THE JOURNAL OF FINANCE • VOL. L, NO. 3 • JULY 1995

Managers of Financially Distressed Firms: Villains or Scapegoats?

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ABSTRACT

In this article, we provide evidence concerning the extent to which managers are to blame when their firms become bankrupt. We study a sample of firms that file for Chapter 11 and determine the actions taken by the firms' managers during the three-year period before the filing. We compare the sample with a control sample of firms that performed better. We suggest that the comparison provides evidence on the way managers act as their firms sink into financial trouble and whether financial distress is the result of incompetence or excessively self-serving managerial decisions or due to factors outside of management's control. We find that managers of the Chapter 11 firms and the control firms make very similar decisions and that, on average, neither set of managers is perceived to be taking value-reducing actions. These results do not change when we control for managerial turnover or managerial ownership. We also find that when managers are replaced in firms that eventually file for Chapter 11 protection, the market does not respond positively, regardless of whether the new managers are from inside or outside the firm. Our findings suggest that when managers are blamed for financial distress, they are serving as scapegoats.

WHILE WE DO NOT yet understand why some firms fail, we do know that managers get a lot of the blame. Thus, an issue that arises in the study of firm failure is the extent to which failure is related to manager actions as opposed to factors outside managerial control. That is, are the managers the villains or the scapegoats in firm failure? Managers are blamed for at least two reasons. First, managers of failed firms are viewed as less competent, and the failure is blamed on their poor judgment. Second, when the financial condition of a firm worsens, managers become more likely to take actions that harm either the whole firm or some specific stakeholders.[1] Because of these arguments, certain scholars have argued that the current bankruptcy system

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[1] The increased probability of such action occurs in financial distress either because managerial contracts do not work well under these circumstances or because agency problems between different stakeholders worsen. The potential for agency costs to increase as a firm's financial position worsens, however, is likely to be independent of the identity of the management.

that allows existing management to remain in control of the firm when it comes under court supervision hurts the various stakeholders of the firm.[2]

Courts and legislatures, though, have tended to permit existing managers to continue making decisions even after a firm has declared bankruptcy. This suggests that lawmakers are not swayed by the argument that existing managers in failed firms are incompetent and/or especially prone to self-serving behavior. Though some may ascribe this posture to rent seeking (lawmakers responding to considerations other than economic efficiency), there is intellectual support for the existing system from scholars such as Fama (1980) and Easterbrook (1990). They suggest that the existing legal and corporate governance arrangements, along with managerial labor markets and the structure of the bankruptcy law, control managerial behavior adequately. Thus, those who support the existing structure of bankruptcy law are rejecting the argument that there are large costs to maintaining existing management in a bankrupt firm. They are assuming that firm failure is due to factors outside managerial control and that blaming managers is simply scapegoating.

This article considers empirically whether firms fail because of poor managerial decisions. We examine the reported decisions of managers of financially distressed firms for three years before the firms filed for Chapter 11 protection. To establish whether managers in the Chapter 11 firms made poor decisions, we compare their decisions to the ones made by managers of a control sample, matched by industry and size, that did not experience financial distress. We document the average abnormal stock price reaction to the manager's actions in both samples and whether there were significant differences in the market's response to the same action across samples.

We also study the market's reaction to managerial turnover and whether the market's perception of the quality of managerial decisions was related to turnover in the firm. We follow this with an analysis of whether any differences in the market's perception of managerial actions were supported by similar changes in fundamental performance measures. We believe that these comparisons can help us distinguish between scapegoating and poor or excessively self-serving management.

When we compare managerial actions across the two samples, we observe that in the three years before filing for bankruptcy protection Chapter 11 firms engaged in asset sales, plant closings, reductions in personnel, acquisitions and expansions, new debt and equity issues, equity for debt swaps, and debt restructuring. Except for a greater frequency in the Chapter 11 sample, especially in those firms with managerial turnover, these decisions were quite similar to those by firms in the control sample. When we examine the market reaction to the announcement of the decisions, we find that, on average, it is similar for the same decision across samples. These observa-

[2] For detailed critiques of current bankruptcy laws, see Baird (1986), Wruck (1990), and Bradley and Rosenzweig (1992).

tions suggest that the managers of distressed firms are not perceived to be taking value-decreasing or poor decisions before the Chapter 11 filing.

Our results from examining the market reaction to announcements of managerial turnover also do not support the premise that managers are taking actions inconsistent with stockholder interests. Given the additional concerns of incompetence and worsening agency problems in financially distressed firms, one might expect to observe a positive reaction to managerial replacement, especially in these firms. However, we observe that the reaction to turnover is significant but negative for both the financially distressed and control samples. To investigate this result further, we subdivide the sample of turnover announcements into those with internal replacement of managers and those with external replacement. We find no significant difference between these categories although earlier researchers have found some evidence that the distinction is important. If the negative reaction to managerial turnover had been concentrated in those firms where turnover came from within, then internal replacement could reflect the bad news of "business as usual" and that current managers were perceived to be at fault in causing the financial distress. Thus, our evidence does not support the hypothesis that managers are the villains in Chapter 11 firms.

We find some evidence of the market's lack of confidence in existing managers of financially distressed firms in the differential reaction to the downsizing decisions by firms with no managerial turnover versus those with managerial turnover. The reaction is strong and positive for financially distressed firms with managerial turnover, while insignificantly different from zero for the other financially distressed firms. These results provide some support for the hypothesis that the market perceives the management in the no-turnover subsample to be entrenched. Note, however, that we still do not find negative reactions to managerial decisions in the firms with no turnover. Also, when we compare actual performance measures between the turnover subsamples, we find no significant differences.[3]

There are several caveats with respect to our results. First, while we measure managerial behavior through reported news stories of actions taken by successful and unsuccessful managers, this is only a crude measure of managerial decision making. For example, we do not measure market response to a bad strategy implemented over time or poor execution of an announced project. Second, event study analysis only determines the value of the unanticipated portion of any announcement. If it is widely known that the firm is in financial distress and it is expected that managers will make poor decisions, the observed decisions may simply be no worse than the expectations. Third, we do not consider the impact of managerial decisions on bondholder wealth due to the scarcity of bond price data. The observed

[3] Jensen and Murphy (1990) find a low pay-for-performance sensitivity, suggesting that incentive contracts may not be the optimal means to controlling managers. The results of our article suggest an alternative hypothesis. There may be a low sensitivity of pay to performance because managers act very similarly and appear to have little effect on firm fundamentals.

managerial decisions may be affecting the riskiness of the firm, lowering the value of the fixed claims against the firm's assets, and, in effect, transferring wealth from the bondholders to stockholders. While we have no direct evidence to this point, we find no indication in news stories that bondholders objected to the managerial decisions.

The article is organized as follows. In the next section we discuss the role of managers in firms that file for Chapter 11 protection, i.e,. are they villains or the scapegoats in these firms. In the second and third sections, we outline our data, methodology, and report our empirical results. We provide concluding comments in the last section.

I. The Debate: Villains or Scapegoats?

Jensen's (1993) Presidential Address to the American Finance Association discusses the recent exit of many firms from product markets. Excess capacity exists in large sectors of the economy due to changes in economic conditions, regulation, technology, organizational innovation, globalization of trade, and even the political economy of formerly non-market-oriented economies. In such an environment, the liquidation of some existing firms is essential to a healthy economy, recalling Schumpeter's (1942) theory of "creative destruction."

Lang and Stulz (1992) find evidence supporting the importance of industry, rather than firm-specific, factors in firm bankruptcy. They find that the announcement of bankruptcy by one firm in an industry leads to a negative wealth effect on the remaining firms. John, Lang, and Netter (1992) lend additional support for the importance of external considerations, finding that managers are much more likely to blame exogenous factors rather than themselves for their financial difficulties. Denis and Denis (1995a) examine a sample of 29 leveraged recapitalizations between 1985 and 1988 and also find that external factors such as recession and regulatory initiatives are important in causing financial distress in these firms. In contrast, Asquith, Gertner, and Scharfstein (1994) find evidence for the importance of firm-specific factors in bankruptcy. They find that most firms end up in distress because they underperform their industry, as opposed to having too much leverage or operating in a poorly performing industry. Opler and Titman (1994) also find evidence connecting firm-specific factors to financial distress. They report that highly leveraged firms within a poorly performing industry are more likely to lose substantial market share than are less leveraged firms within the same industry.

Studies of managerial turnover find evidence that markets discipline managers of poorly performing firms, though these studies do not answer the question of managerial responsibility for the poor performance. Gilson (1989, 1990) and Kaplan and Reishus (1990) report that managers in poorly performing firms are more likely to be replaced and less likely to find new

positions. Similarly, Cannella, Fraser, and Lee (1995) report that managers associated with banks that failed for reasons beyond the managers' control were twice as likely to regain similar positions as managers at other failed banks.[4]

Various attempts have been made to determine whether managers are to blame for poor performance by examining changes in organization performance following managerial changes or by measuring market reaction to managerial changes. Early research in this area focused on performance of sports teams after changes in managers and supports the notion of "ritual scapegoating." Gamson and Scotch (1964) studied 22 midseason changes in baseball managers and found little evidence of subsequent improvement in team performance.[5] Similar studies for business firms are not conclusive. For example, DeAngelo (1988) finds that new managers following successful proxy contests are likely to take an earnings "bath" by adjusting discretionary accounts in their first year, thus resulting in improved accounting performance in later years. Other studies focus on small samples or single industries, with conflicting results. (See Furtado and Karan (1990) for a summary of this research.) Weisbach (1995), however, does find evidence that the probability of selling a poorly performing acquisition increases after managerial changes. Denis and Denis (1995b) find that forced top management changes are followed by significant improvements in operating performance, although normal turnover is not, and Mulherin and Poulsen (1994) report improvements in performance following proxy contests.

Additional research has examined the market reaction when managers are replaced. While most of this research reports insignificant returns at the announcement of managerial turnover, there is evidence of significant market reactions to various subsamples. For example, Warner, Watts, and Wruck (1988) report significant positive reaction to managerial replacement only when the new managers come from outside the firm. Reinganum (1985) finds this result only for small firms, while Furtado and Rozeff (1987) find significantly lower reactions for external replacements only in large firms. Bonnier and Bruner (1989) and Lubatkin *et al.* (1989) find that news of external managerial replacements in high-performing firms is greeted positively but do not find the same result in poorly performing firms.

Our article adds to this debate by comparing reported decisions of a sample of firms in financial distress against those of a sample of firms not in financial distress. By focusing on actual managerial decisions and the market's response to them, we provide further evidence on the relative importance of managerial decisions in distressed firms.

[4] See Coughlan and Schmidt (1985), Warner, Watts, and Wruck (1988), and Mitchell and Lehn (1990) for similar evidence on managerial turnover in poorly performing firms.

[5] See also Eitzen and Yetman (1972) and Brown (1982) for similar results.

II. Chapter 11 Firms and the Control Sample

We obtained from the U.S. Securities and Exchange Commission (SEC) a listing of all public firms filing for bankruptcy protection under Chapter 11 of the Bankruptcy Code. From this original list, we restricted our sample to those firms that have accounting data available on the 1991 COMPUSTAT database and stock return data on the 1991 Center for Research in Securities Prices (CRSP) database. After these restrictions, we have a sample of 128 firms filing for Chapter 11 protection from 1980 through 1990.

Table I provides some details about these firms. The fewest number of firms filing for Chapter 11 protection was in 1981 (5 filings); the largest number of firms was in 1982 and 1987, with fifteen filings in each year. Average book value of assets in each year, measured in the year prior to the filing, ranges from $27.0 million to $2.7 billion. The average for the full sample of 128 firms is $981.3 million. There is less dispersion in the median size of firm, however. Over the 11 years of our study, the median firm size is $51.1 million, ranging from a low $29.5 in 1980 to $317.7 million in 1990.

To better understand the actions of managers of firms in financial distress, we select a control sample that is similar to the Chapter 11 firms in size and industry. To construct the control sample, we determine the Standard Industrial Classification (SIC) code for each of our Chapter 11 firms and compare it to firms with the same SIC code listed in COMPUSTAT. We then choose the firm that is closest to the Chapter 11 firm in value of assets in the year preceding the Chapter 11 filing. Table I provides some details on these firms. Median value of assets is $87.5 million, ranging from a low of $20.3 million in 1980 to a high of $289.2 million in 1990. Our control sample consists of only 118 firms because, especially in those industries in which there were several bankruptcies, there were no possible alternative matches since we allowed the control firm to enter the sample only once.

Table II provides additional comparisons between the Chapter 11 and control samples using COMPUSTAT data. These data help establish the worsening positions of the Chapter 11 firms during the period of our study. The firms in the control sample are similar to the financial distress sample in size, as measured by sales and the book value of assets in the three years before the Chapter 11 filing. Using the Wilcoxon test statistic to test for differences in medians, we find that these absolute measures of size were insignificantly different between the financial distress and control firms.[6] We do find, as expected for firms in financial distress, evidence of the decline in the Chapter 11 firms relative to the control firms. The Chapter 11 firms experience significantly greater declines in sales, book value of assets, and return on assets from three years before to one year before the Chapter 11 filing.

[6] The averages were also insignificantly different. We focus on tests of differences in medians due to the skewness observed in accounting data.

Table I

Number of Firms and Value of Assets (in Millions of Dollars) of Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990, By Year

	Chapter 11 Firms		Control Sample	
Year	Number	Average (Median) Value of Assets	Number	Average (Median) Value of Assets
1980	9	27.0 (29.5)	6	58.2 (20.3)
1981	5	479.1 (37.1)	4	163.5 (44.5)
1982	15	435.4 (195.0)	13	228.6 (73.8)
1983	7	118.9 (69.3)	7	118.5 (69.1)
1984	8	254.3 (32.1)	8	69.1 (46.1)
1985	17	219.1 (61.5)	17	234.0 (104.2)
1986	12	728.8 (92.6)	12	594.3 (154.0)
1987	15	2441.8 (39.5)	12	587.9 (68.7)
1988	14	2746.3 (194.0)	14	1125.1 (221.7)
1989	14	1009.4 (40.1)	14	770.9 (68.9)
1990	12	991.6 (317.7)	11	882.7 (289.2)
Full sample (1980–1990)	128	981.3 (51.1)	118	506.6 (87.5)

III. The Market Perspective on Managers and Their Actions

We use the *Dow Jones News Retrieval* system to identify news about managerial turnover and actions taken by the managers of firms in our Chapter 11 and control samples. We examined all stories reported on this system for the three years preceding the Chapter 11 filing for each firm and its respective control match. In addition to managerial turnover, we identify

Table II

Measures of Size, Performance, and Financial Soundness (in Millions of Dollars) for Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990

	Chapter 11 Firms	Control Firms	Wilcoxon Test Statistic for Difference in Medians
Panel A: Sales Before Filing			
Three years before			
Mean	846.9	358.6	−1.50
Median	96.9	86.7	
Number of observations	122	110	
Change in sales from three years to one year before			
Mean	−0.100	0.234	5.35**
Median	−0.191	0.144	
Number of observations	122	110	
Panel B: Book Value of Assets Before Filing			
Three years before			
Mean	962.0	502.7	0.71
Median	83.6	90.6	
Number of observations	123	111	
Change in value of assets from three years to one year before			
Mean	−0.088	0.256	5.51**
Median	−0.194	0.118	
Number of observations	123	111	
Panel C: Operating Income/Assets Before Filing			
Three years before			
Mean	−0.042	0.032	4.88**
Median	0.003	0.033	
Number of observations	122	111	
Change in operating income/assets from three years to one year before			
Mean	−21.9	−4.49	−8.19**
Median	−6.61	−0.245	
Number of observations	83	83	

*, ** Indicates that the medians are significantly different at the 90 percent (95 percent) level. All data from COMPUSTAT.

several broad categories of managerial actions, including changes in operations such as downsizings (plant closings, asset sales, layoffs, etc.), acquisitions and expansions by the firm, and changes in financing arrangements such as changes in debt arrangements (loan extensions, credit agreements, and new debt), debt swaps, issuances of common or preferred stock, and stock buybacks. Table III details the number of firms announcing each of these events and the number of independent announcements.

Announcements of downsizings were the most common type of managerial action reported in the *Dow Jones New Retrieval* system. Fifty-two of the Chapter 11 firms made 187 separate announcements of plant closings, layoffs, asset sales, or downsizing plans. Fifty-four control firms made 148 similar announcements. Announcements of acquisitions and expansions, new debt, or credit extensions were also common in both samples. Some events were more frequently announced in the Chapter 11 sample (such as debt swaps), while some events were more frequent in the control sample (issuance of stock and stock buybacks.)

We use event study methodology to determine the market reaction to the announcement of managerial turnover and managerial actions. The parameters of the market model are estimated from 170 days to 21 days before the announcement. From these parameters, we determine abnormal stock returns at the event announcement, reporting here the announcement effect from the day before the event to the day of the announcement and from five days before to one day after the announcement. We use z-statistics for the standardized prediction errors to determine significance levels. (See, for example, Dodd and Warner (1983) for a more complete description of the methodology.)

A. Market Reaction to Managerial Actions

We consider the market perspective on the various actions taken by the managers in the three years prior to the Chapter 11 filing. Across the categories in which we can make direct comparisons between the Chapter 11 firms and the control firms, we generally find similar market reaction to managerial actions as reported in Table IV. Restructuring of the firms in terms of plant closings, layoffs, asset sales, or "downsizing" is good news, on average, in both samples. The average abnormal return for the Chapter 11 firms is 2.55 percent and for the control sample is 1.30 percent from the day before to the day of the announcement, both significantly different from zero and not significantly different from each other. The results for the longer window from five days before to one day after the announcement are similar. Thus, the evidence indicates that managers of both samples were viewed as making good decisions of similar quality, independent of the health of the corporation.

In addition to these downsizing announcements, firms in both samples made numerous acquisition or expansion announcements. The 72 expansion announcements by the control group are associated with significantly positive

Table III

Frequency of News Announcements Reported on *Dow Jones News Service* for Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990

Category of News Story	Chapter 11 Firms	Control Sample
Panel A: Changes in Top Management		
Number of firms	52	42
Number of stories	149	76
Average per firm	2.9	1.8
(max., med., min.)	(13, 2, 1)	(6, 1, 1)
Panel B: Plant Closings, Layoffs, Asset Sales or Downsizing		
Number of firms	52	54
Number of stories	187	148
Average per firm	3.6	2.7
(max., med., min.)	(23, 2, 1)	(16, 3, 1)
Panel C: Acquisitions and Expansions		
Number of firms	19	34
Number of stories	38	82
Average per firm	2.0	2.4
(max., med., min.)	(5, 2, 1)	(11, 2, 1)
Panel D: Loan and Credit Agreement Extensions, and New Debt		
Number of firms	40	19
Number of stories	87	24
Average per firm	2.2	1.3
(max., med., min.)	(11, 1, 1)	(3, 1, 1)
Panel E: Debt Swaps		
Number of firms	16	5
Number of stories	20	5
Average per firm	1.25	1
(max., med., min.)	(3, 1, 1)	(1, 1, 1)
Panel F: Issuance of Common or Preferred Stock		
Number of firms	11	32
Number of stories	15	48
Average per firm	1.4	1.5
(max., med., min.)	(3, 1, 1)	(5, 1, 1)
Panel G: Stock Buybacks		
Number of firms	0	13
Number of stories	0	20
Average per firm	0	1.5
(max., med., min.)	(0, 0, 0)	(4, 1, 1)

returns, averaging 1.22 percent for days $(-1, 0)$, while the 33 made by the Chapter 11 firms are associated with insignificant returns, negative in the short window, and positive in the longer window. The Chapter 11 cumulative average returns (CARs) are significantly lower than the returns for the control group in the short window. This is the only case in which we find managers of Chapter 11 firms making significantly worse decisions, although note that the returns associated with the acquisition announcements are not significantly negative.[7]

Announcements of debt financing, including new credit agreements, new debt issuances, and loan extensions are associated with insignificant abnormal stock returns in both samples, and the returns are insignificantly different from each other across the two samples. Debt swaps, which were primarily observed in the Chapter 11 sample, are associated with positive stock returns, although the abnormal returns for both the short and long windows are not significantly different from zero.

New stock issuances were primarily observed in the control sample (48 announcements) as compared to the Chapter 11 sample (15 announcements). The small negative announcement effect for the Chapter 11 and control firms is consistent with the literature concerning equity offerings. (See, for example, Asquith and Mullins (1986)). The CARs from the two samples are not significantly different from each other.

Overall, we find little evidence that actions taken by managers of firms that end up in Chapter 11 are different from those of other managers or that the market views the actions as bad decisions. While it is true that we can only measure the unanticipated abnormal return to these announcements, the absence of significant negative returns to their actions suggests that managerial incompetence is not the reason these firms end up in financial distress. Since the actions taken by these managers are similar in nature to those of the control sample, our results do not support the view that over- and underinvestment problems or examples of just plain incompetency are worse in financially distressed firms.

B. Managerial Replacement

An important measure of managerial responsibility for financial distress is the market reaction to the replacement of managers in financially distressed firms. As discussed above, the literature on managerial turnover generally finds little significant stock price reaction to managerial turnover. Warner, Watts and, Wruck (1988), for example, find an insignificant average market

[7] Mitchell and Lehn (1990) find that managers making bad acquisitions are more likely to be removed through takeovers than other managers. In our Chapter 11 sample, managers make worse decisions than in the control firms yet are not taken over. This is by construction, however, since we have only firms that are in Chapter 11 and that are not acquired. It may be that the firms are not acquired because alternative management teams do not believe new managers would significantly improve firm performance.

Table IV

Cumulative Abnormal Returns (CAR) from Five Days Before to One Day After (−5, +1) and from One Day Before to the Day of (−1, 0) the News Announcement for Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990

	Chapter 11 Firms		Control Sample	
Category of News Story	(−5, 1)	(−1, 0)	(−5, 1)	(−1, 0)
Panel A: Plant Closings, Layoffs, Asset Sales, or Downsizing				
CAR	2.28	2.55	0.95	1.30
z-Statistic	1.80*	4.00**	1.61	3.61**
Percent negative	46.3	44.5	50.5	44.1
Number of observations	153	146	103	102
Panel B: Acquisitions and Expansions				
CAR	0.73	−0.85	1.72	1.22
z-Statistic	0.59	−0.91	1.65*	2.22**
Percent negative	45.5	57.5	42.2	46.5
Number of observations	33	33	72	71
Panel C: Loan and Credit Agreement Extensions and New Debt				
CAR	−1.45	0.28	−0.18	−1.24
z-Statistic	−1.89*	0.61	0.38	−1.83*
Percent negative	56.9	44.5	61.1	61.1
Number of observations	73	71	18	18

Table IV—*Continued*

Category of News Story	Chapter 11 Firms		Control Sample	
	(−5, 1)	(−1, 0)	(−5, 1)	(−1, 0)
Panel D: Debt Swaps				
CAR	2.57	2.55	3.82	4.45
z-Statistic	−0.41	0.33	0.20	0.47
Percent negative	47.4	52.6	75.0	50.0
Number of observations	19	19	4	4
Panel E: Issuance of Common or Preferred Stock				
CAR	−1.41	0.93	−0.33	−0.94
z-Statistic	−0.62	0.14	0.06	−0.50
Percent negative	50.0	44.5	54.8	45.2
Number of observations	12	12	31	31
Panel F: Stock Buybacks				
CAR			3.70	1.76
z-Statistic			9.09**	3.68**
Percent negative			20.0**	46.7
Number of observations			15	15

*, ** Indicates the percent of negative CARs observed is significantly different from 50 percent or the CAR is significantly different from zero at the 90 percent (95 percent) level.

response to a sample of 279 managerial changes reported in the *Wall Street Journal*, although they do report a significant positive reaction to managers that are replaced from outside the firm.

In contrast, the announcements of managerial changes in our study are associated with negative announcement effects. The negative effects occur in both windows, significantly so in the Chapter 11 sample for the longer window and in the control sample for the shorter window, as reported in Table V. If managers were the villains in the Chapter 11 firms, we would expect positive stock price reaction to replacement of the firm's existing managers. The opposite result suggests that managerial replacement is not seen as a cure for the firm in financial distress.

It is possible, of course, that announcements of changes in management provide additional information to the market. For example, it could be that stockholders do not realize the bad state their company is in, and the announced turnover tells them about the impending Chapter 11. We attempt to control for this effect in several ways. First, in each news story about

Table V

Cumulative Abnormal Returns (CAR) from Five Days Before to One Day After (−5, +1) and from One Day Before to the Day Of (−1, 0) the News Announcement of Managerial Turnover for Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990

	Chapter 11 Firms		Control Sample	
Category of News Story	(−5, 1)	(−1, 0)	(−5, 1)	(−1, 0)
Panel A: Changes in Top Management				
CAR	−0.96	−0.09	−1.67	−1.22
z-Statistic	−2.09**	−1.02	−1.36	−2.46**
Percent negative	59.5**	55.0	64.6**	61.5*
Number of observations	121	120	65	65
Panel B: Internal Managerial Turnover				
CAR	−0.12	0.00	−1.14	−0.83
z-Statistic	−1.55	−0.94	−0.71	−1.53
Percent negative	58.4	55.2	64.4	55.6
Number of observations	77	76	45	45
Panel C: External Managerial Turnover				
CAR	−2.42	−0.26	−2.85	−2.09
z-Statistic	−1.42	−0.44	−1.40	−2.15**
Percent negative	61.4	54.5	65.0	75.0*
Number of observations	44	44	20	20

*, ** Indicates the percent of negative CARs observed is significantly different from 50 percent or the CAR is significantly different from zero at the 90 percent (95 percent) level.

managerial turnover we determine whether there is bad news explicitly recognized in the story. In only 6 of the 121 turnover announcements for Chapter 11 firms, and 4 of the 65 announcements for control firms, do we find any mention of negative events at the firm. The exclusion of these announcements does not affect the results substantively. We also consider whether replacement of managers in the year of the Chapter 11 filing (when evidence concerning managerial incompetence might be better known) as opposed to the year before, or two or more years before, the Chapter 11 filing affects the market reaction to the replacement. In the earlier time periods, the announced turnover might provide the first information to the market about the firm's poor position and impending financial distress. Overall, however, we find no significant difference across time.

We also investigate whether there are cross-sectional differences in the market reaction to managerial replacement based on the background of the new manager. We consider whether managers were replaced from inside or outside of the firm. We find that the identity of the new manager does not affect the market perception of the turnover in financially distressed firms (nor in our control sample). In those cases where the new manager comes from inside the financially distressed firm, the market response averages -0.12 percent (insignificantly different from zero) compared to an average insignificant -2.42 percent for external replacements. These results are not significantly different from each other. If managers were to blame for at least some of the financially distressed firm's problems, investors might perceive internal replacement as a continuation of the status quo and view it negatively. External replacement, on the other hand, would be viewed by investors as a step toward turning the firm around—or at least minimizing the losses from the financial distress. We do not find, however, that internal replacement is viewed more negatively than external replacement.

C. Managerial Replacement and Managerial Actions

Managers may have the strongest incentives to maximize shareholder value in those firms where turnover occurs because of the perceived ability of the board of directors and/or shareholders to discipline poorly performing managers. We look at the announcement effects associated with the managerial actions identified in Section III.*A* on the basis of whether they occurred in firms with turnover or no turnover. Forty-two percent of the Chapter 11 firms and 36 percent of the control firms experienced turnover during the three years studied. While the percentage of firms with turnover was not significantly different between the two samples, the Chapter 11 firms changed more managers per firm (median of 2 versus median of 1 for the control sample firms). We also find that, if turnover occurs, firms in the Chapter 11 sample are significantly more likely to have external replacement than the control sample (62 versus 38 percent). Managers of Chapter 11 firms with turnover tended to be more active in terms of the actions measured here than

Table VI

Cumulative Abnormal Returns (CAR) from Five Days Before to One Day After (−5, +1) and from One Day Before to the Day of (−1, 0) the News Announcement for Firms Filing for Chapter 11 Protection and Control Sample, 1980 to 1990, by Managerial Turnover

	Chapter 11 Firms		Control Sample	
Category of News Story	(−5, 1)	(−1, 0)	(−5, 1)	(−1, 0)
Panel A: Plant Closings, Layoffs, Asset Sales, and Downsizing				
No Managerial Turnover				
CAR	1.17	1.83	1.63	1.43
z-Statistic	−0.51	0.91	1.25	2.54**
Percent negative	47.9	42.5	50.0	47.4
Number of observations	48	47	38	38
Managerial Turnover				
CAR	2.80	2.89	0.56	1.23
z-Statistic	2.53**	4.23**	1.06	2.60**
Percent negative	45.6	45.5	50.8	42.2
Number of observations	103	99	65	64
Panel B: Acquisitions and Expansions				
No Managerial Turnover				
CAR	−2.57	0.43	0.51	0.53
z-Statistic	−0.80	−0.28	−0.13	0.62
Percent negative	50.0	50.0	55.9	52.9
Number of observations	6	6	34	34
Managerial Turnover				
CAR	1.47	−1.13	2.84	1.85
z-Statistic	1.03	−0.87	2.42**	2.48**
Percent negative	44.4	59.4	29.7**	40.5
Number of observations	27	27	37	37

Table VI—*Continued*

Category of News Story	Chapter 11 Firms (−5, 1)	Chapter 11 Firms (−1, 0)	Control Sample (−5, 1)	Control Sample (−1, 0)
Panel C: Loan and Credit Agreement Extensions and New Debt				
No Managerial Turnover				
CAR	−4.65	0.56	2.24	0.12
z-Statistic	−3.40**	−0.53	1.54	−0.42
Percent negative	65.4	40.0	62.5	62.5
Number of observations	26	25	8	8
Managerial Turnover				
CAR	0.35	0.13	−2.11	−2.33
z-Statistic	0.19	1.15	−0.87	−2.07*
Percent negative	52.2	45.6	60.0	60.0
Number of observations	46	46	10	10
Panel D: Debt Swaps				
No Managerial Turnover				
CAR	5.11	0.12	5.46	5.72
z-Statistic	0.77	0.04	0.30	0.47
Percent negative	33.3	55.5	66.7	66.7
Number of observations	9	9	3	3
Managerial Turnover				
CAR	0.28	4.72	−1.10	0.64
z-Statistic	−1.30	0.43	−0.11	0.12
Percent negative	60.0	50.0	100.0	0.0
Number of observations	10	10	1	1
Panel E: Issuance of Common or Preferred Stock				
No Managerial Turnover				
CAR	3.56	7.08	−1.05	−0.70
z-Statistic	0.65	2.28*	−0.32	0.28
Percent negative	0 *	0 *	60.0	53.3
Number of observations	4	4	15	15
Managerial Turnover				
CAR	−3.90	−2.14	0.35	−1.17
z-Statistic	−1.23	−1.44	0.39	−0.97
Percent negative	75.0	62.5	50.0	37.5*
Number of observations	8	8	16	16

*, ** Indicates the percent of negative CARs observed is significantly different from 50 percent or the CAR is significantly different from zero at the 90 percent (95 percent) level.

their counterparts in the Chapter 11 firms without turnover. New managers may be brought in with a mandate to take specific actions, or they are more likely to make decisions to establish their authority. The increased managerial activity when there is turnover, although also visible in the control sample, is much less pronounced and confined essentially to downsizing decisions. Weisbach (1995) also found that firms with managerial turnover were more active in selling unprofitable divisions than firms without turnover.

In Table VI, we report the CARs associated with various managerial actions on the basis of whether there was no turnover or turnover.[8] In general, there is little significant difference between the announcement effects. However, with respect to plant closing, layoff, and downsizing announcements, we find that the market reaction is significantly positive for the financially distressed firms with turnover, while positive but insignificantly different from zero (and significantly lower than the turnover category) for downsizing decisions by financially distressed firms with no turnover. We find no such differences in the control sample. These results suggest that while status quo managers are not viewed as taking actions that could, ex ante, keep the firms out of Chapter 11, significant operating decisions taken by new managers are viewed as helping the firm's expected future cash flows.[9] However, since we do not find that the managers in the no-turnover firms are making bad decisions (the market reaction is still positive though insignificant), it may simply be that there are fewer opportunities for profitable downsizing decisions in the no turnover sample.[10]

To determine whether differences in the market perception of managerial actions translates into corresponding differences in actual performance measures, we examine the basic accounting performance measures for each group. Table VII reports no significant differences between firms with turnover and firms without turnover in performance in terms of changes in

[8] We also considered whether internal or external replacement of managers led to any significant differences in shareholder wealth at the announcement of these events. We found no significant differences. While this distinction seemed to be important to turnover in general, it may be that sample size is diminished too much by the three-way classification to identify significant differences.

[9] In the results reported here, we include all announcements whether they occur before or after the first instance of turnover. The decision to include all announcements rather that only those occurring after the first turnover is based on the premise that managers realize their own vulnerability whether or not there has been a recent turnover. If we exclude those announcements before the first turnover, we lose 13 plant closing and 8 credit extension announcements. Our results are substantively the same, although we lose the significance of the difference in the plant closing announcements.

[10] Managers have stronger incentives to choose better projects for their firms when they have higher shareholdings, since they benefit more from any share appreciation. (See, for exmaple, Mørck, Shleifer, and Vishny, 1988.) We also consider whether managerial holdings affect the relative announcement effects for the managerial actions studied here. We find no significant differences based on low or high managerial holdings.

Table VII

Measures of Size, Performance, and Financial Soundness (in Millions of Dollars) for Firms Filing for Chapter 11 Protection, by Managerial Turnover, 1980 to 1990

	No Managerial Turnover	Managerial Turnover	Wilcoxon Test Statistic for Difference in Medians
Panel A: Sales Before Filing			
Three years before			
Mean	213.1	2195.9	3.91**
Median	84.4	304.5	
Number of observations	83	39	
Change in sales from three years to one year before			
Mean	−0.171	0.051	1.57
Median	−0.231	−0.128	
Number of observations	83	39	
Panel B: Book Value of Assets Before Filing			
Three years before			
Mean	597.9	1746.4	3.31**
Median	57.5	235.4	
Number of observations	84	39	
Change in value of assets from three years to one year before			
Mean	−0.117	−0.026	0.87
Median	−0.199	−0.180	
Number of observations	84	39	
Panel C: Operating Income/Assets Before Filing			
Three years before			
Mean	−0.044	−0.039	−0.104
Median	0.002	0.007	
Number of observatons	83	39	
Change in operating income/assets from three years to one year before			
Mean	−25.4	−14.9	0.62
Median	−6.62	−6.61	
Number of observations	42	21	

*, ** Indicates that the medians are significantly different at the 90 percent (95 percent) level. All data from COMPUSTAT.

sales, book value of assets, or return on assets from three years to one year before the Chapter 11 filing. Thus, while the market may appear to prefer some actions taken in firms with managerial turnover, there does not appear to be any real consequences in terms of better performance.

IV. Conclusion

In this article, we provide evidence concerning the extent to which managers are to blame in firms that become bankrupt. We study a sample of firms that end up in severe financial distress to determine the actions taken by firms' managers as their financial positions worsen. We compare this sample with a control sample of firms that performed better. We suggest that the comparison provides evidence on the way managers act as their firms sink into financial trouble and the extent to which financial distress is the result of incompetence or excessively self-serving managerial decisions or due to factors outside of management's control.

We find that managers of Chapter 11 firms and the control firms make very similar decisions and that, on average, neither set of managers is perceived to be taking value-reducing actions. We also find that when managers are replaced in the firms that eventually file for Chapter 11 protection, the market does not respond positively, whether replacement comes from inside or outside of the firm. These findings support the idea that financial distress is due to conditions outside the control of managers.

The active market for corporate control, including the explosion in the number of mergers, proxy contests, and hostile takeovers in the 1980s, suggests that there are managers that are perceived to be bad in many corporations. However, even though the Chapter 11 firms are in severe financial distress, it does not seem that their problems are "fixable" through a corporate takeover. Overall, our results suggest that failure is not the result of managers making less competent decisions than their competitors or taking actions that are inconsistent with shareholder wealth maximization. As such, our results support Fama's (1980) claim that markets do a good job in screening out bad managers and in aligning managerial incentives with stockholder interests.

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