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Strategic bankruptcy: A stakeholder management perspective

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ABSTRACT

There has been growing interest in whether and when a Chapter 11 bankruptcy can be a mechanism through which firms make strategic changes that help to preserve value and overcome competitive disadvantages. Using a stakeholder management perspective, this paper examines the influence of firm characteristics on the likelihood of filing for Chapter 11, subsequently emerging from bankruptcy, and the number of years in bankruptcy. Theoretical predictions are tested in a study of publicly traded firms from 1980–99. Intangible assets and assets that can be efficiently sold in bankruptcy positively influence the likelihood that a firm will file for Chapter 11 and reorganize in a shorter number of years. Further, unfavorable executory contracts with primary stakeholders, a previously unexplored area, positively influence a firm's likelihood of both filing and reorganizing in bankruptcy. These findings are consistent with a stakeholder view of strategic bankruptcy.

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1. Introduction

Over the past two decades, there has been growing interest in whether and when a strategic Chapter 11 bankruptcy can be a mechanism through which firms can make strategic changes that help to preserve and enhance firm value (Delaney, 1992; Evans & Borders, 2014; Gilson, 2001). A strategic bankruptcy is one that helps firms to implement strategic changes to relationships with customers, suppliers, or other trading partners in a manner that positively alters the likelihood of sustainable performance improvements and survival. However, there is disagreement on whether a strategic bankruptcy is an effective mechanism for strategic change (Flynn & Farid, 1991; Moulton & Thomas, 1993). Prior research has examined several factors, such as poor performance and excessive financial leverage, which contribute to a firm's decline and failure (Daily, 1994; D'Aveni, 1989a; Hambrick & D'Aveni, 1988). This literature assumes that bankruptcy is a definitive form of failure and should be a firm's decision of last resort (Platt & Platt, 2012). This research does not reconcile with anecdotal evidence, which indicates that firms have successfully preserved value for all key stakeholders by proactively (i.e., strategically) reorganizing under Chapter 11 of the US Bankruptcy Code. More research is needed to reconcile this contradiction between research and recent trends in proactive Chapter 11 bankruptcy filings, which are more stakeholder focused. This paper addresses this gap in the literature by examining conditions under which a proactive Chapter 11 filing can be an effective mechanism for making strategic changes that improve a firm's performance and long-term viability (Evans & Borders, 2014).

Aside from theoretical and descriptive work on strategic bankruptcy (Delaney, 1992; Flynn & Farid, 1991; Moulton & Thomas, 1993), little is known about firm-specific characteristics that influence whether and when declining firms will proactively file for Chapter 11, subsequently emerge as a going concern entity, and ultimately survive. This study examines the influence of a firm's relationships with key stakeholders (i.e., employees, customers, suppliers, creditors, and shareholders) on its decision to reconfigure its resources in bankruptcy. While prior studies of prepackaged bankruptcies have examined firms' motivations to compel large creditors to renegotiate debt contracts (Asquith, Gertner, & Scharfstein, 1994; Tashjian, Lease, & McConnell, 1996), these studies have not examined a firm's strategic motivations to file for Chapter 11. By emphasizing the influence of difficult-to-trade assets and the need to renegotiate or terminate unfavorable contractual arrangements as part of a firm's strategic reorientation, this study complements prior bankruptcy studies that primarily focused on the effects of firms' financial characteristics. It incorporates firms' resource characteristics that influence the ability to implement strategic changes that improve performance and the ability to create competitive advantages (Barney, 1991).

Stakeholder theory provides a strong foundation from which to evaluate the influence of a firm's relationships with key stakeholders on its strategies for improving long-term performance (for comprehensive reviews of this literature, see Parmar et al., 2010; Laplume, Sonpar, & Litz, 2008). In general, poor relationships with primary stakeholders can have negative performance consequences for a firm (Choi & Wang, 2009; Clarkson, 1995; Hillman & Keim, 2001). For declining firms, in particular, poor stakeholder relations can have irreversible long-term negative effects on performance (Hambrick & D'Aveni, 1988; Meyer & Zucker, 1989; Platt, Mirick, & Platt, 2011). The U.S. Chapter 11 Bankruptcy

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Code allows firms to manage relationships not only with creditors and shareholders, but also with other key stakeholders (e.g., employees, customers, and suppliers) who directly affect a firm's value creation activities.

The decision to file for Chapter 11 is often necessary when a firm has unfavorable relationships with some key stakeholders that can have a detrimental effect on other stakeholders, and the firm is unable to manage these relationships outside of bankruptcy without incurring severe penalties. Using a stakeholder management perspective, theoretical arguments are developed to predict whether a firm is more likely to make value-enhancing strategic changes in bankruptcy and subsequently emerge as a going-concern entity. These predictions are tested on a sample of publicly traded firms that filed for bankruptcy from 1980–1999. The results are consistent with arguments supporting strategic bankruptcies.

The remainder of the paper proceeds as follows. The next section briefly reviews stakeholder management literature. This stakeholder perspective is then used to develop theoretical predictions regarding whether a firm is more likely to file, reorganize, and subsequently emerge from Chapter 11 bankruptcy as a going-concern entity. Empirical analysis follows this section, and the paper concludes with a discussion of implications for research and management practice.

2. Stakeholder management and firm performance

Over the past two decades, the stakeholder perspective has been used to evaluate complex business issues, including how organizations create and capture value (Parmar et al., 2010). This is a salient issue for strategic management scholars who are particularly concerned with understanding why firms differ and what explains variation in firm performance (Rumelt, Schendel, & Teece, 1994). Conventional wisdom argues that a for-profit organization's primary duty is to increase shareholder value, and that managers' incentives must be aligned with shareholders' interests in order to remain focused on this imperative (Jensen, 1986; Jensen & Meckling, 1976). Research in this tradition assumes that managing stakeholder relationships is a zero sum game, where attending to the interests of nonfinancial stakeholders is to the detriment of financial stakeholders.

Alternatively, a stakeholder view argues that firms must also focus on the interests of nonfinancial key stakeholders who materially affect a firm's ability to create and capture value (Becchetti, Ciciretti, Hasan, & Kobeissi, 2012; Freeman, 1984, 1994, 1999; Hillman & Keim, 2001; Platt et al., 2011). For instance, massive corporate failures (e.g., Tyco International, Enron) due to management excesses, despite these firms' efforts to maximize shareholder value, demonstrate that a focus only on shareholders as the most important stakeholder class may not consistently generate the results that theory would suggest. Hillman and Keim (2001) refute the notion of a ‘stakeholder paradox’ by showing that building better relationships with primary nonfinancial stakeholders can help a firm to develop valuable resources that lead to a sustainable competitive advantage and increase shareholder value. Platt et al. (2011) found that an amendment to the 2005 US bankruptcy code, which gave landlords stronger bargaining power against debtors in the acceptance or rejection of commercial leases, had the unintended consequence of higher failures of retailers, thereby decreasing commercial rents. This is another example of how a focus on one key stakeholder to the detriment of others can have unintended negative consequences not only for a firm, but also for the disgruntled stakeholder.

Building on this stakeholder management perspective, strategy scholars have emphasized the importance of understanding how managing relationships with all stakeholders influences a firm's competitive advantages and performance persistence (Bosse, Phillips, & Harrison, 2009; Choi & Wang, 2009; Harrison, Bosse, & Phillips, 2010). Bosse et al. (2009) theorize that stakeholders' perception of a firm's distributional fairness reciprocated this treatment, and firms that focus on such fairness generate higher economic performance. Similarly, Harrison et al. (2010) argue that firms focused on managing stakeholder relationships garner greater trust and cooperation from stakeholders, are better able to adapt to unforeseen changes in the external environment, and are more likely to achieve a sustainable competitive advantage. Choi and Wang (2009) demonstrate that positive stakeholder relations not only contribute to the persistence of superior financial performance, but also help a firm to recover from poor performance.

Taken together, this work supports a positive association between managing relations with key stakeholders and firm performance. Empirical studies demonstrate that this perspective can not only improve firm performance, but also stem performance declines by helping firms to better adapt to environmental changes. While previous work has focused on the persistence of superior performance as a benefit of stakeholder management, few have emphasized its effect on mitigating the persistence of inferior performance (Choi & Wang, 2009). Drawing on these insights, this study examines firm characteristics that increase the likelihood of a strategic bankruptcy, which helps firms to shorten the duration of poor performance and refocus on value-enhancing resources.

3. Stakeholder view of strategic bankruptcy

Firms in declining industries can improve performance by proactively implementing strategic change before industry opportunities enter a period of persistent decline and before a firm experiences financial distress (Harrigan & Porter, 1983). However, when there are high barriers to exit stemming from assets that are difficult to trade, have environmental concerns, or other attributes that hinder a fair asset valuation, firms may have difficulty implementing strategic changes without experiencing value-destroying disruptions to their operations. For some firms, a Chapter 11 bankruptcy filing can provide a stable forum in which to better manage relationships with key stakeholders (Gilson, John, & Lang, 1990) and achieve a persistent improvement in post-bankruptcy performance. To the extent that Chapter 11 is an efficient mechanism for implementing value-enhancing strategic change, a firm is more likely to file, reorganize, and emerge in a timely manner.

Under Chapter 11 of the U.S. Bankruptcy Code, court protection through a stay of pre-petition liabilities provides a firm with management-led operating stability and time to make strategic changes that are necessary for sustainable performance improvements and long-term survival. At the same time, Chapter 11 provides access to debtor-in-possession financing that allows a firm to retain key employees and maintain relationships with key suppliers, both of which are critical for value creation activities. By actively managing relationships with all key stakeholders, a declining firm can maximize value for all. Thus, a stakeholder perspective does not trade off the interests of financial stakeholders in favor of nonfinancial interests. As a firm's post-bankruptcy value and likelihood of long-term success increases, so does the value of assets held as security for secured creditors while also maintaining key employees, customers, and suppliers who directly influence firm value. Prior research argues that firms should pursue bankruptcy only as a last resort after it has explored all out-of-court options (Moulton & Thomas, 1993). However, in some cases, delaying bankruptcy may cause relationships with key stakeholders to deteriorate beyond repair and could threaten a firm's survival. A chronically ailing firm that does not strategically file risks losing key customers, employees, and suppliers, as instability causes stress and concern for all involved. Such firms can end up in a downward spiral or become known as permanently failing (Hambrick & D'Aveni, 1988; Meyer & Zucker, 1989).

Declining firms that have greater intangible assets are more likely to have difficulty restructuring outside of bankruptcy because these assets are difficult for potential acquirers to value (Hand & Lev, 2003) and, therefore, may not yield expected values that are sufficient to repay debt obligations. As a result, a firm's efforts to sell these assets outside of bankruptcy may unintentionally lead to operational instability and

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