enhances a firm's and its manager's embeddedness with the multiplicity of stakeholders, namely the various classes of shareholders, the employees, the debt providers, the suppliers, the customers, the regulators, and the local public. (Aguilera, Rupp, Williams, & Ganapathi, 2007). This network provides competitive advantages (Russo & Fouts, 1997) and furthers the firm's legitimacy (Bear, Rahman, & Post, 2010; Hanan & Freeman, 1984; Pfeffer & Salancik, 1978).

Nonetheless, in the context of financial distress, a company's commitment to CSR becomes a very specific source of salient agency conflict between the managers and owners because of their differing perspectives (Eisenhardt, 1989) on the use of the firm's scarce and declining resources (Jensen & Meckling, 1976). The conflict exists in terms of risk, interests, and strategy preferences

when dealing with impending financial insolvency, bankruptcy, liquidation, and/or turnaround. On the one hand, managers, during critical times, want to continue with CSR investments which have the effect of protecting their own reputations by averting the negative effects of potential future "bankruptcy stigma" (Sutton & Callahan, 1987). On the other hand, owners, during critical times, advocate for savings and a concentration of resources as the firm directs its efforts toward efficiency-improving activities, all in an environment of information asymmetries and declining corporate governance. Indeed, managers use CSR as part of their ex-ante stigma management to distance themselves from eventual failure should the firm not survive, as Semadeni, Cannella, Fraser, and Lee (2008) explained. Managers do this in an effort to either sustain support from key stakeholders, to facilitate an eventual recovery, or to keep professional career options open. However, retaining stakeholder support is not a direct response from stakeholders to CSR expenditures. Rather, stakeholder support comes from the accumulated stock of social and reputational capital created through sustained CSR commitment ex-ante the firm undergoing financial distress.

Certainly not every firm that experiences some level of financial distress becomes a failed one. However, a financial distress situation is one in which the firm struggles to attain a critical and fragile equilibrium between cash inflows and outflows. Uncontrolled use of a resource-taking activity may push a firm toward the edge of a fatal disequilibrium. Chronic insolvency marks the peak of a firm's financial distress situation where liabilities are greater than available assets, forcing the firm to be consistently unable to satisfy its current obligations to its wide spectrum of creditors, suppliers, and employees.

Therefore, the main assumptions in this study are:

a) financial distress is a process with successive phases that fluctuate in its representation over time, given the changing nature of the endogenous and external environments (Hill, Perry, & Andes, 2011);

b) a firm's decision-making processes for resource allocation reflect the nature of the evolving interests (Jensen & Meckling, 1976) of management and shareholders; and

c) CSR consumes critical resources needed either to improve operational efficiency (Klassen & Whybark, 1999) or to sustain liquidity and solvency, including cash, human resources, and management time. It also diverts resources away from the firm's core business.

1.3 Objectives of the Dissertation and Research Questions

The research questions driving this study pertain to firms experiencing financial distress and include:

a. How does CSR relate to the probability of a firm under financial distress filing for bankruptcy?

b. How does CSR relate to the speed of recovery for a firm attempting to exit from bankruptcy?

c. How does organizational slack relate to a firm's probability of filing for bankruptcy?

d. How does slack affect the relationship between CSR and a bankruptcy-filing outcome?

e. What role does CSR play in a firm's exit from a bankruptcy proceeding?

1.4 Potential Contributions and Limitations

This study advances a new perspective on agency conflict by suggesting that managers behave rather selflessly in their actions during a period of financial distress. Managers in firms

under financial distress may sacrifice current benefits with the expectation of avoiding permanent failure. In other words, they may anticipate a successful post-bankruptcy recovery by using retained stakeholder support and influence (Barnett, 2007) that they amassed through pre-bankruptcy CSR investments**.** This study is also the first to examine the role of CSR in the post-bankruptcy recovery process. This examination reveals an agency theory paradox, where managers, by doing "wrong" before bankruptcy (i.e., continuing to incur CSR expenses while being financially distressed), are actually providing a safe passage to a speedy recovery from it. This study advances this theory by explaining that "bad" pre-bankruptcy expenditures on CSR commitments that may have a negative effect on a firm's survival, MAY result in "good" outcomes (Cai, Jo, & Pan, 2012). Overall, pre-bankruptcy CSR commitment has a delayed "angel agents" effect (Miller & Sardais, 2011) that comes into place during the post-bankruptcy recovery phase. Thus, "bad" pre-bankruptcy CSR expenditures become an accumulated stock of reputational capital that procures a "safety net" (Fombrun, Gardberg, & Barnett, 2000). Thus, CSR acts as an "insurance like" protection (Godfrey, Merrill, & Hansen, 2009; Minor & Morgan, 2011a; Peloza, 2006) through the generation of valuable post-bankruptcy support from stakeholders (Barnett, 2007) that eases and speeds post-bankruptcy recovery (Aguinis & Glavas, 2012) through the reduction of the firm's idiosyncratic risk as well.

In fact, "bad" pre-bankruptcy CSR commitments become a valuable post-bankruptcy resource generator during the recovery process (Boutin-Dufresne & Savaria, 2004; Luo & Bhattacharya, 2009; Oikonomou, Brooks, & Pavelin, 2012) because these commitments help to generate cooperative ties and good relations with stakeholders (Henisz, Dorobantu, & Nartey, 2013). Firms benefit from these relationships during the reorganization process because there is reduced conflict among debtors (Gertner & Scharfstein, 1991), which facilitates reaching

agreement on 1) debt restructuring, and 2) lowering financial costs (Goss & Roberts, 2011). Additionally, firms may benefit by achieving revenue stability based on retained customer loyalty (Luo & Bhattacharya, 2009).

This study expands the views of agency theory and examines its relationship with stewardship theory. By increasing the risk of failure through the consumption of critically needed resources (Margolis & Walsh, 2003) when the firm is under financial distress, managers are in reality acting as stewards of the firm even in the face of what appears to be an agency conflict (Barnea & Rubin, 2010). These managers secure the means and ways to develop a sounder reorganization process with fewer distortions and conflicts among creditors and other interested parties than there otherwise would be.

The results of this study suggest that a “bad” management action of diverting critical and needed resources away from the core business and toward support for CSR commitments negatively mediates the effects of CSR on a firm’s financial performance in that the “bad” action accelerates the firm’s pace toward bankruptcy. However, in an extension of agency theory and its integration with stewardship theory, this study suggests that managers who continue to invest in CSR activities, notwithstanding the financial distress of the firm, opt for an accelerated exit from bankruptcy or quick resolution, rather than a costly delay of failure (Shepherd, Wiklund, & Haynie, 2009). Moreover, managers favor a process in which the odds of successfully exiting from bankruptcy will allow them to avoid “bankruptcy stigma” and gather, group, negotiate, retain, and positively use stakeholder support for the firm´s eventual turnaround (Laguir & Elbaz, 2014).

This study advances an understanding of the behavior of firms following a period of financial distress and the resulting outcomes for the firm. Specifically, it analyzes firms under the context of financial distress, bankruptcy filing, and post-bankruptcy recovery. Further, this study

assesses these factors in relation to the availability of varying levels of slack resources and conflicts of interest in the allocation of those resources (Melo, 2012). To highlight the conflicts of interest in resource allocation, I bring attention to the resource needs that a firm has when pursuing CSR activities. Such allocation and use of resources with limited availability, within the context of financial distress, may cause conflicts of interest among managers, shareholders, and other stakeholders, particularly when CSR objectives differ, as such objectives may be altruistic, coercive, or strategic (McWilliams, Siegel, & Wright, 2006). Nevertheless, the further investment in CSR activities may be part of management's response to environmental and other immediate threats (D'aveni, 1989a), such as increased market competition, employee strikes, and the imposition of more stringent government regulations. Because these investments absorb scarce resources, they restrict management's flexibility in taking actions to improve the firm's performance and the diversity of those actions (Weick, 1979). This study contributes to the extension of CSR theory through the analysis of its relationship with a firm's financial failure and turnaround. Moreover, this study incorporates the management dimension in the process of failure and turnaround under the context of financial distress.

Additionally, this study extends the analysis of CSR effects on a firm's performance by including models that consider the moderating and mediating roles of organizational slack in the CSR-bankruptcy relationship and the moderating effects of managements' restructuring efforts, as well. It unveils a new perspective on CSR that differs widely from it being viewed as just a social obligation to the surrounding communities. It is not just a social obligation or the procurement of political standing or the building of a reputation as a good corporate citizen; rather, is also the development of critical support networks that can be activated during times of critical financial distress and subsequent Chapter 11 negotiations. Managers' motivations and their recognition that

there is a risk that the firm will undergo financial distress opens the way for the strategic use of CSR. This study reinforces the perception that CSR is a strategic resource for the firm, while altering the associated anthropomorphic views on the firm's behavior in its relationship with society. Further, it adds to the discussion on the relationship between CSR and financial performance, where CSR commitment is contingent upon a firm's financial and managerial context and the available slack, elements that are not homogeneous in action, time, and composition.

1.5 Organization of Dissertation

This dissertation is organized into an introduction (Chapter 1) and four additional chapters. Chapter 2 analyzes the relevant core literature on bankruptcy, slack, restructuring, and CSR, setting the stage to advance a set of hypotheses about the paradoxical effects of CSR on a firm's financial decline and subsequent recovery. Chapter 3 describes the methodology used, nature of the sample, data sources, main issues related to the data collection process, and the set of variables included in the analytical model. It also explains the analytical model and the statistical methods used in the testing of the hypotheses and the results. Chapter 4 explains the results of the analysis. Lastly, Chapter 5 discusses practical implications, contributions, and further research directions.

CHAPTER 2 - CORE CONCEPTS AND LITERATURE REVIEW

The goal of this dissertation is to build a theory around the behavior and actions firms undertake during periods of financial distress and during the recovery process (i.e., leaving Chapter 11 Bankruptcy). Bankruptcy, slack resources, non-core resource-draining initiatives (e.g., CSR), and the length of time in Chapter 11 are the key core concepts that play important roles in the research model.

2.1 Bankruptcy

Management inefficiencies, policy errors (Ooghe & De Prijcker, 2008), and adverse industry and market changes cause a firm's profitability and liquidity to decline (Probst & Raisch, 2005; Williamson, 1991). This organizational decline (D'aveni, 1989a), with a significant reduction in resource availability and a decreasing ability to cope with internal and external market demands, leads to chronic insolvency and the failure of a firm to perform its obligations. The inability to fulfill current payment obligations can result in a firm undergoing reorganization under Chapter 11 (Kahl, 2002) or liquidation under Chapter 7 of the bankruptcy laws. The bankruptcy proceeding can be initiated by the firm's creditors (involuntary) or by the firm (voluntary). Chapter 11 fosters the firm's survival and minimizes losses for all parties. (11 U.S.C. §§ 301, 30) Chapter 7 leads to a permanent liquidation of the firm (Hotchkiss, 1995).

I am interested not only in the probabilities of a firm failing but also in it recovering from insolvency. Thus, this study focuses on the Chapter 11 bankruptcy process, which allows for court protection from creditors and presentation of a reorganization plan to convince the judge that the firm's rescue from chronic financial distress can be successful (Denis & Rodgers, 2007). Through court protection, Chapter 11 minimizes inefficiencies in the recovery process, preserves the