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Does corporate social responsibility engagement benefit distressed firms? The role of moral and exchange capital

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ABSTRACT

Extant literature supports the view that Corporate Social Responsibility (CSR) engagement could potentially act as a risk mitigation device. We extend this literature to address the issue of whether CSR engagement could benefit firms which are already in bankruptcy. A unique feature of our empirical tests is the decomposition of CSR into two components – moral capital and exchange capital. We find that moral capital is associated with the likelihood of a distressed firm emerging from bankruptcy. Further, moral capital appears to reduce the number of days a distressed firm spends in bankruptcy. Our empirical evidence also suggests that moral capital increases the likelihood that a distressed firm successfully negotiates a pre-packaged agreement with its creditors. Finally, our empirical results indicate that the exchange capital component of CSR is positively related to the probability of procuring debtor-in-possession financing by a distressed firm whilst in bankruptcy. Overall, our results imply that both moral and exchange capital components of CSR play a role in facilitating a firm's emergence from bankruptcy.

1. Introduction

Increasingly, institutional investors are adopting environmental, social and governance standards, which are collectively referred to as Corporate Social Responsibility (CSR), in their investment decisions (Cheng et al., 2014). Researchers have examined CSR engagement in the corporate sector through different lenses. First, the duty-aligned perspective posited by Swanson (1995) suggests that corporate moral behavior may be expressed by obligations and duties derived on the basis of rights and justice without regard to a utilitarian assessment. Second, firms follow a utilitarian perspective and implement CSR initiatives to achieve performance objectives such as enhancing profitability, returns on investment or sales growth. Some scholars label this as the strategic view of CSR, which maintains that firms engage in profit maximizing CSR (Baron, 2001; McWilliams and Siegel, 2001) and that companies "do well by doing good." Finally, the stakeholder-driven view proposes that corporations adopt social responsibility activities in response to pressures from various stakeholders. In a meta-analysis, there is mixed evidence on whether or not CSR is value-enhancing (Freeman, 1984; Orlitzky et al., 2003; Margolis and Walsh, 2003).

More recently, a strand of research has emerged which suggests that a firm's CSR activities may be used to mitigate its risk. Attig et al. (2013) suggest three channels for the CSR-risk linkage. First, by improving a firm's relations with its stakeholders, a firm enhances the long-term sustainability of the firm. Second, by engaging in CSR activities, a firm signals efficient use of its

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internal resources. Finally, by positive CSR engagement, a firm reduces the likelihood of incurring costs associated with socially irresponsible behavior. In line with their postulations, Attig et al. (2013) show a positive linkage between CSR activities of a firm and its credit rating. Kim et al. (2014) find that CSR mitigates stock price crash risk. They attribute this finding to the greater level of financial reporting transparency of socially responsible firms and less bad news hoarding behavior. Sun and Cui (2014) find a negative relationship between the level of CSR engagement of a firm and its default risk. Their finding is consistent with the Resource Based Theory (RBT) since CSR stabilizes the financial performance of a firm by enhancing corporate image and reputation (Carter, 2005). Further, Godfrey et al. (2009) propose that when negative events occur, stakeholders will punish a firm with high CSR less than comparable low CSR firms, resulting in lower loss of revenues. Finally, Branco and Rodrigues (2006) claim that engaging in socially beneficial activities builds closer relationships with governments and communities resulting in more favorable contract terms when required. Goss and Roberts (2011) find that firms with below average CSR performance pay between 8 and 17 basis points more for their bank loans. Thus, banks respond to CSR concerns of firms by offering less favorable terms.

Although there are numerous studies that link CSR with financial performance, there is no research studying the impact of CSR engagement on firms in financial distress. What is the role of prior CSR engagement? Does a firm benefit by showing itself to be a good corporate citizen? Or do stakeholders ignore good corporate citizenship when it comes at the cost of basic survival? It is not clear *ex-ante* whether a firm's socially responsible behavior will facilitate its emergence from bankruptcy. Given the lack of prior work, we therefore examine this issue empirically. We investigate four non-mutually exclusive aspects of CSR effects. First, we examine whether CSR engagement explains a firm's emergence from bankruptcy. Second, we investigate whether CSR impacts the time spent by a distressed firm in bankruptcy. Third, we study whether CSR engagement explains the probability of a distressed firm in closing a prenegotiated settlement with its creditors. Finally, we consider the impact of CSR engagement on the probability of obtaining debtor-in-possession (DIP) financing by a distressed firm.

A unique feature of our paper is the segmentation of CSR engagement into two components – exchange capital and moral capital based on Godfrey (2005) and Mattingly and Berman (2006). CSR activities targeting primary stakeholders are labelled as exchange capital since it facilitates the potential to generate beneficial exchanges between the firm and its primary stakeholders. CSR activities directed at secondary stakeholders are labelled as moral capital. We argue that moral and exchange capital play complementary roles in the context of a bankrupt firm. Our work examines the relative efficacy of moral and exchange capital components of CSR in facilitating a distressed firm to successfully emerge from bankruptcy.

Although the theoretical underpinnings of our paper are based on the work of Godfrey (2005), our empirical tests are carried out under a different setting than Godfrey et al. (2009). Godfrey et al. (2009) examined negative events such as the initiation of a lawsuit by a customer, third party or competitor, or the announcement of regulatory action including investigations, fines and penalties by a government entity. Our negative event is the filing of corporate bankruptcy under Chapter 11. The dependent variable used by Godfrey et al. (2009) is the 2-day abnormal stock return following the public disclosure of the negative event. Our primary variable of interest is the emergence of a distressed firm from Chapter 11 proceedings. Thus the window over which we expect a firm's CSR engagement to work is over a longer-term. In the setting of Godfrey et al. (2009), shareholders are the primary stakeholders who are expected to respond to a firm's moral and exchange capital. In our setting, the relevant stakeholders include shareholders, creditors, employees, suppliers, and customers.

We conduct our empirical investigations by matching US firms with available CSR scores from the *MSC*I ESG database[1] with the UCLA-LoPucki Bankruptcy Research database over the 1992 to 2014 period. We find that CSR engagement is positively associated with the likelihood of a distressed firm successfully emerging from bankruptcy. On further examination, we observe that it is the moral capital component of CSR that explains a distressed firm's emergence from bankruptcy. Exchange capital is not associated with the probability of a distressed firm's emergence from bankruptcy. Further, we find that moral capital is also associated with a decrease in the number of days spent by a distressed firm in bankruptcy. We also find that CSR engagement is positively associated with the likelihood of a distressed firm concluding a prenegotiated settlement with its creditors and this association results mainly from the moral capital component of CSR. Finally, we find that CSR engagement has an impact on the prospect of a firm obtaining DIP. Since DIP financing is a major determinant of a firm's emergence from bankruptcy, this finding is of significant importance to several key stakeholders of distressed firms. The exchange capital component of CSR is associated with the probability of securing DIP financing while the moral capital is not significant.

In summary, our results suggest that CSR engagement has significant impact on distressed firms in bankruptcy. CSR engagement explains the probabilities of a firm emerging from bankruptcy, concluding a prenegotiated settlement with its creditors, securing DIP financing and reduces the time spent in bankruptcy. Both components of CSR – moral and exchange play a role in helping a distressed firm emerge from bankruptcy.

The rest of the article proceeds as follows. In Section 2, we discuss the Literature Review and develop the hypotheses used in our empirical tests based on the theoretical underpinnings suggesting a CSR-risk management link. We also develop our main hypotheses on the relation between CSR components and emergence from bankruptcy of distressed firms. In Section 3, we describe our data, the methodology employed and the measurement of key variables used in in this study. In Section 4, we report our empirical results. In the final section, we offer our concluding remarks.

[1] *MSC*I bought the Kinder Lydenberg Domini (KLD) database in 2010. Several published research papers use the KLD database.

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