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What influences the duration of negative impacts from organizational deviance on other innocent firms?

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ABSTRACT

Previous studies of crisis spillovers show that innocent firms suffer from undeserved losses of legitimacy when other members of their industries misbehave. However, how these innocent companies recover their legitimacy remains a mystery. We draw on the crisis spillover literature and institutional theory to predict how companies recover their legitimacy—that is, what institutional factors influence the duration of crisis spillover. This "guilt by association" can last a long time, but audiences use institutional signals to detect the strength of association between a focal firm and a deviant firm. In the Chinese context, *ex-ante* characteristics of firms such as no political connection and international market presence make it less likely that audiences will see them as categorically similar to a firm that is responsible for wrongdoing. This in turn helps innocent companies disassociate from deviant firms in their industries, thereby shortening the duration of crisis spillover.

1. Introduction

Strategic legitimacy is not only about managerial control over stakeholder support (Suchman, 1995). To remain competitive in the global arena, firms also need to be able to recover their legitimacy following unforeseen crises (Jonsson, Greve, & Fujiwara-Greve, 2009). Recovering legitimacy is a key strategic achievement, because losing legitimacy reduces a firm's capacity to find investors, build stable alliances, and maintain loyal customer bases (Vergne, 2012).

Scholars have studied in depth how firms can minimize *deserved* losses of legitimacy following their own wrongdoing (Suchman, 1995). However, recent studies demonstrate that losses of corporate legitimacy result not only from their own deviant behavior, but also from other industry members' errors (Barnett & King, 2008; Desai, 2011; Jonsson et al., 2009; Yu, Sengul, & Lester, 2008; Zavyalova, Pfarrer, Reger, & Shapiro, 2012). As many studies recognize the negative impacts resulting from an organizational deviance on other innocent parties (e.g., Reuber & Fischer, 2010), the consequence of corporate deviance has extended from the perpetrator to a wide range of recipients (e.g., Jonsson et al., 2009, Pozner, 2008).

A central observation in these studies is that the firms most similar to the deviant organizations also suffer for the sins of those deviant organizations; this phenomenon is known as *crisis spillover* (Yu et al., 2008). In those situations, audiences perceive innocent organizations negatively simply because they have similar forms or features attributed to the cause of the wrongdoing. For instance, consumers avoided all salad products after the Food and Drug Administration's (FDA) announcement about contaminated spinach on September 14, 2006 (Barnett & King, 2008).

However, little work examines how innocent firms can recover their lost legitimacy when industry members misbehave (Jonsson et al., 2009). For instance, after the March 2011 Shuanghui Corp. scandal, in which a leading Chinese meat manufacturer used the drug clenbuterol in pork (Xinhua News, 2011), the consumption of all pork products declined for the whole year (Schnitkey, 2013). However, China's per capita pork consumption rebounded in 2012 after the Shuanghui scandal in 2011 (Schnitkey, 2013).

Several studies of legitimacy and corporate characteristics provide many theoretical insights to understand this phenomenon. At a cognitive level, audiences may be influenced by more than the mere intensity of a firm's association with a deviant firm (Vergne & Wry, 2014). Vergne (2012) suggests, for example, that weapon manufacturers operating in multiple industry categories can divert their audiences' attention away from certain stigmas and dilute the resulting vilification, which corresponds with Alexy and George (2013).

Moreover, several studies suggest that innocent organizations have strategic responses to prohibit crisis spillover and protect their legitimacy. For example, Carberry and King (2012) find that firms adopt defensive practices in the face of new organizational stigma, such as establishing self-regulatory institutions (Barnett & King, 2008).

However, these two streams of research have several limitations. First, industries that suffer from crisis spillovers generally do not have

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illegitimate *salient* features before the crisis happens (e.g., the Chinese pork manufacturing industry before Shuanghui Corp. scandal). Audiences tend to categorize and generalize firms based on easily accessible organizational features, such as manufacturing similar products. Previous studies find evidence of this in the chemical industry (Barnett & King, 2008), the financial industry (Jonsson et al., 2009), and the toy manufacturing industry (Zavyalova et al., 2012). The emergence of associations between innocent firms and deviant firms during crisis spillover represents the early formation of a causal-link rather than a long-lasting, *salient*, and illegitimate one (Kennedy & Fiss, 2013) that may have a great effect on the duration of crisis spillover.

Moreover, active responses to industry members' crises (e.g., establishing an industry self-regulatory institution) may reduce the magnitude of legitimacy loss, but they do not necessarily shorten the duration of crisis spillover or hasten the recovery of legitimacy. In fact, Yu et al. (2008) argue that preferential detachment strategies do not function well in the short-term. Institutional theory proposes that firms sharing the same environment tend to choose similar strategies, which strengthens the association of an innocent firm with the deviant firm operating in the same industry.

Recovering an innocent firm's legitimacy thus remains a mystery. In particular, firms that suffer from crisis spillover recover in different ways (e.g., recovery of pork manufacturers following Shuanghui Corp. scandal). We build on categorization and institutional theory to investigate one important, unsolved, theoretical issue: what kinds of corporate characteristics shorten the duration of crisis spillovers for those innocent firms?

Previous studies on categorization show that when audiences are aware of an event, they become concerned about the risks of dealing with similar corporations (Jonsson et al., 2009; Yu et al., 2008). If creating new associations for similar companies with the deviant firm is informative and useful for simplifying complicated situations, the association emerges in the audience's mind (Kennedy & Fiss, 2013). Audiences consequently practice “guilt by association” by comparing corporate features with category prototypes. However, audiences extract different institutional signals from interpreting the features of innocent firms, which helps them detect the strength of the associations among them.

The Chinese institutional context provides several unique advantages. First of all, innocent firms in the same industry have different connections to the government (e.g., Jia & Zhang, 2013). Although political ties help businesses in China, the public at large also associates them with bribery and ineffective regulation of deviant firms (Guo, 2008; Ko & Weng, 2012). The social-level distrust of the state thus causally induces audiences to distrust innocent but politically connected firms. Second, although social-level distrust generates great uncertainty for businesses in China, many Chinese firms engage a strategy of mimetic isomorphism to achieve conformity through imitating the models they perceive to be successful in their industries (e.g., “go global”) (Brouthers, O'Donnell, & Hadjimarcou, 2005; Deng, 2009).

Thus, by appearing to have different features, companies can disassociate themselves from deviant industry actors. Consequently, we draw attention to specific corporate characteristics that divert audience attention, disrupt their tendency to lump focal firms together, and decrease the perceived magnitude of the focal firms' downside risks. For example, although the Shuanghui Corp. scandal influenced the consumption of all pork products, customers gradually turned to other manufacturers and continued to consume other meat products. Meat imports grew dramatically in 2011 as Shuanghui was trapped in its scandal (Zheng, Lu, & Yang, 2013).

Accordingly, we study the duration of crisis spillover in the food-manufacturing industry for a representatively transitional economy: China. We focus on the *shareholders*—an important audience—and analyze stock price recoveries to see how innocent firms bounce back from 39 instances of wrongdoing in the Chinese food industry from 2008 to 2012.

2. Theory and hypotheses

2.1. Corporate deviance, associations with deviant firms, and innocent firms'loss of legitimacy

Fig. 1 demonstrates our theoretical framework. As shown, when they see a perpetrator (firm A) in an industry at stage 1, audiences naturally wonder whether the companies they like in the industry (e.g., firms B and C) also engage in similar practices, even though they have no evidence. Unfortunately, audiences rarely know the reasons for a perpetrator's deviant behavior (Yu et al., 2008), and in turn they tend to apply a causal-link model as well as goal-based approach to simplify the situation (Durand & Paolella, 2013).

For instance, they associate the features of similar companies with the reason for deviance. Through this mental process, audiences scrutinize firms that are similar in some way to deviant firms. When audiences decide these firms have a propensity to engage in similar deviant behaviors simply because they have features similar to the perpetrators, the audiences consequently lump these innocent firms in with the perpetrator. By lumping firms together and retaliating against all of them (including firms A, B, and C rather than just the perpetrator, firm A) at stage 2, audiences achieve their goal of avoiding downside risk. In particular, audiences withdraw their support for these companies and abandon their relationships with them (Barnett & King, 2008).

We recognize that the loss of corporate legitimacy happens when audiences associate innocent companies (e.g., firms B and C) with the deviant firm. Consequently, the duration of crisis spillover should correspond to the strength of that association at stage 3.

We look at the difference between recovery timing and the intensity of negative spillover. We recognize that previous studies explore the determinants of the magnitude of negative spillover. However, a question remains regarding how long innocent firms take to recover from spillovers. To answer this question, we distinguish the concept of category similarity or category generalization, which previous studies use to explain the mechanism underlying crisis spillover, from the concept of

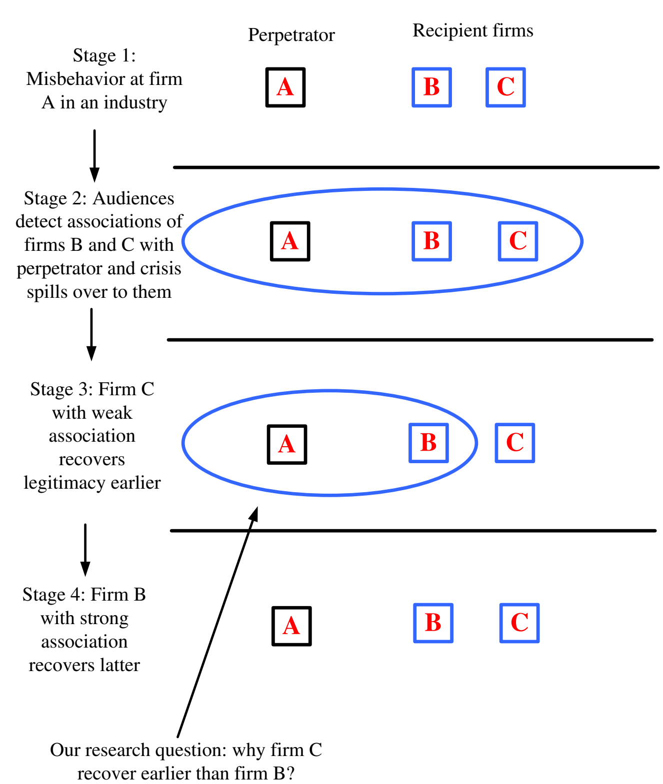

Fig. 1. Theoretical framework.