



# How prior investments of time, money, and employee hires influence time to exit a distressed venture, and the extent to which contingency planning helps



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## ABSTRACT

Unfortunately, for many entrepreneurs there comes a time when they must exit their firms due to economic distress. While some exit quickly once they perceive the need to do so, others delay, and there are benefits and costs to both approaches. Using an escalation of commitment framework, we explore variation in exit speed, and find that time to exit after the firm experiences distress depends on the types and extent of investments made prior to that distress. Further, our data indicate that contingency planning moderates the relationships between certain types of investments and time to exit.

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## Executive summary

Prior research on exit in entrepreneurship has examined factors that cause firms to fail or succeed (e.g., Bruderl et al., 1992; Cumming, 2008; Ghemawat and Nalebuff, 1985), factors that lead to different methods and routes of exit (e.g., Dehlen et al., 2014; Wennberg and DeTienne, 2014; Wennberg et al., 2010), and factors that affect the timing of exit (Garud and Van de Ven, 1992; Mitchell et al., 2008; Shepherd et al., 2009), but there are very few studies of the factors that influence the duration of the exit process (e.g., how long it takes entrepreneurs to exit). We focus our study on time to exit a distressed venture to add to this nascent literature. A distressed venture is defined here as one that is underperforming based on the threshold the entrepreneur has for his or her own venture (Cope, 2011; DeTienne and Cardon, 2012; Gimeno et al., 1997; Ucbasaran et al., 2013). Our focus is on firms that experience economic distress, both objectively and subjectively as determined by the entrepreneur, and ultimately exit through a “distress liquidation” path (Wennberg et al., 2010) rather than firms that are able to bounce back from distress.

Understanding why some entrepreneurs exit quickly and others exit after a longer time after experiencing distress is essential for several reasons. First, when resources are tied up in distressed ventures, they are not available for more productive purposes. Second, delaying exit far beyond the point of distress can lead to firms that are “permanently failing” (Meyer and Zucker, 1989), “living dead” (Ruhnka et al., 1992), and “chronic failures” (van Witteloostuijn, 1998), all of which are simply “unproductive” (Baumol, 1990). In order to better understand the “total cost of failure” (Ucbasaran et al., 2013) including psychological, financial, and societal costs, we need to understand what drives the decision making of individual entrepreneurs concerning exit timing.

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We explore how three types of resources the firm has at the time of distress influence time to exit the venture: investment of time, investment of money, and investment in employee hiring. Using an escalation of commitment framework, we develop theory concerning why each of these types of investments might lead entrepreneurs to delay the exit of a venture that is in distress. We also want to understand how to prevent or at least mitigate unhealthy escalations of commitment of entrepreneurs to distressed ventures (Khavul et al., 2009), and suggest that one possible method is through contingency planning. We examine our hypotheses using a sample of 93 founding entrepreneurs who experienced venture distress and exit in Japan.

Our results indicate that entrepreneurs vary in the extent to which they delay exit based on the amount of investments they have made in their firm prior to the point of distress, where investments of time and money prior to the point of distress increase time to exit. Surprisingly, investment in employee hiring prior to distress does not lead to delayed time to exit in our sample. Instead it appears that the greater the number of employees at the time the entrepreneur realizes the firm is in distress, the less entrepreneurs are prone to delay that exit, and the more likely they are to quickly make the exit. Our data analyses also indicate that planning for such potential performance problems (contingency planning) helps mitigate escalation of commitment behaviors by decreasing time to exit based on investments of time and money, thereby reducing the total cost of failure for such firms.

Further, although we focused our analyses on 93 firms that were both subjectively and objectively in financial distress (entrepreneurs felt distress and were objectively unprofitable), an additional 96 firms/entrepreneurs indicated that although they were profitable, they felt that their firm was in distress and as a result exited the firm from the market. Despite objective profits, the entrepreneurs felt distress due to some economic downturn, such as a decline in sales or profitability, or profitability being below their own personal threshold. Our results concerning time to exit are remarkably similar for the profitable and non-profitable groups of distressed entrepreneurs, suggesting that regardless of the objective data that indicate whether or not these firms were profitable, the mechanisms for time to exit and contingency planning were based on the perception that one's firm was under distress and the behavioral reactions to that realization of distress, not based upon the objective indicator of distress.

## 1. Introduction

Venture failure is a fundamental element in entrepreneurship not only because it is common, but also because it can be a precursor of another emergence and future success (Aldrich, 1999; Knott and Posen, 2005; Learned, 1999; McGrath, 1999; Shane, 2001). Indeed, there is evidence that some (but not all) entrepreneurs come back from a failure and start new businesses even after being unsuccessful in their previous entrepreneurial efforts (Flores and Blackburn, 2006; Hayward et al., 2006; Hessels et al., 2011; Schutjens and Stam, 2006). Scholars have suggested that such failure recovery, including learning from failure, can be influenced by how quickly an entrepreneur exits a failed business (Jenkins, 2012; Shepherd et al., 2009; Yamakawa and Cardon, 2015). Thus the timeliness of exit is a relevant concern, yet is quite understudied (Balcaen et al., 2011).

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We focus our study on time to exit a distressed venture to add to this nascent literature. A distressed venture is defined here as one that is underperforming based on the threshold the entrepreneur has for his or her own venture (Cope, 2011; DeTienne and Cardon, 2012; Gimeno et al., 1997; Ucbasaran et al., 2013). Our focus is on firms that experience economic distress, and ultimately exit through a “distress liquidation” path (Wennberg et al., 2010) rather than firms that are able to bounce back from distress.<sup>1</sup> For many scholars and practitioners, exit by distress liquidation may well be considered a failure. Indeed, Justo et al. (2015) argue that firms in which the exits are due to poor performance can be referred to as failures, since failure includes “the cessation of involvement in a venture because it has not met a minimum threshold for economic viability as stipulated by the entrepreneur” (Ucbasaran et al., 2013: 175). Consistent with Balcaen et al. (2011), we use the term exit throughout our paper, given our focus on better understanding the time to exit a distressed firm.

We use an escalation of commitment framework to examine time to exit a distressed venture, and how it might be impacted by resource investments of time, money, and employee hiring prior to the point of financial distress. Escalation of commitment occurs when individuals continue to invest resources in a project that has produced negative financial outcomes in the past (Staw, 1976). The critical point with escalation of commitment is the decision whether (and to what extent) to allocate resources

<sup>1</sup> We include exits by both liquidation and bankruptcy, as long as the firm was under distress at the time of exit, and was closed down instead of sold (see Wennberg et al., 2010).

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