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IS MANAGERIAL ENTRENCHMENT ALWAYS BAD? A CSR APPROACH [†]

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Abstract

In this paper, we argue that managerial entrenchment may be positive when there is excessive external pressure from financial markets. In these situations, managers have more freedom to implement value-enhancing strategies, such those related to corporate social responsibility (CSR) activities. This is a *good-type* of entrenchment. On the other hand, when the external pressure is not so high, given that the pressure is from inside the firm, managerial entrenchment is bad and the use of CSR investments may exacerbate the agency problem. We prove this claim in an empirical study conducted of 279 international firms that operate in 22 different countries for the period 2002-2005. These firms participate in two different institutional contexts: that of the Anglo-Saxon countries, where the pressure of financial markets is intensive, or that of the Continental European countries in which the corporate control mechanisms are mainly internal.

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Traditionally, managerial entrenchment has been considered to be one of the costliest manifestations of agency problems (Jensen & Ruback, 1983). Managers, who obtain substantial private benefits from being in control and yet are only responsible for a small amount of its associated costs, are able to pursue costly entrenchment strategies in order to keep their positions, even when they are not sufficiently competent or qualified to manage a company (Shleifer & Vishny, 1989). There is a variety of entrenchment practices that managers may employ (Walsh and Seward, 1990), such as poison pills, supermajority amendments, anti-takeover devices, or the so-called golden parachutes (Dahya *et al*., 1998; De Miguel *et al.*, 2004; Denis *et al*., 1997; Morck *et al.* 1988; Stulz, 1988). Maintaining such managers in these positions leads to an expropriation of investor wealth or an inadequate assignment of company resources (Shleifer & Vishny, 1997).

However, some researchers (e.g., Sundaramurthy, 2000) have indicated that there are some circumstances where management entrenchment may lead to an improvement in company results or, at the least, may do nothing to harm them. Within the context of a highly active capital market centered on short-term returns, the adoption of entrenchment practices would generate a type of long-term contract; this would enable management to feel more protected in order to carry out specific investments whose returns occur over a longer period of time. Also, Rajan and Wulf (2006) argued that managerial perks, which are generally related to the implementation of managerial entrenchment strategies, may have positive effects on managerial productivity and which, in turn, may improve financial performance.

Taking these differing perspectives into account, the present study analyzes the relationship between management entrenchment, creation of value for the shareholders and a very specific type of investment, that of corporate social responsibility. Corporate social responsibility (CSR) may play a role in both of the following cases: when managerial entrenchment is positive and also when it has negative consequences for a firm's performance.

On the positive side, in those environments in which firms suffer substantial pressure from the outside (e.g., in Anglo-Saxon countries), managers may implement entrenchment strategies not only for their short-term survival but also to be able to invest in value-enhancing long-term projects. In most cases, the development of these projects requires that stakeholders' specific investments be stimulated by means of CSR activities. Within this context, the protection provided by anti-takeover devices and other entrenchment mechanisms gives the manager enough slack to implement these social activities (McGuire *et al*., 2003). It is through such social activities that a group of intangible assets are generated and, with them, financial performance will increase (Waddock & Graves, 1997).

On the negative side, when the pressure from external (market) corporate governance mechanisms is less intense, managerial entrenchment does not serve to correct a high-pressure situation; in this context, managers do not need to establish a minimum of flexibility to determine optimal investment strategies. In a low-external pressure framework, managerial entrenchment only pursues managerial survival as an objective in itself. In such a context, CSR activities only reinforce the negative aspects of managerial entrenchment and, in fact, CSR is an integral part of the manager-

designed entrenchment strategy (Surroca & Tribó, 2008). This is so because when external market mechanisms are less developed (e.g, in Continental Europe), traditional entrenchment mechanisms such as anti-takeover devices are useless and entrenched managers seek out alternative mechanisms. One of these alternatives is to gain collusion with stakeholders by means of implementing a CSR-intensive policy (Cespa & Cestone, 2004; Pagano & Volpin, 2005). There are two arguments that justify these socially responsible practices. Firstly, interest groups may accumulate sufficient power to promote or boycott a manager (DeAngelo and DeAngelo, 1998; Hellwig, 2000; Rowley and Berman, 2000). Secondly, through a generous policy of concessions towards these interest groups, management is making the company less attractive to potential buyers, as contracts established between workers and providers may not be rescindable in the short-term (Pagano and Volpin, 2005).

Moreover, Cespa and Cestone (2004) stated that entrenchment practices involving the satisfaction of stakeholders' interests will be more likely when stakeholder protection is more developed and when stakeholders have accumulated substantial power due to the lack of pressure from financial markets. In contrast to Anglo-Saxon countries, such situations commonly occur in Continental Europe.

This study departs from the previous dichotomy of managerial entrenchment and shows empirically that in some situations –when external corporate governance is well developed– managerial entrenchment is positive and may be connected to the implementation of CSR activities that generate value. The usual mechanisms of entrenchment in the Anglo-Saxon model are enough to isolate the manager from the pressure from the external mechanisms of governance. As a result, concessions made

towards stakeholders are considered to be a long-term investment with positive effects upon the company's results. On the other hand, when external pressure is less intense (as is the case of Continental Europe), corporate control relies on internal mechanisms, including stakeholder activism. In this case, entrenchment strategies of collusion with stakeholders (CSR activities) are implemented in order to reduce the efficiency of internal control mechanisms. This in turn has a negative effect on financial performance.

In order to demonstrate this theoretical argument, this study has drawn upon an international database provided by the Sustainable Investment Research International (SiRi) Company, an international network of research institutions dedicated to social and environmental scrutiny of the most important companies in the world. The data includes and expands upon information supplied by the Kinder, Lyndemberg, Domini, and Company (KLD) that has been already extensively used in previous literature (Agle et al., 1999; Berman et al., 1999; Hillman & Keim, 2001; Waddock & Graves, 1997). The final sample includes a total of 717 companies from 27 different countries, which makes it representative of different institutional contexts. As has been argued, such contexts play an important part in shaping the relationships between corporate governance and corporate social responsibility (Aguilera & Jackson, 2003; Schneper & Guillén, 2004).

THEORY AND HYPOTHESES

As argued by Shliefer and Vishny (1997), a good governance structure is one which is able to align the interests of both principals and agents. In this sense, several

mechanisms can force agents to interiorize the interests of the principal; mechanisms that are classified according to their internal or external nature. Internal mechanisms are managerial incentives, such as stock options or other performance-based payment schemes, or control structures such as the presence of institutional shareholders, the presence of outsiders in the board of directors or the existence of committees for auditing, remuneration, and nomination. On the other hand, the market for corporate control, and competition in the product and management job markets, are all examples of what are known as external governance mechanisms.

Building upon this classification of governance mechanisms, in most international comparisons, researchers contrasted two dichotomous models of corporate governance, depending on which of the two competing sets of mechanisms –internal or external– prevail in each institutional context (La Porta et al., 1998). The Anglo-Saxon model, sometimes labeled as outsider, market-oriented, or shareholder-centered model, relies primarily on external (market) mechanisms of governance; while internal mechanisms are of critical importance to reduce agency problems in the insider, bank-oriented, or stakeholder-centered model of Continental Europe and Japan. In explaining these differences in corporate governance practices across national boundaries and why certain practices are more widely spread in some countries than in others, some authors have relied on institutional elements. From La Porta and colleagues' (1998) study, it is well-known that the relative importance of each type of control mechanism depends on the institutional context in which the company belongs. As a result, countries which emphasize the protection of shareholders' rights will base company control on external governance mechanisms such as the market for corporate control. In contrast, countries

that give more protection to other groups such as workers or creditors will base such control on internal mechanisms. In both cases, however, the need for governance mechanisms grows greater as the proportion of managerial ownership becomes smaller; because the costs of bad or opportunistic decisions are not fully internalized by the manager. In these circumstances, the two alternative models of governance –the market or outsider model of Anglo-Saxon countries and the insider model of European countries and Japan– propose two alternative responses to the agency problem. In the first model, takeover bids play a leading role, while in the second model, banks and other institutional shareholders, as well as the concentration of ownership and stakeholder activism, are the most effective mechanisms to discipline managers (Shleifer & Vishny, 1997). We summarize the main differences between both systems in Table 1.

Table 1 about here

Acknowledging these differences in institutional frameworks and in the pressures exerted on managers, in this study we investigate whether managerial entrenchment is always bad. As we will argue, a key element to answer this question is CSR.

Managerial Entrenchment and CSR in Outsider Models of Corporate Governance

Managerial control from outside is mainly achieved via takeover bids. When managers do not create enough value, the price of the shares goes down and the company is likely to be taken over. The result of this process is that managers are fired

even when they are not fully responsible for the decrease in prices, or simply because the decrease in prices is the result of investing in a long-term project that does not create enough value in the short-term. By the same token, an increasing proportion of takeover bids are made for young companies with good growth perspectives and which have not fully capitalized the value they expected to generate in the first stages of development. In this situation, the managerial adoption of entrenchment initiatives may be socially optimal (Walsh & Seward, 1990).

Obviously, the likelihood of being fired is negatively related to managerial ownership (a proxy of managerial power). When managers are also owners, they assume part of the costs of poor decisions and opportunistic behaviours, and thus will avoid activities that destroy value (Jensen & Meckling, 1976). By increasing their participation in the ownership of the firm, managers are less dependent on entrenchment activities to retain their positions. A rise in managerial ownership may not always increase shareholder wealth, however. Managers may increase their participation until they are capable of dominating the board of directors, thus protecting themselves from internal and external control (Fama & Jensen, 1983). In a similar fashion, Morck *et al* (1988) and De Miguel *et al* (2004) argued that entrenchment occurs at intermediate levels of managerial ownership. Below the lower bound, supervision of management is so intense that there is no possibility of entrenchment. Above the higher bound, managers internalize the costs of entrenchment and thus take steps to avoid malpractice.

Companies that are pressured from outside are generally those in which managerial ownership is low. In these companies, managers have different mechanisms for implementing an entrenchment strategy (Denis *et al.*, 1997; Dahya *et al*, 1998). The

limitation of voting rights in certain types of shares, the repurchase of large blocks of shares without shareholder approval, poison pills, the issue of different types of shares, carrying out certain types of acquisitions and disinvestments, supermajority amendments, or golden parachutes are some of the mechanisms usually employed by managers to avoid the intense supervision of capital markets. What is more, in some cases, these practices reduce the efficiency of the control mechanisms to the extent that the cost of carrying out a takeover may be greater than the benefits obtained by a successful bidder.

As some authors have suggested (e.g., Kochhar & David, 1996), the most active agents in the capital market –particularly in the Anglo-Saxon countries– are myopic. Thus, they tend to value short-term more than long-term returns. Institutional investors, who play an important role in hostile takeover bids, rarely have access to the internal information of a company and, as such, have difficulty in calculating the long-term value of a company as well as the quality of the managerial team. Instead, they tend to focus on more easily quantifiable methods of measuring performance such as accounting profits. Moreover, investment fund managers are themselves subject to the problem of short-termism and their behaviour is evaluated by their own investors yearly. As a result of this myopic behaviour, managers pressured from capital markets tend to favour projects with certain returns in the short term and rule out riskier projects with longer recovery periods and higher present value (Hoskisson *et al.*, 2002).

Taking into account the markets' myopia, some researchers have suggested that anti-takeover devices are contracts that protect management against takeovers. Entrenchment allows managers to focus on long-term strategic decisions, without the

threat of losing control of the company or even their own jobs (Jonson & Rao, 1997). As such, entrenchment reduces myopic decisions that management would take when they are under pressure from the market for corporate control.

Anti-takeover devices allow managers to invest in projects that yield long-term returns, such as those activities that a company develops to create good relationships with its stakeholders or CSR. There is vast literature that argues that the investment in CSR helps to generate intangible assets that lead to a more effective use of company resources, which has a positive impact on financial performance (Hillman and Keim, 2001). In spite of this positive association between CSR and financial performance, many managers find themselves under pressure to obtain immediate results and, therefore, abandon social programs that offer long-term returns (Waddock and Graves, 1997).

Outside pressures may lead managers to break the implicit contract between the firm and its stakeholders. Anticipating this behavior, stakeholders are less willing to make the kind of specific investments that generate value-enhancing intangible resources. In this scenario, an entrenchment strategy may provide credibility and consistency to the CSR strategy and, may generate improvements in a firm's financial performance. Therefore, the development of CSR activities is a signal that managerial entrenchment is attempting to generate value. Hence, in this case we have an example of a *good-type* of entrenchment.

The institutional framework of Anglo-Saxon countries is an example of pressure from external control mechanisms. In these countries, as shown in Table 1, there is greater legal protection for investors, less presence of large investors, share ownership is

more diluted among small investors, and large companies issue debt to the capital market in order to raise capital. We thus expect that in this institutional framework managerial entrenchment will trigger CSR activities and that their combined effect on financial performance will be positive. This is our first hypothesis to be tested:

> ***Hypothesis 1****: In firms that are subject to external control pressure, like those in Anglo-Saxon countries, managerial entrenchment will trigger CSR. The combined effect of CSR and entrenchment on financial performance will be positive.*

Managerial entrenchment and CSR in Insider Models of Corporate Governance

When the control of managers is made from inside the firm, the composition of the board of directors, the existence of different subcommittees or the presence of large shareholders (*blockholders*) like families or banks play a pivotal role in the control of managers. In the absence of significant external pressure from financial markets, these mechanisms are effective ways of controlling managers and prevent the eventual negative effect of managerial entrenchment on firm value (Walsh & Seward, 1990; Sundaramurthy et al., 1997; Sundaramurthy, 2000).

Among the different internal mechanisms, blockholders have incentives to gather information and monitor the manager, and as a result, have the power to reduce agency costs and hinder managerial entrenchment (Shleifer & Vishny, 1986). The inside information obtained by blockholders has two consequences: first, it provides them with good knowledge of managerial quality. Second, it enables blockholders to adopt a more long-term perspective in their investment decisions. Hence, controlling shareholders

will rarely force managerial replacement when a good-quality manager has not generated enough short-term value. In this context, the response of managerial entrenchment is an inefficient strategy from a social point of view and can rarely be justified in terms of seeking stability in order to implement long-term strategies that, eventually, will involve different stakeholders. In fact, contrary to what we argued in the external corporate control scenario, the implementation of CSR activities as part of an entrenchment strategy is now a signal that managerial entrenchment is bad and destroys value.

Managers that want to implement an entrenchment strategy need to find internal allies and gain their support through generous social concessions. This is because traditional entrenchment measures like poison pills, anti-takeover devices or golden parachutes are not effective in an internal corporate control setting. Workers or consumers are natural allies against the interests of shareholders and potential buyers (Cespa and Cestone, 2004). When managers are in risk of replacement, they may implement expensive policies aimed at improving firm's CSR. Hellwig (2000) or DeAngelo and DeAngelo (1998) provided examples of managers, in their search to escape investor pressure, find allies in sectors such as the political system, the media, the legal system, the workers or universities. Obviously, the greater the power that these same groups have, the greater the advantages offered by their support. As Schneper and Guillén (2004) argued, in countries where there are internal control mechanisms, stakeholders such as workers, creditors or public authorities have a great capacity to influence business decisions, including the decision to replace a firm's CEO.

At the same time, expensive social programs to satisfy stakeholders make companies less attractive to possible buyers. Generous long-term contracts with workers and suppliers, as well as long-term commitments to support social and environmental organizations are difficult to revoke (Pagano & Volpin, 2005).

In short, the implementation of an intensive CSR policy leads to a reduction in stakeholder activism, which is also a component of a firm's internal control mechanisms, and makes a firm less attractive to potential external buyers. Both consequences reinforce managerial positions against pressure from internal corporate control mechanisms. In this respect, the implementation of CSR policies is an integral part of an entrenchment strategy that is aimed at destroying shareholder value (Surroca & Tribó, 2008). We have here an example of the *bad-type* of entrenchment.

These types of concessions to stakeholders which are linked to an entrenchment strategy are what McWilliams and Siegel (2001) defined as "discretional CSR". As such, these concessions are not justified by their strategic nature but rather by the specific objective of remaining in a job position. Therefore, the use of discretional CSR by managers is negatively related to financial performance.

As suggested (and shown in Table 1), the Continental European model of governance –in which capital markets have a very limited function– emphasizes internal control mechanisms. The threat of a hostile takeover is almost anecdotal and pressure from share prices is limited by the reduced liquidity and transparency of the capital market. Instead, large shareholders, families and banks play an important part in supervising management. Thus, the Continental institutional framework is a corporate governance model where pressures to control managers are originated inside the firm. In

this context, managerial entrenchment may trigger CSR policies, and this may in turn, negatively affect financial performance. This is our second hypothesis to be tested:

> ***Hypothesis 2:*** *In firms that are subject to internal control pressures, like those in Continental Europe and Japan, managerial entrenchment may trigger CSR. The combined effect of CSR and entrenchment on financial performance will be negative.*

METHODS

Sample

In order to test our hypotheses, we used a sample made up of 279 industrial companies from 22 different countries. These companies have been included, for at least one year, in the 2002-05 SiRi Pro™ database. These data are compiled by the Sustainable Investment Research International Company (SiRi), one of the most important international organizations in the study of socially responsible investment. SiRi is made up of eleven different independent research institutions such as KLD Research Analytics in the USA and Centre Info in Switzerland. Together, these institutions carry out detailed profiles of the main corporations in the world, and analyze them on the basis of their informative procedures, their policies and guidelines, management systems and other data of interest. Basically, the information is extracted from financial accounts, documentation provided by the company, international databases, and media reports, interviews with the principal interest groups and from permanent contact with company managers.

A company is thus evaluated according to 199 points of information that cover the main stakeholder groups, such as community, customers, employees, corporate governance, suppliers, and environment. We complement these data on corporate responsibility with data on financial and ownership structure that is extracted from OSIRIS. This is a database compiled by Bureau van Dijk (BvD) that provides information on financial, ownership and earnings for 38,000 companies, including listed, unlisted and de-listed companies from over 130 countries.

Variables

Corporate Social Responsability (CSR). Previous literature has recognized the difficulty of measuring this variable (Aupperle et al., 1985). As a multi-dimensional construct (Carroll, 1979) it captures a broad range of dimensions; one for each relevant stakeholder group (Waddock & Graves, 1997). Until relatively recently, many studies have approached CSR via information regarding just one stakeholder (Wood & Jones, 1995). However, with the KLD data, this problem has been resolved and there are now many studies that employ the information provided by this North American institution (for example, Hillman & Keim, 2001; Berman et al., 1999; Waddock & Graves, 1997). This study uses the SiRi PRO™ database, which includes dimensions similar to those provided by the KLD database. Five of these dimensions measure the level of company responsibility towards its stakeholders: community, consumers, employees, the environment, and suppliers. Other sections provide a summary of company management practices. Each one of the items included in each of the dimensions is separately evaluated and assigned a rating between 0 (the worst evaluation) and 100 (the

best evaluation). Importantly, each information item is weighted according to a methodology developed by SiRi. These weights are sector-specific and are developed annually. For each sector, SiRi's analysts determine the firm's potential negative impact on each stakeholder and assign a weight in proportion to this potential. For example, the "environment" is weighted more heavily for energy companies than it is for companies in the banking industry. The final score provided by SiRi is the sum of each of the scores of the 199 items averaged by its corresponding weight and rated on a scale from 0 (worst) to 100 (best).

Financial performance. This variable has been approached by means of *Tobin's q,* which is obtained by dividing the sum of the company's market value, long-term debts, current liabilities for the book value of inventories, property, plants and equipment (see Cheng & Pruitt, 1995; this approach has also been used by Dowell et al., 2000, and King & Lenox , 2002). Both studies highlight the advantages of *Tobin's q* with regard to using accounting measures for results; these advantages include its greater capacity to capture long-term value of investments such as intangible assets (Dowell et al., 2000).

Managerial entrenchment. As has been noted in the theoretical section, managers that try to isolate themselves from the control of external governance mechanisms may attempt to pursue different entrenchment strategies. In this study, different measures –provided by the SiRi PRO™ database– have been employed: 1) the existence of anti-takeover measures; 2) limits on the shareholders' voting rights; 3) the existence of different types of shares with different voting rights; 4) manager-controlled ownership; and 5) managerial tenure.

Anti- takeover measures: this is a dummy variable that is given the value 1 if the company has implemented one of the following measures: the creation of voting caps, the increase of voting rights over time, the restriction on board members' right to election, and 'poison pills'.

Voting rights amendments: a dummy variable where the value 1 corresponds to the situation in which important controversies occur and have a negative impact upon the shareholders' rights (these may include internal scandals that affect managers or conflict of interests between board members). The value 0 indicates that the analysts at SiRi have not found any controversy that might affect the shareholder.

Dual-class shares: this is a dummy variable that has value 1 if the company has multiple types of shares with different voting rights.

Managerial ownership: Stulz (1988) demonstrated that high levels of managerial ownership could prevent hostile takeover bids. Similarly, Weston (1979) emphasized that companies that had over 30% of internal ownership would never be acquired via a hostile takeover. Conforming to the previous proposals, Morck et *al* (1988), McConnel and Servaes (1990) and De Miguel *et al.* (2004) have found the existence of a non-linear relationship between management ownership and company performance, where entrenchment appears at intermediate levels of ownership. Adopting this perspective, the current study follows the proposals made by De Miguel *et al.* (2004) and thus estimates *Tobin's q* as related to management ownership (as well as its quadratic and cubic terms). Size, leverage and investment have been used as controls (defined below). Results show that the relation between *Tobin's q* and management ownership decreases in the range between 17% and 69%. *Management ownership* is thus a dichotomic

variable that takes the value 1 when the level of ownership under management control falls within this range.

Managerial tenure: Fredrickson et al (1988) show that a substantial amount of executive directors have a maximum tenure of 3 years. As a result, when this upper limit is passed, managers are likely to employ a strategy of entrenchment. This is why *managerial tenure* is a dummy variable that takes the value 1 when the tenure of the manager's position is greater than 3 years and it takes the value of 0 when it is less than 3 years.

Managerial entrenchment: further to the previous partial measures, a global measurement of entrenchment has been generated that consists of the sum of the previous 5 indicators.

Controls. There are two groups of control variables included in our empirical models: variables that reflect how internal governance mechanisms work as well as other variables of control, such as financial structure, dividends, size and age of the company, capital intensity, growth opportunities, the industry, the country and the year in question.

Internal corporate control mechanisms: different measurements have been used to approach the strength of internal mechanisms; 1) the degree of board independence; 2) separation between the CEO and the chairman of the board; 3) the existence of board subcommittees; 4)the existence of a system to evaluate managers' results; and 5) the presence of large shareholders.

Board independence is a Likert-type scale provided by SiRi that takes three possible values contingent on the percentage of independent directors with respect to the

mean value of the sector. The highest value corresponds to the situation in which a majority of non-executive directors are considered independent; the intermediate value indicates that 50% or less of non-executive directors are independent; and when the information disclosed by the company does not allow us to determine the share of independent non-executive directors, the firm receives the lowest value. *CEO's non-duality* is a dichotomic variable from SiRi that takes the value 1 when the chairman of the board is not the CEO of the company. The variable *Board subcommittees* is a Likert-type scale that may take 4 different values: 3 means that the company has an auditing committee, a remuneration committee and a nomination committee: 0 represents the lack of any one of these subcommittees. The intermediate values indicate the number of existing subcommittees within the company.

The *Performance evaluation* variable takes three values according to the SiRi classification: it takes the value 1 when the board has a performance evaluation system and there are no controversies identified with regard to executive salaries (such as the existence of salaries unrelated to results, golden parachutes, changes in prices of stock options, or excesses in the pension-fund packages for managers). The variable takes the value 0 when one of these two conditions is not satisfied and takes -1 when none of the two are satisfied.

Another internal control mechanism is the role played by large shareholders (blockholders). This study incorporates this factor by means of two measurements: *State ownership*, which is the percentage of government-controlled ownership, and *Ownership concentration*, which is measured by the sum of participation of the three largest blockholders (excluding managers).

Other control variables. In order to control for the financial structure, the variable *Leverage* is defined as the ratio of total liabilities to shareholders funds. *ROA* is the ratio of earnings before interest and tax to total value of assets. The variable *Dividends* identify the company's compensation policy. *Growth* is approached through the sales rate. *Size* has been defined by the natural logarithm of assets, and *Age* is the number of years a company has existed. The variable *Capital intensity* is the ratio of fixed assets to total assets; in similar way, the variable *Intangibles* is the proportion of intangible assets to total assets. In addition, temporal and sectorial dummy variables have been incorporated into the empirical models. Lastly, four types of countries have been identified according to the classification made by La Porta and others (1998); this is made according to whether the rules governing the development of business activity are British, French, German or Scandinavian. These variables will be the proxies for the pressure from external control mechanisms. Consistently with our theoretical contentions, firms in Anglo-Saxon countries are controlled through external mechanisms while firms in Continental Europe and Japan are controlled through internal mechanisms.

Empirical analysis

In order to test our hypotheses, we estimated two models by conducting robust regressions, clustering the error terms at a firm level. The first model explains CSR while the second explains financial performance. The first model is:

$\text{CSR}_{i\,t+1} = \alpha_1 + \alpha_2$ Managerial entrenchment $_{it}$ + α_3 Board independence $_{it}$ + α_4 CEO non-

duality $_{it}$ + α_5 Board subcommitees $_{it}$ + α_6 Performance evaluation $_{it}$ + α_7 State ownership $_{it}$ + α_8 Ownership concentration $_{it}$ + α_9 Leverage $_{it}$ + α_{10} ROA $_{it}$ + α_{11} Dividends $_{it}$ + α_{12} Growth$_{it}$ + α_{13} Size$_{it}$ + α_{14} Age $_{it}$ + α_{15} Capital Intensity$_{it}$ +α_{16} Intangibles $_{it}$ + ε_{it} (1)

The previous model also incorporates temporal and sectorial dummy variables. The estimation was carried out in differences (fixed-effects estimation) in order to eliminate the unobservable heterogeneity that might be potentially correlated with independent variables. For example, managers' specific characteristics could condition the company's policy of social concessions, as well as the implementation of entrenchment activities that, eventually, could affect the characteristics of corporate control mechanisms. Also, we lead the dependent variable by one period to tackle the potential problem of reverse causality in the estimations.

The second model attempts to explain financial performance using the following equation (that also includes temporal and sectorial dummy variables):

Tobin's $q_{i\,t+1}$ =β_1 + β_2 Managerial entrenchment $_{it}$ + β_3 CSR + β_4 CSR × Managerial entrenchment + β_5 Board independence $_{it}$ + β_6 CEO non-duality $_{it}$ + β_7 Board subcommittees $_{it}$ + β_8 Performance evaluation $_{it}$ + β_9 State ownership $_{it}$ + β_{10} Ownership concentration $_{it}$ + β_{11} Leverage $_{it}$ + β_{12} Dividends $_{it}$ + β_{13} Growth $_{it}$ + β_{14} Size $_{it}$ + β_{15} Age $_{it}$ + β_{16} Capital intensity$_{it}$ + β_{17} Intangibles $_{it}$ + θ_{it} (2)

By using both models it is possible to test the above hypotheses. Hypothesis 1 is supported when, using the sub-sample of companies belonging to the Anglo-Saxon model, the coefficient α_2 is positive and significant in specification (1) and, at the same

time, the coefficient β_4 is also positive and significant is specification (2). Likewise, Hypothesis 2 has support when, in the sub-sample of companies belonging to the Continental model, the coefficient α_2 is positive and significant in specification (1) and, at the same time, the coefficient β_4 is negative and significant in specification (2).

RESULTS

Tables 2 and 3 report descriptive statistics and Pearson's correlations for all variables. From the correlations' matrix, we observe a positive and significant correlation between managerial entrenchment and CSR. More specifically, it can be observed that the CSR is positively related to anti-takeover measures, with a deterioration of shareholders' rights and with changes in management ownership. It is important to mention the fact that satisfaction of stakeholder groups is also negatively correlated to different internal control mechanisms such as the existence of independent committees for auditing/compensation/nomination, or the implementation of performance-based payment schemes. Debt levels and dividends also hinder concessions to interest groups. These results thus provide preliminary evidence of the existence of a relationship between managerial entrenchment and CSR. Also, internal control mechanisms attempt to eliminate such practices because, in this context, entrenchment is negative. In the following tables these relationships are analyzed in greater detail.

Tables 2 and 3 about here

The results of equation 1 are summarized in Table 4, which attempts to explain the effect of entrenchment on CSR for each institutional context that proxies for the different corporate control mechanisms.

Table 4 about here

Figures of Table 4 reveal that variations in entrenchment have a positive impact on the CSR of the subsequent period; this is the case with both the Anglo-Saxon model of governance based on external control mechanisms (column 2) and the Continental model that relies on internal control mechanisms (column 4). Moving on to examine the details of the factors that explain CSR in each model of governance, the following can be observed: for those firms that suffer external pressure (the Anglo-Saxon model), it can be seen that anti-takeover measures, voting rights constraints, the existence of different class actions and managerial tenure, all have a positive and significant effect on CSR. Particularly relevant is the impact of anti-takeover measures upon CSR –a mechanism that is gaining increasing importance in the British and North American contexts. On the other hand, the lack of significance of the managerial ownership variable suggests that a powerful manager (with a significant stake) pursues his own private benefits even at the expense of stakeholders' interests. This is the second agency problem of expropriation by significant shareholders.

As regards the influence of internal governance mechanisms, it can be observed that financially-based incentive schemes serve to impede the activities of CSR. With

respect to the remaining controls, it can be seen that CSR is explained by dividend policy, which has a negative influence; and that growth opportunities and the existence of intangibles both have a positive effect. These results suggest that a generous dividend policy impedes the implementation of socially responsible practices (firms have less financial slack to satisfy stakeholders' interests), whilst the positive influence of growth and intangibles is consistent with previous findings in the stakeholder literature.

When we focus on those firms that are internally controlled (firms from Continental Europe; columns 3 and 4), we do find that anti-takeover measures, such as managerial ownership, have a positive impact on CSR. We argue that these are measures that are closely related to managerial discretion, differently to other entrenchment mechanisms that need the approval of different agents in the firm. Managers, then, have some leeway to implement anti-takeover devices and to change their own stake. As part of their entrenchment strategy, they complement the change of such variables with the implementation of a CSR intensive policy. Regarding internal governance mechanisms, CSR practices are impeded by both incentive systems and the existence of independent sub-committees for auditing, remuneration and nomination. The opposite result is found when the State is a shareholder: stake ownership leads companies to set up social and environmental projects. We can argue that the State may be less interested in preventing entrenchment practices if they are associated with improvements in stakeholders' satisfaction, principally workers and customers.

Finally, in respect to controls, results show that the dividend policy reduces the availability of resources to carry out CSR activities, while companies that grow and

invest in intangibles require active participation from interest groups and, for that reason, undertake CSR activities.

In resume, results of Table 4 suggest that, independently of whether the corporate control is external or internal, managerial entrenchment triggers CSR activities.

Equation 2, whose results are depicted in Table 5, explores the *ex-post* consequences of combining managerial entrenchment with implementation of CSR activities. With that, we may explain the reasons that lead managers to foster CSR.

Table 5 about here

Results of Table 5 correspond to the use of *Tobin q* (lead by one period) as a proxy of performance. The use of alternatives proxies such as ROA provides consistent results. In this Table, the main variable to be analyzed measures the combined effect of entrenchment and CSR, and is indicated by the multiplicative variable *CSR* × *Entrenchment*. As can be observed, the effect of this variable depends on the control model analyzed. In the outsider model, CSR practices fostered by an entrenchment strategy have a positive effect on *Tobin's q*. This result, combined with the positive influence of entrenchment on CSR, provides empirical support to our Hypothesis 1.

When we focus on the scenario of internal corporate control mechanism (column 2), the CSR that follows an entrenchment strategy has a negative effect on financial performance. Such evidence further supports our Hypothesis 2. Also, as with the previous model, entrenchment itself only has a negative effect on *Tobin's q.* Considered together, these results show that CSR serves as strategy to enforce

managerial entrenchment, specifically in those contexts where stakeholder activism may play a more important role in motivating or impeding manager replacement. On the other hand, in those institutional contexts where the capital market plays an active role, stakeholders have very little legal protection (and by extension, little influence in the corporate governance). When managers isolate themselves from the threat of hostile takeovers (by means of anti-takeover measures), their reasons for carrying out socially responsible activities have more to do with generating long-term value. In this case, entrenchment is initially dedicated to generating value through the implementation of CSR activities. This is why we have called this entrenchment a *good-type* entrenchment.

With regard to internal governance mechanisms, it is worth mentioning the relevant role played by independent board members in the external control model in order to enhance financial performance. In the internal control model, the separation between the CEO and the chairman of the board, as well as the existence of result-based incentive schemes, all have a positive influence on the *Tobin's q*.

DISCUSSION AND CONCLUSION

In this paper we have studied in what circumstances the implementation of entrenchment strategies has a positive effect on the generation of value. We have argued that the combination of entrenchment with corporate social responsible (CSR) activities is positive in a context of external control mechanisms, while it is negative when the corporate control mechanisms are internal.

A contingency approach was adopted in order to study of the relationship between entrenchment and CSR. The basic premise of this approach is that the role

played by CSR is determined by the type of pressure applied to management: CSR may be either an investment strategy with long-term results or an entrenchment strategy.

The pivotal element in determining the role played by CSR is the realization that management may be subject to shareholder control, both externally (through capital markets) or internally (through the board or through the activity of other interest groups such as workers or banks). The possible capacity for control of all of these groups- including shareholders- depends on the institutional context in which the company operates (La Porta et al., 1998). There are thus two institutional contexts analyzed in the current study: the Anglo-Saxon and the Continental European. The first of these contexts covers countries such as the United States and the United Kingdom and is characterized by the defense of shareholders' interests (particularly those of minority shareholders). The second institutional context provides greater protection for interest groups and is characteristic of countries such as Germany, Japan and the rest of Europe. At the same time, it is important to emphasize that the protection that favors some interest groups over others has consequences in terms of company governance. For this reason, Schneper and Guillén (2004) speak of governance models directed towards shareholders and models directed towards group interests.

In the Anglo-Saxon model directed towards shareholders, hostile takeover bids play a fundamental part in regulating management performance. Yet at the same time, the pressure applied by capital markets to achieve short-term results leads to a myopic perspective amongst managers; in extreme situations, this may cause the company to neglect long-term investments of greater actual net worth and to instead favor projects with a shorter recovery time. For this reason, managers' ability to isolate from external

takeover threads may have favorable effects on company's investment policy. In this study we analyze one of these long-term investment decisions: investments in corporate social responsibility. That is, we take this type of investment to be a proxy of the implementation of a long-term strategy by entrenched managers. The empirical evidence obtained here thus suggests that those managers who end up entrenched (as a result of the use of anti-takeover measures, limits on shareholder voting rights, the issue of numerous types of shares with different voting rights, or management tenure) have the sufficient freedom to undertake projects related to improving relationships with interest groups such as consumers, providers, workers, communities and environmentalists. Although, in the short- term, the capital market does not positively value such investments in social activities, the results presented in this study allow us to affirm that such investments ends up having a positive influence on company's market value (as measured by the *Tobin q*). Hence, such managerial entrenchment combined with the implementation of CSR policies indicates that when managers adopt a long-term strategic perspective in their investment decisions, they end up generating value. This is the "*good-type*" of entrenchment.

In other institutional contexts, managerial entrenchment is unambiguously negative and the implementation of CSR policies reinforces such perverse effects of entrenchment on financial performance. In particular, this situation occurs when the market for external corporate control plays a secondary role and the internal control mechanisms-such as ownership concentration- are very relevant. In this context, the presence of *blockholders* that have inside information allows them to discriminate good from bad managers and decisions to remove managers will not be based on isolated

short-term financial results. This is particularly the case when the presence of *blockholders* is accompanied by different internal control mechanisms such as independent members on the board of directors, the non-CEO duality, and/or the existence of subcommittees on the board (of auditing, remuneration and nomination). In this context, managerial entrenchment policies are unambiguously negative and a manager who seeks to remain in charge, and who is immune to the pressure from the capital markets, may need to reinforce his position against other internal control mechanism by colluding with other members inside the firm. A possible strategy is to seek out support among the interest groups. These groups are capable of developing activist strategies that end up being of influence in the running of the company. A manager may thus organize collusion between interest groups as a way of neutralizing pressure from internal control mechanisms; this collusion takes the form of numerous transfers to the workers and other interest groups covered by the concept of CSR. As such, investment in socially responsible activities becomes, in this context, part of an entrenchment strategy. Finally, as indicated by the obtained results, this policy of transfers towards interest groups has a negative effect on financial performance.

Implications

The central result in this paper is that managerial entrenchment is good when combined with CSR policies in a context of external corporate control mechanisms (something commonplace in Anglo-Saxon countries). In this case, management entrenchment has beneficial effects for the shareholder by providing company investment policy with a more long-term perspective. Isolated from the short-term focus of capital market, the manager is free to make whichever investment decision that may

best serve his long-term particular interests. Obviously, the particular interests that arise from CSR practices can be divided into two groups: private benefits obtained by better relationships with interest groups and greater remuneration obtained when social investments improve financial results. Then an efficient incentive scheme is essential for eliminating the risk of private benefit extraction that would lead to an excessively generous policy of social concessions and, presumably, would be contrary to sound investment policy. It is for this reason that management salaries based on a company's financial results constitute a counterpoint that has important benefits for efficiency.

The second implication of this paper is that attempts to satisfy the interests of different interest groups may have negative consequences for results when these attempts are part of an entrenchment strategy. As aforementioned, giving management *carte blanche* to determine the company social policy does not seem to be good policy as this may only end up becoming another aspect of entrenchment. This is particularly apparent in those institutional contexts in which interest groups have enough power to influence company governance. Moreover, the results presented in this article appear to suggest that the presence of internal control mechanisms -which are apparently efficient- is not sufficient guarantee that CSR will be properly employed by management. In this context, the question to be asked is 'How can we resolve this problem? One possibility is to regulate CSR in order to avoid overinvestment. Without doubt, a first step in this direction would be accounting practices that would oblige these issues to be reflected in the company's public accounts. A second solution to prevent problems of entrenchment might be to transfer part of the ownership to such groups. As company shareholders these interest groups will then internalize the costs of an

entrenchment strategy based on CSR. It is paradoxical that the best protection of shareholders' interests may lie in transferring stake to other interest groups.

Future Research

A possible extension of the work presented here would consist of analyzing specific dimensions of CSR with the aim of determining which interest groups would be most relevant in order to reinforce the positive aspects of managerial entrenchment (in a external corporate control framework) or the negative ones (in an internal corporate control framework). Another possible extension would consist of in-depth research on the connection between ownership structures and the causes that lead to entrenchment. The type of shareholder and his/her social sensibility might foreseeably have an important affect upon the reaction of interest groups towards management use of entrenchment strategies with social ends. Finally, we posit the idea that other variables such as a firm's age are relevant in determining whether managerial entrenchment and its connection to CSR is positive or negative. Young firms need to be flexible enough to undertake the kind of firm specific investments -like those related to CSR- which are necessary to ensure their growth. For these firms, the implementation of managerial entrenchment measures in a context of high external pressure would be a particularly effective way to reinforce the CSR-type of investment that creates value. On the other hand, for mature firms, in which stakeholders have developed their own private benefits, external pressure is particularly positive. CSR policies that favor stakeholders' interests, as well as managerial entrenchment, hinder external pressure and consequently have negative consequences for financial performance. The investigation of these issues is left for future research.

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TABLE 1

Patterns of Control: the Continental Model and the Anglo-Saxon Model.

	Continental model	**Anglo-Saxon model**
• *Standard countries within the model*	• Germany and Japan.	• The United States and the United Kingdom
• *Type of control*	• Leading shareholders. • Mixed stockholdings and pyramidal structures.	• Capital Market.
• *Ownership structure and type of shareholder*	• Concentrated. • Companies,families,banks.	• Dispersed. • Individual investors and institutions (funds).
• *Capital market*	• Less importance due to limited liquidity and transparency	• Elevated liquidity and informative transparency.
• *Role of takeover bids*	• Very limited.	• Important.
• *Role of administration board*	• Distinction between management and supervision.	• Efficient management control mechanism.
• *Management incentives and salaries*	• Basically fixed and based on accounting indicators. • Light-weight stock options.	• Important weighting of the variable, linked to the market. • Wide use of stock options.
• *Guidance in company law*	• Protection for creditors.	• Protection for shareholders against management.
• *Protection for workers*	• In Germany, they form part of the supervisory board.	• They are not considered.

TABLE 2

Descriptive Statistics

Variable	Full Sample					Anglo-Saxon Model		Continental Model	
	n	Mean	s.d.	Minimum	Maximum	Mean	s.d.	Mean	s.d.
CSR	766	47.33	15.44	6.12	79.09	46.25	14.70	48.40	16.09
Tobin's *q* (log)	846	-0.79	0.44	-3.05	1.55	-0.79	0.46	-0.78	0.42
ROA	969	4.14	12.25	-207.47	45.80	4.23	15.98	4.04	6.76
Managerial entrenchment	644	1.34	0.70	0.00	4.00	1.31	0.58	1.36	0.80
Anti-takeover devices	644	0.46	0.50	0.00	1.00	0.44	0.50	0.48	0.50
Voting rights amendments	644	0.75	0.43	0.00	1.00	0.90	0.31	0.61	0.49
Dual-class shares	644	0.93	0.26	0.00	1.00	0.92	0.28	0.94	0.23
Managerial ownership	969	3.16	13.34	0.00	100.00	2.03	9.57	4.29	16.17
Managerial tenure	644	0.52	0.50	0.00	1.00	0.64	0.48	0.39	0.49
Board subcommittees	644	1.83	1.35	0.00	3.00	1.95	1.41	1.71	1.27
CEO's non-duality	644	0.60	0.49	0.00	1.00	0.48	0.50	0.73	0.45
Board independence	644	0.85	0.34	0.00	1.00	0.85	0.32	0.84	0.35
Performance evaluation	644	0.35	0.49	-1.00	1.00	0.53	0.52	0.18	0.40
State ownership	969	1.96	8.12	0.00	89.65	0.05	1.02	3.85	11.10
Ownership concentration	969	26.50	21.12	0.00	100.00	23.42	17.41	29.55	23.89
Leverage	948	110.77	147.29	-932.67	974.68	101.13	150.06	120.14	144.10
Dividends	819	9.9E+05	2.8E+06	-4.1E+07	2.2E+07	1.1E+06	3.2E+06	9.0E+05	2.3E+06
Size	969	1.6E+07	2.9E+07	3.2E+04	3.9E+08	1.7E+07	3.5E+07	1.4E+07	2.3E+07
Age	969	69.57	44.37	1.00	339.00	64.26	38.21	74.85	49.21
Capital intensity	969	0.58	0.20	0.01	0.99	0.62	0.21	0.54	0.19
Growth	969	0.17	0.38	0.00	1.00	0.18	0.38	0.16	0.37
Intangibles	899	0.32	0.25	0.00	0.95	0.35	0.26	0.29	0.24

TABLE 3

Pearson's Correlations [a]

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
1. CSR																				
2. Tobin's q (log)	.06																			
3. Managerial entrenchment	.13	–.05																		
4. Anti-takeover devices	.21	.01	.43																	
5. Voting rights amendments	.12	.06	.42	.07																
6. Dual-class shares	.06	.00	.42	–.07	.04															
7. Managerial ownership	.16	.02	–.16	–.01	.01	–.09														
8. Managerial tenure	–.09	–.07	.36	–.31	–.05	.12	.02													
9. Board subcommittees	–.24	–.08	.01	–.32	–.01	.01	–.05	.29												
10. CEO's non-duality	–.08	–.01	–.13	–.05	–.05	–.08	–.04	–.17	–.07											
11. Board independence	.04	–.06	.07	–.03	.00	.13	–.03	.04	–.04	.10										
12. Performance evaluation	–.24	–.03	.03	–.24	–.04	.05	–.01	.23	.42	–.08	–.02									
13. State ownership	.09	.02	–.13	.08	–.10	–.03	–.01	–.15	–.09	–.03	–.01	–.01								
14. Ownership concentration	.04	.06	–.10	.00	–.06	.07	.16	.12	.06	.04	.01	.09	.02							
15. Leverage	–.11	–.04	–.15	.05	.06	–.09	.05	–.24	–.03	.02	–.08	–.09	–.05	.05						
16. Dividends	–.33	–.11	.06	–.09	–.12	.15	–.05	.23	.23	–.25	.03	.22	.03	–.05	–.09					
17. Size	–.33	–.02	–.03	–.03	–.08	.09	–.08	.04	.19	–.18	.03	.16	.01	.02	.29	.60				
18. Age	–.18	–.02	–.07	.01	.06	.00	–.04	–.08	–.02	–.07	–.04	–.03	–.10	–.04	.12	.04	.04			
19. Capital intensity	.01	.04	.05	.06	–.02	–.05	–.01	.01	–.07	–.08	–.09	.01	.03	–.11	–.10	.02	–.14	–.11		
20. Growth	.06	.03	–.06	–.06	.12	–.05	.12	–.16	–.02	–.05	–.06	–.04	–.19	–.07	.04	–.04	–.03	.11	–.05	
21. Intangibles	.38	.17	.01	.01	.06	.02	.08	–.01	.03	–.04	–.01	.01	.09	.07	–.13	–.15	–.18	–.13	–.07	.01

[a] Correlations above .1 are significant at $p < .1$.

TABLE 4

Results of Regression Models for Predicting CSR: Effects of Managerial Entrenchment

Variable	Anglo-Saxon Model		Continental Model	
	Model 1	**Model 2**	**Model 3**	**Model 4**
Entrenchment Measures				
Anti-takeover devices	2.0774*		1.5234*	
Voting rights amendments	0.8165†		0.1422	
Dual-class shares	1.0107†		1.1444	
Managerial ownership	0.3838		0.9768*	
Managerial tenure	2.7307†		–0.0282	
Managerial entrenchment		1.6670*		1.6234†
Internal Corporate Control Mechanisms				
Board independence	–2.2944	–2.1005	2.7827	2.8643
CEO's non-duality	–1.9069	–2.1999	–0.1136	2.0489
Board subcommittees	1.2364	–1.0011	–1.1737	–1.3272†
Performance evaluation	–4.6581**	–5.7189**	–2.4531†	–2.5097†
State ownership	–0.1422	–0.0874	0.1238**	0.1291**
Ownership concentration	0.0256	0.0655	–0.0236	–0.0173
Other Controls				
Leverage	0.0069	0.0074	–0.0115*	–0.0102
ROA	0.1081	0.1390	–0.1400	–0.1706
Dividends	–6.5E–07**	–6.9E–07**	–9.9E–07**	–8.7E–07**
Growth	5.7166**	6.0794**	3.5709†	3.2854†
Size	2.5E–08	2.4E–08	–3.74E–08	–3.91E–08
Age	–0.0008	–0.0040	–0.0183	–0.0158
Capital intensity	–0.2236	–2.54E–01	–0.6150	–0.3346
Intangibles	10.1257**	9.8826**	10.0797**	10.7614**
Intercept	9.7219†	14.1756***	5.6346	4.3988
R^2	58.55	55.74	49.51	48.06
F	5.86**	6.35**	4.90**	5.59**
n	140	140	163	163

† $p \leq .10$
* $p \leq .05$
** $p \leq .01$

TABLE 5

Results of Regression Models for Predicting Tobin's *q*: Effects of CSR and Managerial Entrenchment

Variable	Anglo-Saxon Model	Continental Model
	Model 1	**Model 2**
Managerial entrenchment	–0.0716*	–0.1355**
CSR	0.0360	–0.0078
CSR × Managerial entrenchment	0.6889*	–0.0772*
Internal Corporate Control Mechanisms		
Board independence	0.9753†	0.1672
CEO's non-duality	0.8159	0.5853†
Board subcommittees	0.0756	0.0111
Performance evaluation	0.0620	0.1318*
State ownership	–0.0447†	–0.0012
Ownership concentration	–0.0088	–0.0003
Other Controls		
Leverage	–0.0015	–0.0006*
ROA	0.0214	0.0116**
Dividends	1.58E–07†	2.56E–08*
Growth	0.4361	–0.0719
Size	–2.78E–09	–3.46E–09*
Age	–0.0007	–0.0007
Capital intensity	–0.0098	0.1145*
Intangibles	0.1992	0.0757
Intercept	–1.1613	–0.1268
R^2	18.96	31.58
F	3.02**	2.66**
n	140	163

† $p \leq .10$
* $p \leq .05$
** $p \leq .01$