Corporate Social Responsibility and Managerial Entrenchment. [1]

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Abstract

When stakeholder protection is left to the voluntary initiative of managers, relations with social activists may become an effective entrenchment strategy for inefficient CEOs. We thus argue that managerial turnover and firm value are increased when explicit stakeholder protection is introduced so as to deprive incumbent CEOs of activists' support. This finding provides a rationale for the emergence of specialized institutions (social auditors and ethic indexes) that help firms commit to stakeholder protection even in case of managerial replacement. Our theory also explains a recent trend whereby social activist organizations and institutional shareholders are showing a growing support for each others' agenda.

1 Introduction

When stakeholder protection is left to the voluntary initiative of managers, relations with stakeholders and social activists may turn into a powerful entrenchment strategy for incumbent CEOs. This is particularly true in countries and periods where political lobbying, social activism and media campaigns have the power to promote or disgrace top executives of large corporations. Inefficient managers have then a special motive for committing themselves to a socially responsible behavior that gains stakeholders' support. This paper suggests that explicit stakeholder protection - whether enforced by courts and regulators, or by private monitoring institutions specialized in corporate social responsibility (CSR) issues - can break this alliance, thus favoring control contestability and managerial turnover.

There is by now a large consensus that stakeholders enjoy substantial *effective* control on firms by the threat of costly boycotts and media campaigns. [1] Local communities, unions and environmental organizations also interfere in corporate governance matters by acting as "white squires" to block hostile takeovers. Indeed, some recent controversial takeover contests displayed incumbent CEOs relying on activists' and media support to buttress their positions. When in 1997 the German steel producer Krupp-Hoesch launched a hostile bid over its competitor Thyssen with the assistance of Deutsche Bank, Thyssen's management spurred local communities and politicians to lobby against the takeover. Harsh criticisms from the German public and political pressures from the regional government of North Rhine-Westphalia led Krupp to withdraw its bid (see Hellwig 2000). Intense media campaigns against corporate takeovers have also been led by environmental activists. In 1986 a group of environmental organizations including Sierra Club and Earth First! started a campaign against the acquisition of Pacific Lumber, a timber company, by MAXXAM, on the grounds that Pacific Lumber's management was a more reliable "partner" for the environment and local communities. The media largely supported the view that Pacific Lumber's old management had gained "a reputation for enlightened management of its trees and benevolent paternalism for its people...," [2] while neglecting the many financial indicators suggesting it was highly inefficient. On the contrary, MAXXAM CEO's Charles Hurwitz was depicted as the utmost example of the evil corporate raider, mainly interested in extracting profits from the acquired company at the expense of stakeholders. Although the acquisition succeeded in spite of the protests, this case well illustrates the process whereby the media helped NGOs to spread a negative view of the 1980's takeover wave (see DeAngelo and DeAngelo (1998) for a detailed report of the Pacific Lumber case and its extensive media coverage).

Recent takeover battles in the European telecoms, banking and energy industries also

help illustrate how connections with local communities, politicians, and unions represent a valuable entrenchment tool for incumbent managers. Interestingly, political and media support against outside raiders has become even more valuable to incumbent CEOs since EC Directives and EU member states' reforms have made it more difficult to resort to standard anti-takeover defensive tactics. [3]

In line with this evidence, we propose a simple model where stakeholders other than shareholders [4] can affect the likelihood of CEO replacement, and incumbent CEOs can make *manager-specific* commitments to adopt a stakeholder-friendly behavior. This subtle entrenchment strategy becomes more appealing to CEOs when corporate law and the firm's charter promote independent boards, proxy fights and hostile takeovers. When deciding whether to support the incumbent CEO against a takeover or a proxy fight, stakeholder activists trade off the cost of a less talented manager against the benefit of managerial concessions. The latter are less valuable if stakeholders expect to receive a fair treatment *independently* of who runs the firm. Within this framework, we show the following facts. First, when private benefits of control are large and stakeholder activism is effective, shareholder value is enhanced when explicit stakeholder protection is introduced, so as to undermine corporate officers' entrenchment strategies. Our theory thus rationalizes why firms increasingly submit their behavior to the monitoring of ethic indexes and social auditors in an attempt to make CEOs less central to relations with stakeholders. Second, we show that although stakeholders may support an inefficient CEO committed to a socially responsible behavior against an alternative manager, stakeholder welfare is always increasing in the degree of control contestability. This is because CEOs who can rely on anti-takeover defenses and dominated boards do not need stakeholders' support to buttress their positions. In light of the former findings, stakeholders and shareholders have more interests in common than one would expect. Finally, we show that inefficient CEOs are always opposed to any institutionalization of stakeholder protection which would deprive them of discretionality over CSR and thus of their grip on stakeholders.

Our work contributes to rationalize a recent trend whereby social activists and shareholders are growing increasingly supportive of each others' agendas, as corroborated by the following stylized facts:

Shareholders' support for explicit stakeholder protection.

Mainstream shareholder activists and institutional investors are asking firms to institutionalize stakeholder protection, rather than leave it in the hands of CEOs. Firms then resort to specialized institutions whose role is to monitor their environmental and social

performance and report it to the public. Indeed, consulting firms are increasingly specializing in social auditing, while stock market ethic indexes are being created to respond to shareholders' demand for certified "ethic stocks."[5] Our theory adds to the common wisdom explanation for this phenomenon - i.e. that shareholders endorse explicit CSR measures simply because they fear costly boycotts - by linking shareholder value, corporate governance factors, and CSR. In particular, while the boycott rationale implies that in the presence of powerful activists shareholders benefit from the stock's inclusion in sustainability indexes, our model yields the additional prediction that firms' incentive to undergo ethical screening for inclusion in such indexes is stronger when corporate control is more contestable.

Social activists' interest for corporate governance issues.

Social and environmental activists are increasingly involved in the corporate governance debate. Many activists have in fact joined forces with shareholders' lobbies to campaign against anti-takeover devices, CEO-dominated boards and lenient auditors, issues that used to be well beyond the traditional social activism program. [6] While social activists may endorse independent boards and shareholder voice to the extent that institutional investors are likely to promote stakeholder interests within the firm's board, it remains puzzling that they advocate pro-takeover reforms of corporate charters. [7] Our paper proposes an explanation for this latter fact. [8]

This paper contributes to the current debate on the stakeholder society (see Hellwig 2000, and Tirole 2001), trying to assess *who* has an interest in endorsing a stakeholder society concept, whereby managers are intended to have a multiple mission of aiming at both shareholder value and stakeholder welfare. We wonder whether both stakeholders and shareholders may not be better off when managers are bound to maximize shareholder value, while clear covenants restricting the firms' set of actions are established either by firm charters or by the law to rule out actions that may impose large negative externalities on stakeholders. Tirole (2001) argues that putting in place managerial incentives and control structures that ensure firms' respect of stakeholder rights may be very costly. Our paper shows that the decision *not* to institutionalize stakeholder protection may prove even costlier, leaving managers with the monopoly of relationships with stakeholders. In other words, the lack of rules on corporate behavior is not always a synonymous for firm profitability and shareholder value; often, it is only an excuse for managerial discretion (see Jensen (2002)).

Our work is related to Pagano and Volpin (2005a), who analyze the behavior of incumbent managers and workers in a firm faced with a hostile takeover threat, and argue that incumbents are *natural allies* of workers: the former have an interest in offering long-term

contracts to workers so as to discourage the takeover, while the latter are likely to support a lazy manager prone to low monitoring against a more efficient raider. Contrary to our theory, in their model incumbent managers can only gain, and shareholders lose, from any institutionalization of stakeholder protection. The paper is also related to the recent literature on the political economy of corporate governance (see Pagano and Volpin 2005b, and Perotti and von Thadden 2006 for the relevant references), to the extent that our results may be applied to a political economy framework in order to study how corporate governance and stakeholder protection laws and regulations are simultaneously determined.

The paper proceeds as follows. In section 2 we set up the basic model. We rule out potential collusion between incumbent managers and stakeholders, and study how shareholder value and stakeholder welfare are affected by stakeholder protection and corporate governance. In section 3, we assume that incumbent managers can commit to a stakeholder-friendly behavior in order to obtain stakeholders' support against a replacement attempt. There, we also study under which conditions an alliance between managers and stakeholders arises. In section 4, we analyze shareholders', stakeholders' and incumbent managers' preferences over corporate governance and explicit stakeholder protection. In section 5 we comment on our results.

2 The model

Consider a firm run by a manager (I) enjoying a large private benefit of control γ from running the firm. A fraction of shares α is held by the manager, while $(1 - \alpha)$ shares are dispersed among small shareholders (SH). Dispersed shareholders have no control over the firm's course of action. The firm generates both a monetary profit, which accrues to its owners, and a non-monetary externality on its other stakeholders (ST). We think of natural stakeholders like potential pollutees, customers, workers or local communities. Stakeholders derive no utility from money. All agents in the model are risk-neutral.

Projects

The model we have in mind is suited to describe the early stages of new product development, when firms *do not know yet to which extent their profit maximizing choices will impose costs on stakeholders.* Of course, based on industry factors and the current state of technological and scientific knowledge, they have a subjective assessment of how likely such a conflict is to arise. Consider the following example. A firm is developing a new product, and has to choose between alternative production processes: before the R&D stage is completed,

not much is known about the payoffs associated to different technologies; hence, no project will be chosen until further research is successfully completed under the CEO's supervision. Both shareholders and stakeholders anticipate that the firm will eventually face a choice between a few (say, 2) relevant alternatives. Of these, one technology will be more profitable than the other. Both technologies may require that consumer/environmental safety is partly sacrificed. The firm and its stakeholders anticipate that with a non-zero probability the *least* profitable technology will be the least safe for consumers and the environment; hence, they expect that their preferences will *sometimes* coincide. This situation is captured by the following hypotheses.

Incomplete contracting framework - The firm's manager can either run the status quo project, or try to improve on it by discovering a new project. The status quo project (project zero) is highly disliked by both shareholders and stakeholders in that it yields zero profits to shareholders and no private benefit to stakeholders. There are also N a priori identical projects, which yield a verifiable monetary profit R with ex-ante unknown probabilities, an ex-ante unknown (non-verifiable) private benefit to stakeholders, and can *possibly impose a cost* on the firm and/or on its stakeholders. Note that in our incomplete contracting setting, *all projects look the same ex-ante*: payoffs cannot be attached to new projects unless further investigation is carried out. This assumption captures a major feature of firm management in R&D-intensive industries, where at the early stages of product development, firms (and their stakeholders) are aware of the available alternatives (e.g. different research methodologies, or "technology trajectories"), but cannot assign different payoffs to each of them. This is the case, for example, when a pharmaceutical firm can orient its research towards the development of different drugs, whose potential market demand, cost effectiveness – as well as impact on consumer safety – are still unknown.

It is known that $(N-2)$ projects are worse than project 0 for both SH and ST, and that at least one of them imposes a "sufficiently large" cost on both (one may think of this as an R&D project which has disastrous consequences for the firms' profits, and also turns out to have a very negative impact on stakeholders). This assumption ensures that a party who is uninformed about the projects' payoffs always prefers the status quo to picking a project at random. Hence, if a different project from the status quo is to be selected, the controlling party in the firm *must* have discovered the payoffs attached to all alternative projects. In this setting, a "more talented" manager is one that is better able to discover project payoffs, and thus to improve on the status quo.

Congruence of preferences over alternative projects - It is common knowledge that as $N-2$

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projects are worse than the status-quo, upon information collection the choice will focus on two "relevant projects," whose expected monetary payoffs to shareholders and externalities on stakeholders are displayed in table 1.

[Table 1 about here.]

According to the table, the shareholders' preferred project (say, project 1) yields profit R with probability $p + \tau$. Project 2 instead yields R only with probability p, and is thus the project that shareholders like the least. With probability λ, project 1 generates a positive externality $B > 0$ on stakeholders (whereas project 2 does not), and is thus also the stakeholders' favorite one.[9] Conversely, with probability $(1 - \lambda)$, the shareholder's preferred project yields no private benefit to stakeholders, while the less profitable project 2 does. Hence, the parameter λ measures the congruence of interests between shareholders and stakeholders; alternatively, $(1 - \lambda)$ captures the trade off between profit maximization and social/environmental objectives. [10]

We assume that the degree of congruence λ is common knowledge at the onset of the corporate governance game, and that λ belongs to $(0, 1)$: before project payoffs are discovered, stakeholders and shareholders expect that their favorite projects will *sometimes* coincide. Our assumption that $\lambda \in (0, 1)$ allows to encompass both those cases where socially responsible actions impose extra costs on the firm, as well as those cases where projects increasing stakeholders' payoffs also maximize shareholder value. This occurs for instance when a firm follows an enlightened employee policy that boosts workers' morale and productivity (see Huselid (1995) for evidence on this), or when the firm's adoption of a green technology ensures a high demand for its product and contributes to reduce production costs (empirical evidence showing that this is quite a common pattern abounds. See for instance Klassen and McLaughlin (1996), and Dowell, Hart, and Yeung (2000)).

Managerial talent

A manager i learns the new projects' payoffs with probability θ_i, in which case she selects the one she prefers the most. With probability $(1 - \theta_i)$, the manager does not learn anything; hence, she optimally decides to run the status quo project. We define θ_i to be the managerial talent for innovation. The incumbent CEO has talent θ_I. A better alternative manager, with talent $\theta_R > \theta_I$ is known to exist. However, she still has to be identified in the managerial labor market. We define $\Delta\theta \equiv \theta_R - \theta_I$.

CEO replacement attempts

We assume that with probability $\pi \in [0,1]$ the board of directors or a coalition of shareholders identifies the alternative manager; alternatively, the latter realizes that he can increase the firm's value and launches a hostile bid on the firm. π thus captures those legal and contractual factors that favor CEO replacement by: *(i)* facilitating the identification of an alternative manager by shareholders (e.g., board independence, rules reducing the cost of shareholder activism and proxy fights); *(ii)* encouraging outsiders' acquisition of control through hostile bids (e.g., regulatory and charter provisions that limit the set of anti-takeover defenses available to CEOs).

Stakeholder activism

When a replacement attempt occurs, stakeholder representatives such as social and environmental activists or local communities may side with the incumbent CEO to make sure that she is not replaced. Activists dispose of powerful tools in this respect: they may start a media campaign and even threaten a boycott in case the replacement occurs; alternatively, by exerting pressure on political leaders to back their cause, they can create an adverse political climate to the proxy fight or the takeover (Hellwig 2000). We assume that, a stakeholder campaign succeeds with probability a in deterring CEO replacement, where $a \in (0,1)$, and fails with probability $(1-a)$. We also assume that stakeholders do not choose the intensity of the campaigning activity, but only whether to campaign or not (hence a is an exogenous parameter measuring the efficacy of activism), and that a stakeholder campaign is costless (the cost of campaigning could be taken into account in the model without changing its qualitative results).

Notice that while π captures those charter provisions facilitating CEO turnover, and thus can be affected by shareholders, a proxies for the effectiveness of *stakeholders* in interfering in the corporate governance game. It is true that shareholder activists are as well likely to turn to "non-governance" channels (e.g., media campaigns) to support the raider in his takeover attempt. Accounting for this effect would call for a more general approach whereby the relative impact of ST and SH on the takeover contest is the outcome of a lobbying game, whose equilibrium may well have shareholders "get the upper hand" ($a = 0$). [11] However, the evidence we presented in the introduction seems to suggest that stakeholders have a comparative advantage in relying on non-conventional voice tools. This, in our opinion, justifies the assumption that $a > 0$ (see however Remark 2, p. 17 on this).

Formal stakeholder protection

The firm's choice of a course of action may be constrained by stakeholder protection rules.

We model this by assuming that – once projects are discovered – with probability $x_r \in [0, 1)$ the manager is obliged to pick the project yielding B to stakeholders, independently of whether this maximizes profits. Thus, with probability $(1 - \lambda)x_r$ stakeholder protection is detrimental to shareholder interests. In other words, an ex-ante commitment to CSR imposes an extra cost on the firm only with probability $(1 - \lambda)$, as with probability λ the profit-maximizing project is also socially responsible. In line with Baron (2001), we might say that λx_r measures the extent of "strategic corporate social responsibility" going on in the firm.

The variable x_r has two interpretations. *(a) Legal Stakeholder Protection* – A regulatory agency with the unique objective of maximizing stakeholder welfare has the formal right to make binding recommendations over the choice of projects (for instance, it may rule out projects requiring a polluting production process or impose a minimal standard of safety for consumers and workers). However, it effectively exerts this right only if it is informed about the projects' payoffs, which happens with probability $x_r \in [0, 1)$. [12] We think of x_r as being inversely related to the authority's degree of overload, and directly related to the quality of its staff and the resources on which it can draw to pursue its investigations and enforce its decisions. [13] *(b) Contractual Stakeholder Protection* – The firm commits to a CSR policy of ruling out projects that yield very low outcomes to stakeholders (i.e., $B = 0$). To stick to its commitment the firm buys the services of a monitor specialized in social responsibility issues, such as an ethic index or a social auditor; the intensity of such monitoring determines the extent of the firm's compliance (x_r) with stakeholder protection.

Timing

The timing of events is described in figure 1. At $t = 1$, with probability π an alternative manager challenges the incumbent CEO. If so, stakeholders may campaign and threaten a boycott against the potential new management. The campaign succeeds with probability a. At $t = 2$, the manager who is in control learns the payoffs and selects a new project with probability θ_i $(i = I, R)$. If stakeholder protection rules are enforced, the manager has to comply with them; otherwise, she is free to choose her most favored project. At $t = 3$, monetary payoffs accrue to shareholders and the manager (who also enjoys the private benefit of control γ), while stakeholders bear the externalities generated by the firm's activity. In section 3, we will assume that at an initial date $t = 0$ the incumbent CEO can make a *manager-specific* investment to credibly commit herself to a socially responsible behavior, so as to establish a privileged relationship with powerful stakeholder activists.

[Figure 1 about here.]

2.1 CSR and the (potential) conflict between shareholders and stakeholders

Our framework is meant to capture various realistic features of the (potential) conflict between shareholders and stakeholders that in our view should be incorporated in a model of corporate social responsibility.

First, shareholders and stakeholders do not simply bargain over how to share the corporate pie; they mostly dispute which course of action the firm should undertake, a feature that calls for a control rights model. This fact also motivates our simplifying assumption that stakeholders are not sensitive to monetary incentives. In fact, including a monetary component in the stakeholders' utility function would raise the additional issue that stakeholders may be compensated via lump sum transfers such as charitable contributions for the externalities they bear. For instance, the local community may receive a large donation upon the firm's introduction of a downsizing plan or its adoption of a polluting technology. Although this is what often happens in reality, it is also true that real-world stakeholders do not seem to regard monetary transfers as a perfect substitute for the indirect control on the firm's choices guaranteed by CSR and media campaigns. A further issue that would be raised by stakeholders' taste for money is that market mechanisms (e.g. tradable pollution permits) might lead the firm to internalize the externalities produced, thus solving the conflict between shareholders and stakeholders. Ruling out such market solutions allows instead to account for the large non-monetary value that stakeholders seem to attribute to control on the firm's actions, so as to study the role of stakeholder activists, i.e. those "players that seek to change the practices of a firm" (Baron, 2001). Finally, allowing for monetary transfers would also open the possibility that "nasty activists" blackmail the firm by threatening media campaigns and boycotts. Though this is an interesting issue per se, ruling it out helps focus on the paper's bottom line, i.e. the role of "genuine" activists.

A second feature of our model that we would like to emphasize is that it accounts for the fact that while shareholders' and stakeholders' preferences over alternative actions are often in conflict, in many real life cases socially responsible actions are also profit-maximizing. This justifies our adoption of the Aghion and Tirole (1997) setup, with $\lambda \in (0, 1)$ capturing the extent of such congruence. This framework also allows to encompass both "strategic CSR," whereby the firm adopts a course of action that is good for stakeholders but nonetheless maximizes profits, and more genuine CSR, i.e. those "changes in business practice that are in contrast with profit maximization" (Baron 2001).

2.2 The benchmark with no social activism

In this section we study the basic model where incumbent CEOs *cannot* entrench themselves by building relationships with stakeholders (i.e., events in figure 1 occur from $t = 1$). We look at the impact of control contestability (π) and explicit stakeholder protection (x_r) on shareholder value, stakeholder welfare and the incumbent's utility.

In this benchmark case, at $t = 2$, whenever free from regulatory interference, *any* manager chooses the project which maximizes equity value. As the incumbent manager's preferences are *not* more congruent with stakeholders than the raider's, stakeholders benefit when a more efficient manager takes over:

$$\theta_R \left[\lambda + (1 - \lambda) x_r \right] B > \theta_I \left[\lambda + (1 - \lambda) x_r \right] B.$$

A better manager discovers new projects more often ($\theta_R > \theta_I$); yet, both the incumbent CEO and the alternative manager pick the stakeholders' favorite project only with probability $\lambda + (1 - \lambda) x_r$ (either the project maximizes firm profits as well, or it is imposed on the firm by the regulatory agency/corporate social responsibility monitor).

It is immediate that social activists have no interest in supporting the incumbent CEO at $t = 1$. Hence, if a raider appears the manager is always replaced. Given this, shareholder value is:

$$
\begin{aligned}
V_{SH}(\pi, x_r) = & \qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad\qquad (1) \\
= & \; \pi \theta_R \left[x_r(p + \lambda \tau) + (1 - x_r)(p + \tau) \right] R + (1 - \pi) \theta_I \left[x_r(p + \lambda \tau) + (1 - x_r)(p + \tau) \right] R \\
= & \; (\theta_I + \pi \Delta \theta) \left[p + \tau - (1 - \lambda) \tau x_r \right] R,
\end{aligned}
$$

where expected project returns under the relevant regulatory constraints are multiplied by the expected managerial quality $\theta_I + \pi \Delta \theta$. Stakeholder welfare also depends on project choice and expected managerial quality:

$$
\begin{aligned}
W_{ST}(\pi, x_r) & = \pi \theta_R \left[x_r + (1 - x_r) \lambda \right] B + (1 - \pi) \theta_I \left[x_r + (1 - x_r) \lambda \right] B \qquad (2) \\
& = (\theta_I + \pi \Delta \theta) \left[\lambda + (1 - \lambda) x_r \right] B.
\end{aligned}
$$

Finally, the incumbent manager's utility is:

$$U_I(\pi, x_r) = (1 - \pi) \left[\gamma + \theta_I \left(p + \tau - (1 - \lambda) \tau x_r \right) \alpha R \right] + \pi \theta_R \left(p + \tau - (1 - \lambda) \tau x_r \right) \alpha R.$$

An incumbent CEO with a high enough stake might be better off in case she is replaced, to the extent that the additional value of her equity offsets the lost benefits of control. Here, however, we want to focus on CEOs whose private benefits of control are sufficiently large relative to their equity stake that they always want to stay on (see page 15 for a discussion of the restrictions imposed on the managerial equity stake in the model). Hence, we make the following assumption:

Assumption 1

$$\gamma > \Delta\theta \left(p + \tau\right)\alpha R.$$

In the following Lemma we describe the preferences of all agents (stakeholders, shareholders, and incumbent CEO) with respect to control contestability and formal stakeholder protection.

Lemma 1 *An increase in control contestability increases stakeholder welfare and shareholder value, and decreases managerial utility. An increase in formal stakeholder protection increases stakeholder welfare, and decreases both shareholder value and managerial utility.*

Notice that while shareholders and stakeholders have dissonant preferences over the extent of stakeholder protection, they are both better off under a tighter corporate governance regime. Indeed - although their views may differ on which is the best project to adopt - both stakeholders and shareholders have *a common interest in enhancing managerial turnover*. The reason for this is that in our model new managers increase the corporate pie rather than redistribute it from shareholders to stakeholders. Indeed, shareholder value need not necessarily be created at the expense of stakeholder welfare; indeed, it is often the case that more efficient and innovative managers, by increasing the size of the corporate pie, benefit both shareholders *and* stakeholders. [14]

Let us also stress that in this basic model, both shareholders and incumbent managers benefit from a weak stakeholder protection, whereas stakeholders and incumbent managers have no common interests. Moreover, shareholder value is maximized when π and x_r are respectively close to 1 and 0, that is, when the quality of corporate governance is high while stakeholder protection is minimized. In what follows, we allow stakeholder activists to campaign against the potential new manager, so that the incumbent CEO has an interest to commit to make concessions to stakeholders. As we will see, this changes dramatically shareholders' preferences over corporate governance and stakeholder protection.

3 Stakeholder activism and managerial entrenchment

We now assume that stakeholder activism can reduce the likelihood of CEO replacement, and show that at $t = 0$ the incumbent manager may try to entrench herself by building a privileged relationship with stakeholders. The story we have in mind is one where the CEO achieves a credible commitment to be friendly to stakeholders through *manager-specific* investments (see Shleifer and Vishny 1989) that align her preferences with those of stakeholders. One instance of such investment is the acquisition of expertise in implementing socially responsible policies and sustainable production processes (e.g., through specialized executive courses), that will later turn stakeholder-friendly projects into "pet projects" for the CEO. A further example is that of a manager who spends long hours gathering the advice of, and building relationships with, NGO representatives, local communities and environmentalists. [15] Finally, the CEO can start a parallel career in a social activist organization, and enjoy personal gratification from being praised by other members (e.g. William Clay Ford Jr., Ford's CEO, engaging in active membership of the environmental NGO Sierra Club). She may then have an incentive to distort managerial choices so as to preserve her "membership" to this social network. More generally, she can develop a reputation for being lenient to stakeholders' requests.

We model this idea in the following way. At $t = 0$, the CEO can make an observable, manager-specific investment in CSR expertise. If she invests x_c at cost bx_c, with probability x_c she enjoys a private benefit b when implementing stakeholder-friendly projects in the firm she runs. Our assumption that the CSR investment cost equals the expected private benefit of stakeholder-friendly projects implies that the investment is (weakly) never profitable unless it is part of an entrenchment strategy. In case of replacement, the CEO enjoys some private benefits anyways thanks to the human capital acquired through the investment. We will assume for simplicity that these amount to bx_c (the case where fewer private benefits are enjoyed in case of replacement yields the same qualitative results, though at the expense of more cumbersome algebra). The investment in CSR expertise and stakeholder-relationships is *not* feasible to outside managers.[16] We also assume:

Assumption 2
$$b > \alpha \tau R.$$

This implies that when an investment x_c is undertaken, with probability x_c the manager picks the stakeholders' favorite project even at the expense of security benefits so as to enjoy

the private benefit b. With probability $(1 - x_c)$, the manager gains no expertise and her preferences are congruent with shareholders'; in this case, she only picks the stakeholders' favorite project with probability λ. This directly implies the following lemma:

Lemma 2 *The degree of congruence between the incumbent manager's and the stakeholders' objectives is measured by $\lambda + (1 - \lambda)x_c$; it increases from λ to 1 as the CEO increases her investment in CSR expertise x_c from 0 to 1.*

x_c thus measures the amount of managerial concessions to stakeholders. At $t = 1$, stakeholders are willing to support the incumbent CEO provided x_c satisfies the following constraint:

$$\theta_I \left[\lambda + (1 - \lambda)x_r + (1 - \lambda)(1 - x_r)x_c\right] B \geq \theta_R \left[\lambda + (1 - \lambda)x_r\right] B,$$

which can be written as:

$$\theta_I (1 - x_r)(1 - \lambda)Bx_c \geq \Delta\theta \left[\lambda + (1 - \lambda)x_r\right] B.$$

The value of concessions expected under the incumbent CEO outweigh the cost for stakeholders of bearing a less efficient manager. This constraint implies that managerial concessions must be sufficiently large, i.e.:

$$x_c \geq \underline{x}_c(x_r) \equiv \frac{\Delta\theta \left[\lambda + (1 - \lambda)x_r\right]}{\theta_I (1 - x_r)(1 - \lambda)}. \tag{3}$$

Notice that $\underline{x}_c(x_r)$ is increasing in x_r, i.e., the minimum investment in stakeholder relationships to gain activists' support increases with the level of explicit stakeholder protection. Indeed, when stakeholder protection is strong, activists have less reason to support an inefficient CEO.

On the other hand, the incumbent CEO is willing to invest in stakeholder relationships if and only if the following condition is satisfied:

$$\pi a\{\gamma - \alpha\Delta\theta R\left[(p + \tau) - (1 - \lambda)x_r\tau\right]\} \geq (1 - \pi + \pi a)\theta_I \alpha R(1 - \lambda)(1 - x_r)\tau x_c.$$

The left hand side of the above inequality represents the net expected gain from receiving stakeholders support: in the event that the takeover is attempted *and* the stakeholder campaign succeeds (which occurs with probability πa), the CEO preserves the private benefit of

control γ while bearing the monetary cost of a less valuable equity stake. The right hand side represents instead the loss in value of the CEO's equity stake due to managerial concessions (which are granted whenever the CEO stays in power, i.e. with probability $1 - \pi + \pi a$).

The above condition can be rewritten as follows:

$$x_c \leq \overline{x}_c(x_r) \equiv \frac{\pi a\{\gamma - \alpha \Delta \theta R\left[(p + \tau) - (1 - \lambda)x_r\tau\right]\}}{(1 - \pi + \pi a)\left[\theta_I \alpha R(1 - \lambda)(1 - x_r)\tau\right]}. \tag{4}$$

Note that the "alliance" between the CEO and the firm's stakeholders will be feasible if and only if $\overline{x}_c(x_r) \geq \underline{x}_c(x_r)$.

A first inspection of condition (4) allows us to state the following lemma:

Lemma 3 *The incumbent CEO is more willing to invest in stakeholder relationships (namely, $\overline{x}_c$ is larger) when she is under a tougher replacement threat (i.e. π is higher), and when social activism is more effective (i.e. a is larger).*

When good corporate governance deprives managers of standard tools to protect their jobs (such as anti-takeover defenses and CEO-dominated boards) CEOs turn to subtler ways to stay in power. Moreover, as the effectiveness of social activists' campaigns increases, investments in CSR expertise and close relationships with stakeholder representatives become powerful entrenchment tools.

Notice also that consistently with intuition, managerial concessions $\overline{x}_c$ are increasing in the level of private benefits of control (γ), and provided γ is large enough (see further, assumption 3) also in the degree of congruence (λ). Indeed, a manager earning larger private benefits of control is more eager to make concessions in order to entrench herself. The same occurs if the monetary cost of managerial concessions is small, as when there is little trade-off between profit maximization and social/environmental objectives. Furthermore, $\overline{x}_c$ is increasing in the level of legal stakeholder protection (x_r): the CEO is more eager to retain control when stakeholders enjoy a considerable level of legal protection, to the extent that under her (less efficient) management the value of her equity share is little affected by stakeholder protection rules. On the other hand, $\overline{x}_c$ decreases in the manager's stake (αR), in the probability of the project success p, and in the talent gap between raider and incumbent managers ($\Delta \theta$): an increase in any of the latter parameters increases the expected monetary cost that entrenchment imposes on the manager via her equity stake, thus making the CEO *less* willing to make concessions.

We now define:

$$\Gamma \equiv \frac{\gamma}{\alpha R},$$

as a measure of the relative importance of private benefits of control versus monetary returns in the CEO's objective function. This variable is of crucial importance to our results; indeed, only when control benefits are large enough compared to the managerial equity stake (i.e., when Γ is "large"), is the CEO willing to resist a replacement, even undergoing the cost of pro-stakeholder concessions. One may argue that increasing the CEO's equity stake α would allow for a straightforward remedy to the managerial entrenchment problem. Indeed, a similar caveat applies to many corporate governance models of managerial entrenchment, starting with Shleifer and Vishny (1989, p. 129). One reply to this objection is that if large equity stakes were an effective and cheap instrument to deter managerial entrenchment, we would *not* observe top executives resorting to anti-takeover defenses and engaging in creative self-entrenchment strategies, as we in fact do. In line with this reasoning we have decided to focus our attention on a single corporate governance mechanism (the replacement threat π), rather than studying the interaction between implicit and monetary incentives for managers. [17] Notice also that the assumption that the CEO's equity share α is small is well-grounded in reality. Jensen and Murphy (1990) present evidence that CEOs hold a very limited amount of the firm's shares, while Shleifer and Vishny (1988) and Tirole (2005) discuss various rationales for this fact, ranging from managerial risk-aversion to fear of shareholder lawsuits or public outcry (see however Remark 1, p. 17 on the case where $\alpha = 0$).

The following proposition establishes that, for any level of control contestability, an appropriate level of explicit stakeholder protection can counter the CEO's entrenchment strategy:

Proposition 1 *For any $\Gamma > \Delta\theta(p + \tau + \lambda\tau)$, there exist $\pi_0(\Gamma)$, $\pi_1(\Gamma)$, with $0 < \pi_0 < \pi_1 < 1$, such that, for any $\pi \in [\pi_0, \pi_1)$, $\widehat{x}_r(\pi) \in [0, 1)$ is the threshold level of stakeholder protection above which the incumbent CEO's entrenchment strategy becomes unfeasible. The threshold $\widehat{x}_r$ is increasing in π and Γ, and decreasing in $\Delta\theta$ and λ.*

Proof. See the appendix. ∎

Figure 2 depicts the function $\widehat{x}_r(\pi)$ in the space (π, x_r). Above the $\widehat{x}_r(\pi)$ locus, the incumbent CEO never invests in stakeholder relationships. This is either because poor corporate governance (low π) makes it easy for the CEO to preserve her job, or because explicit stakeholder protection (x_r high) makes stakeholders value less managerial concessions. Indeed,

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when faced with a potential alliance with the incumbent management, stakeholders trade off the benefit of managerial concessions against the cost of a less innovative management: if they expect to receive a good treatment independently of who runs the firm, they have no interest in the alliance with the incumbent CEO.

The $\widehat{x}_r(\pi)$ locus is shifted downwards by an increase in $\Delta\theta$: ceteris paribus, social activists are less likely to support more inefficient incumbents. $\widehat{x}_r$ also decreases as λ increases, as stakeholders are more supportive of a control change when their interests are more in line with an efficient project choice. Conversely, $\widehat{x}_r(\pi)$ is shifted upwards by an increase in Γ, as larger private benefits of control make incumbent managers more prone to build an alliance with stakeholders, which in turn requires a stronger stakeholder protection to prevent the alliance. Notice that, by Proposition 1, $\pi_0 < 1$ if and only if $\Gamma > \Delta\theta(p + \tau + \lambda\tau)$. If $\Gamma \leq \Delta\theta(p + \tau + \lambda\tau)$, $\pi_0 \geq 1$, hence by Proposition 1 for any level of $\pi \in [0, 1]$, $\widehat{x}_r(\pi) = 0$, and thus (even when $x_r = 0$) no alliance arises between the firm's CEO and its stakeholders. In words, unless control benefits are large enough, the incumbent CEO never finds it profitable to secure stakeholders' support through concessions. As we are interested in the potential alliance between managers and stakeholders, and the instruments to prevent it, we rule out the latter case by making the following assumption:

Assumption 3
$$\Gamma > \Delta\theta\left(p + \tau + \lambda\tau\right).$$

[Figure 2 about here.]

Let us assume that π and x_r lie below the $\widehat{x}_r(\pi)$ locus, so that the incumbent CEO commits to a protection of stakeholders' interests which goes *beyond* that to which the firm itself is committed. We also assume that incumbent managers have no bargaining power vis-à-vis stakeholders, and thus CEOs' commitment to stakeholder concessions equals $\overline{x}_c$:

$$x_c^* = \overline{x}_c(x_r) \equiv \frac{\pi a\left\{\Gamma - \Delta\theta\left[p + \tau - (1 - \lambda)\tau x_r\right]\right\}}{(1 - \pi + \pi a)\left[\theta_I(1 - \lambda)(1 - x_r)\tau\right]}. \tag{5}$$

Straightforward calculations show that $(\partial x_c^*/\partial\pi) > 0$, $(\partial x_c^*/\partial x_r) > 0$ and $(\partial x_c^*/\partial\lambda) > 0$. Intuitively, a tougher replacement threat (e.g., an independent board or a ban on anti-takeover defenses) makes the incumbent manager more willing to relinquish concessions

to stakeholders in order to preserve control. The incumbent manager is also *forced* to larger concessions when stakeholders' welfare under the alternative manager is increased due to a larger degree of stakeholder protection or a higher congruence of interests between stakeholders and profit-maximizing raiders.

Notice that since there is a bilateral monopoly between the stakeholders and the incumbent CEO, we could equally well assume a different distribution of the bargaining power, and thus choose any $x_c^* \in [\underline{x}_c(x_r), \overline{x}_c(x_r)]$. Assuming any interior Nash-bargaining solution would, however, imply more cumbersome notation and algebra, while leaving the main results in the paper unaffected. The only case we need to rule out for our purposes is the one where the CEO has all the bargaining power, and thus sets $x_c^* = \underline{x}_c(x_r)$. Indeed, as can be seen from equation (3), in this case concessions would be completely independent from the pressure that the market for corporate control exerts on CEOs (π). This assumption seems to us less representative of the situation our model is meant to capture: a manager who needs stakeholders's support to fend off a replacement attempt is unlikely to hold *all* the bargaining power vis-à-vis stakeholders.

Remark 1 As emphasized at page 15, the size of the incumbent CEO's stake (α) plays an important role in our model. Indeed, for proposition 1 to hold we need α not to be too large. At a first sight, it might seem that imposing a null equity stake (and thus having that $\Gamma = \infty$) would bring *at no cost* more straightforward results, by rendering assumption 3 automatically satisfied. However, the assumption $\alpha = 0$ would come at the cost of obtaining less empirically compelling predictions: first, incumbent CEOs would be ready to make CSR concessions to stakeholders even when faced with a *very mild* replacement threat (π small); second, stakeholder activists would always be eager to support incumbent CEOs even when the extent of legal stakeholder protection (x_r) is *very* large.

Remark 2 According to (5) a non-null stakeholders' ability to influence the replacement attempt ($a > 0$) is crucial for the incumbent CEO to be willing to make concessions. Indeed, if stakeholders were unable to affect the outcome of the takeover or if shareholders had more power in this respect (i.e. if $a = 0$), the incumbent would be *unwilling to commit* to any meaningful concession vis-à-vis stakeholders (i.e. $\overline{x}_c = 0$). As argued in section 2, the evidence presented in the introduction suggests that the assumption $a > 0$ is well grounded in reality.

4 Who benefits from good corporate governance and explicit stakeholder protection

We now build on the previous section to study how corporate governance rules enhancing managerial turnover and explicit stakeholder protection affect shareholder value, stakeholder welfare, and CEOs' rents. We argue that stakeholders and shareholders may to some extent have congruent preferences over both issues.

4.1 Shareholder value, control contestability and stakeholder protection

In our model, small shareholders completely delegate control to managers, while an active market for corporate control ensures that inefficient managers are replaced. If social activism can impair the functioning of this market, incumbent CEOs have an incentive to secure stakeholders' support by committing to a less efficient project choice. This potential alliance changes dramatically shareholders' preferences over corporate governance and explicit stakeholder protection, as the results in this section show.

We proceed in the following way. We start by assuming that the firm's CEO chooses to entrench by making concessions to stakeholders. Next, we ask which levels of π and x_r maximize shareholder value under the constraint that managerial entrenchment is countered (Proposition 2). Hence, we turn to the opposite case where managerial entrenchment is allowed (Proposition 3). Finally, we compare shareholder value in the two cases and find conditions such that it is optimal to counter managerial entrenchment via explicit stakeholder protection (Proposition 4).

Proposition 2 *Suppose managerial entrenchment is to be countered. Then, shareholder value is concave in π, and is maximized when control contestability is set equal to $\pi^* < 1$ and the minimal level of protection $\widehat{x}_r(\pi^*) \in [0, 1)$ is provided to stakeholders. π^* is decreasing in Γ and a and increasing in λ.*

Proof. See the appendix. ∎

The intuition for the above result is as follows. In contrast with section 2.2, when managers can entrench themselves by committing to a socially responsible behavior, shareholder value is a *non monotone*, rather than increasing, function of π (i.e. increasing for low values of π and decreasing as π becomes larger). Indeed, as π increases two offsetting effects

impinge on shareholder value. On the one hand, shareholders benefit from the opportunity to replace the incumbent CEO with a more talented manager. This, in turn, has a positive impact on shareholder value. However, as π increases, the cost of countering managerial entrenchment via explicit stakeholder protection increases as well, to the extent that the incumbent has stronger incentives to seek stakeholders' support when faced with a tougher takeover threat. This latter effect has a negative impact on shareholder value. As a result of these two contrasting effects, shareholder value is maximized when competition in the managerial labor market is *not* too intense (i.e. π is *strictly* lower than 1).

Proposition 3 *Suppose managerial entrenchment is not to be countered. Then, shareholder value is maximized by $x_r = 0$ and a level of control contestability given by*

$$
\pi^* = \begin{cases} 1 & \text{if } a\Gamma < \Delta\theta(p + \tau), \\[2mm] 0 & \text{if } a\Gamma \geq \Delta\theta(p + \tau). \end{cases}
$$

Proof. See the appendix. ∎

According to the above result, if managerial entrenchment is not to be countered, it is clearly in the shareholders' best interest not to provide explicit protection to stakeholders. Indeed, absent the need to compete with managerial concessions, any form of stakeholder protection negatively affects shareholder value. As a consequence, shareholder value is a monotonic function of π. If private benefits of control are small, and social activism is not very effective, a tougher replacement threat does not spur larger concessions to stakeholders, while leading more often to an efficient CEO replacement; hence, shareholder value is maximized by $\pi = 1$. If, on the other hand, stakeholders pressure is very effective *and* private benefits of control are large, shareholders are better off insulating the incumbent from competition, ensuring him tenure.

Finally, the following result finds a sufficient condition under which countering managerial entrenchment through explicit stakeholder protection is indeed in the interest of shareholders.

Proposition 4 *If $a\Gamma \geq \min\{\Delta\theta(p + \tau), \tau\theta_R(1 - \lambda)\}$, shareholder value is maximized when a minimal level of explicit protection $\widehat{x}_r(\pi^*) \in [0, 1)$ is secured to stakeholders.*

Proof. See the appendix. ∎

When private benefits of control are large and social activists are powerful, shareholders are better off if explicit protection is granted to stakeholders, so as to prevent a very effective

managerial entrenchment strategy. Though such protection implies a less efficient project choice, shareholders benefit anyway due to the higher CEO quality induced by managerial turnover. Notice that in this case, the corporate pie (inclusive of stakeholder welfare) is *increased* at the expense of incumbent managers, though some shareholder value is lost to stakeholders. Shareholders thus get *a smaller share of a larger pie.* Proposition 2 also states that shareholder value is maximized by *not* putting CEOs under a very tough replacement threat, namely, by choosing $\pi^* < 1$ (see example 1). The optimal levels of π and x_r decrease with Γ and a. Thus, as Γ and a get very large, it is optimal to set π^* close to zero, in that insulating incumbent managers from competition becomes a less costly way to fight managerial entrenchment than institutionalizing stakeholder protection (see example 2). This case captures the intuition that sometimes shareholders may prevent inefficient entrenchment strategies simply by "granting the CEO some insulation from competition for his job," an idea advanced in the corporate governance literature by Shleifer and Vishny (1989).

Example 1 In figure 3 panel (a) we set $\theta_I = .1$, $\theta_R = .5$, $\alpha = .5$, $p = .5$, $\tau = .5$, $\lambda = .1$, $a = .3$, $B = .1$ and $\Gamma = 2$. With these parameters $\pi^* = 0.18$ and $\widehat{x}_r(\pi^*) = 0.49$.

Example 2 In figure 3 panel (b) we keep the same data of example 1 but assume that the stakeholder ability at affecting the replacement decision is higher (i.e. we set $a = .9$). In this case: $\pi^* = 0.017$ and $\widehat{x}_r(\pi^*) = 0.03$.

Notice that in both examples shareholder value is indeed maximized by countering managerial entrenchment (i.e., it is not optimal to set π and x_r below the $\widehat{x}_r(\pi)$ locus).

[Figure 3 about here.]

4.2 Stakeholder welfare and control contestability

The stakeholder welfare function changes according to whether x_r and π lie below or above the locus $\widehat{x}_r(\pi)$. By Proposition 1, whenever $x_r \geq \widehat{x}_r(\pi)$, W_{ST} coincides with (2); hence, it is increasing in x_r as well as π: stakeholders can only benefit from the replacement of an inefficient manager. When instead $x_r < \widehat{x}_r(\pi)$, stakeholders' welfare writes as:

$$W_{ST}(\pi, x_r) =$$
$$[\theta_I + \pi(1-a)\Delta\theta]\,[\lambda + (1-\lambda)x_r]\,B + (1-\pi(1-a))\theta_I(1-x_r)(1-\lambda)x_c^*(\pi, x_r)B,$$

which is also increasing in π and x_r. Notice that the additional term with respect to (2) represents the benefit of managerial concessions: stakeholders now have an additional motive for endorsing good corporate governance, to the extent that the incumbent's concessions are an increasing function of π. Indeed, bad corporate governance rules allowing anti-takeover defenses and staggered boards make CEOs less eager to appeal to stakeholders, in that they do not need stakeholders' support to buttress their positions. This implies that even those stakeholders who would support incumbent CEOs in return for concessions prefer the firm's control to be contestable ex ante:

Corollary 1 *Although stakeholder activists may want to side with the incumbent CEO at t=1, their welfare is always increasing in the quality of corporate governance rules enhancing managerial turnover.*

Corollary 1 adds a further argument to a common view on the use of anti-takeover defenses: "...who benefits from such protection against outside bids? Not shareholders, who lose their chance to vote on a change of management; and not employees or other stakeholders, whose interests may be better served by a new and more dynamic ownership. The only beneficiaries from obstacles to a market in corporate control are managers." ("Takeover Troubles," *The Economist*, January 31st, 2002). Our result also rationalizes the recent interest of social and environmental activists for the corporate governance agenda, and in particular the puzzling fact that activists advocate pro-takeover reforms of corporate charters (see footnote 8).

4.3 CEO's utility and stakeholder protection

Interestingly, inefficient CEOs have opposite preferences with respect to stakeholders over corporate governance and stakeholder protection rules. Indeed, the results in section 3 imply the following result:

Corollary 2 *The incumbent manager always benefits from a reduction in the intensity of the replacement threat and from a reduction in explicit stakeholder protection.*

That CEOs may be opposed to tough competition in the managerial labor market is not surprising. Here we would rather stress the result that CEOs prone to make personal commitments to stakeholder representatives (which is the case whenever $x_r < \widehat{x}_r(\pi)$) are indeed opposed to welcome stakeholder-protection laws, or the introduction of explicit pro-stakeholder covenants in *the firm*'s charter. This finding is in line with casual evidence of

managers who profess concerns for corporate social responsibility, but are then reluctant to endorse pro-stakeholder regulations and all "attempts to institutionalize considerations of stakeholder interests in corporate governance" (see Hellwig 2000). It also supports Shleifer and Vishny (1989)'s informal argument that entrenchment objectives may explain why managers try to make the firm's contracts with stakeholders implicit rather than explicit. [18]

5   Discussion and concluding remarks

In this paper we have argued that shareholders' interests are better served when the protection of stakeholders is not left to CEOs' discretion. Incumbent managers under a tough replacement threat may in fact use relationships with stakeholder activists as an effective entrenchment strategy. Our model hence predicts that in countries where good corporate governance promotes the market for corporate control and social activism is very effective, introducing some explicit stakeholder protection may increase firm value. This finding provides a rationale for a recent phenomenon whereby a growing number of firms are submitting their ethical behavior to the monitoring of ethic indexes and social auditors, in an attempt to commit to protect stakeholders' interests beyond current regulatory mandates.

We emphasize that - in contrast to the common wisdom explanation for this phenomenon, i.e. that shareholders endorse CSR simply to prevent costly boycotts - our model provides testable predictions on the interaction among shareholder value, corporate governance factors, and CSR. In particular, we predict that firms' incentives to undergo ethical screening for inclusion in sustainability indexes and to submit their behavior to social audits are stronger when corporate control is more contestable. We also predict that when activists' power is strong, shareholders should forego the explicit protection of stakeholder rights and rather insulate CEOs from competition, for instance by allowing for anti-takeover provisions in the corporate charter.

Our theory is closely related to Pagano and Volpin (2005a), who argue that in the face of a takeover threat incumbent managers are natural allies of workers: incumbents have an interest in offering long-term contracts to workers so as to discourage the takeover, while unions are prone to support a poorly-monitoring manager against a more efficient raider. In that paper, managerial effort is instrumental to reducing workers' wages, hence takeover gains occur via a reduction in stakeholder welfare. [19] This has two natural implications. First, workers are always opposed to rules favoring control contestability. Second, incumbent managers can only gain (and shareholders lose) from an increase in employment protection,

to the extent that long term labor contracts can be used as poison pills to deter takeovers. We derived opposite predictions in a model where raiders *increase* the corporate pie rather than simply redistribute it from stakeholders to shareholders. This derives from our assumptions that the raider discovers a highly profitable project more often than the incumbent manager, and that such project sometimes coincides with stakeholders' favorite one. Indeed, it is this feature of our model that leaves room for a *congruence of interests* between shareholders and stakeholders over corporate governance and stakeholder protection regimes. In this respect, it is interesting to note that as λ gets close to zero (i.e., extra profits always come at the expense of stakeholder welfare), our model yields similar predictions to Pagano and Volpin (2005a): explicit stakeholder protection is no longer beneficial to shareholders.

A straightforward extension of our model would be to allow for a takeover contest between two competing raiders differently related to the target's stakeholders, rather than a fight between an incumbent CEO and an outside raider. Our story would then suggest that the outcome of the takeover contest may be deeply affected when one of the two contenders has managed to build a privileged relationship with stakeholders and has thus gained their support. This extension would help rationalize the events that occurred during the controversial takeover battles that took place in the Italian banking industry in 2005. [20]

To conclude, our results can be applied to a political economy framework where interest groups (shareholders, incumbent managers and stakeholders) contribute to determine financial regulation and institutional stakeholder protection. Our results suggest that besides endorsing a better corporate governance regime, small shareholders may want to support the introduction of stakeholder protection laws to prevent the implicit agreement between inefficient managers and stakeholders. We leave this and other extensions for future research.

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Appendix

Proof of proposition 1

Define $\widehat{x}_r(\pi)$ as the level of explicit stakeholder protection such that $\overline{x}_c(x_r) = \underline{x}_c(x_r)$:

$$\widehat{x}_r(\pi) = \frac{[\Gamma - \Delta\theta(p + \tau + \lambda\tau)]\pi a - \lambda\tau\Delta\theta(1 - \pi)}{(1 - \lambda)\tau\Delta\theta(1 - \pi)}. \tag{6}$$

When $x_r > \widehat{x}_r(\pi)$, $\underline{x}_c > \overline{x}_c$, and thus the alliance between incumbent CEO and stakeholders is not feasible. By inspection of (6), $\widehat{x}_r(\pi) < 1$ if and only if $\pi < \pi_1 \equiv \tau\Delta\theta/(\tau\Delta\theta + a(\Gamma - \Delta\theta(p + \tau + \lambda\tau)))$. Hence, if $\pi \geq \pi_1$ no feasible level of stakeholder protection can counter the CEO's entrenchment strategy. Also, $\widehat{x}_r(\pi) > 0$ if and only if $\pi > \pi_0 \equiv \lambda\tau\Delta\theta/(\lambda\tau\Delta\theta + a(\Gamma - \Delta\theta(p + \tau + \lambda\tau)))$. When $\pi \leq \pi_0$, the alliance does not arise, even at $x_r = 0$. The assumption $\Gamma > \Delta\theta(p + \tau + \lambda\tau)$ guarantees that $\pi_0 \in (0, 1)$ and $\pi_1 \in (0, 1)$. Since $\lambda < 1$, $\pi_0 < \pi_1$. The sign of the first three derivatives is immediate. To see that $(\partial\widehat{x}_r/\partial\lambda) < 0$, note that

$$\frac{\partial\widehat{x}_r(\pi)}{\partial\lambda} = \frac{1}{(1 - \lambda)^2}\left(\frac{\pi a(\Gamma - \Delta\theta(p + \tau(1 + \lambda))) - \Delta\theta\tau(1 - \lambda))}{(1 - \pi)\tau\Delta\theta} - 1\right),$$

and the latter expression is negative if and only if

$$\pi < \tilde{\pi} \equiv \frac{\tau\Delta\theta}{(1 - a)\tau\Delta\theta + a(\Gamma - (p + \tau)\Delta\theta)}.$$

As $\tilde{\pi} > \pi_1$, and for $\widehat{x}_r(\pi) \in [0, 1)$ it must be that $\pi \in [\pi_0, \pi_1)$, the result follows. ∎

Proof of proposition 2

Let $H_1 = \Delta\theta(p + \tau(1 + \lambda))$ and $H_2 = \Delta\theta(1 - a)(p + \tau(1 + \lambda)) + a\Gamma$ where $\Delta\theta = \theta_R - \theta_I$. If managerial entrenchment is to be countered, using (1) shareholder value writes as

$$
\begin{aligned}
V_{SH}(\widehat{x}_r(\pi)) &= R(\theta_I + \pi\Delta\theta)(p + \tau - (1 - \lambda)\tau\widehat{x}_r(\pi)) \\
&= R\left(\frac{\theta_I + \pi\Delta\theta}{\Delta\theta(1 - \pi)}\right)((p + \tau)(1 - \pi)\Delta\theta - (\Gamma - \Delta\theta(p + \tau))\pi a + \lambda\tau\Delta\theta(1 - \pi(1 - a))) \\
&= R\left(\frac{\theta_I + \pi\Delta\theta}{\Delta\theta(1 - \pi)}\right)(H_1 - \pi H_2).
\end{aligned}
$$

The first order condition for an interior solution to the shareholder value maximization

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problem is given by

$$\frac{R}{\Delta\theta(1-\pi)^2}\left(\pi^2\Delta\theta H_2 - 2\pi\Delta\theta H_2 - (\theta_I H_2 - \theta_R H_1)\right) = 0.$$

Solving for π^* we obtain

$$\pi_{1,2} = 1 \pm \sqrt{\frac{\theta_R a(\Gamma - \Delta\theta(p + \tau(1+\lambda)))}{\Delta\theta(a\Gamma + \Delta\theta(1-a)(p + \tau(1+\lambda)))}}.$$

By assumption 3, $\Gamma > \Delta\theta(p+\tau(1+\lambda))$, and the optimal level of corporate governance quality is given by

$$\begin{aligned}
\widehat{\pi} &= 1 - \sqrt{\frac{\theta_R a(\Gamma - H_1)}{\Delta\theta H_2}} \\
&= 1 - \sqrt{\frac{\theta_R a(\Gamma - \Delta\theta(p + \tau(1+\lambda)))}{\Delta\theta(a\Gamma + \Delta\theta(1-a)(p + \tau(1+\lambda)))}}. \quad (7)
\end{aligned}$$

If $\widehat{\pi} \leq \pi_0$ ($\widehat{\pi} \geq \pi_1$) shareholders choose $\pi^* = \pi_0$ ($\pi^* = \pi_1$), otherwise $\pi^* = \widehat{\pi}$. Notice that $\pi^* \in [\pi_0, \pi_1) \subset (0,1)$ is decreasing both in a and Γ. To see that π^* increases in λ consider first the case of an internal solution. Then differentiating (7) yields

$$\frac{\partial\widehat{\pi}}{\partial\lambda} = \left(\frac{\Delta\theta H_2}{\theta_R a(\Gamma - H_1)}\right)^{1/2}\frac{\theta_R a\tau\Gamma}{H_2^2},$$

which is always positive. When $\pi^* = \pi_0$, it is easy to see that

$$\frac{\partial\pi_0}{\partial\lambda} = \frac{\tau\Delta\theta a(\Gamma - (p+\tau)\Delta\theta)}{[\lambda\tau\Delta\theta + a(\Gamma - \Delta\theta(p + \tau(1+\lambda)))]^2} > 0.$$

Therefore, for all $\pi^* \in [\pi_0, \pi_1)$, $(\partial\pi^*/\partial\lambda) > 0$. ∎

Proof of proposition 3

When managerial entrenchment is not to be countered, shareholder value is given by

$$\begin{aligned}
V_{SH}(\overline{x}_c(\pi)) &= (\pi a + 1 - \pi)(\theta_I R(p + \tau - (1-\lambda)\overline{x}_c\tau)) + \pi(1-a)\theta_R R(p+\tau) \\
&= ((p+\tau)\theta_I - \pi a(\Gamma - \Delta\theta(p+\tau)))R + (1-a)\pi(p+\tau)R\Delta\theta, \quad (8)
\end{aligned}$$

as by inspection of (4) $\overline{x}_c$ is increasing in x_r and thus in this case shareholders optimally

choose $x_r = 0$. Differentiating (8) with respect to π yields

$$V'_{SH}(\overline{x}_c(\pi)) = R(-a\Gamma + \Delta\theta(p + \tau)). \tag{9}$$

From (9) it is immediate that shareholders' value is maximized with *no* control contestability if and only if $a\Gamma > (p + \tau)\Delta\theta$. ∎

Proof of proposition 4

If $a\Gamma > \Delta\theta(p+\tau)$, then $V_{SH}(\overline{x}_c(\pi))' < 0$ and $\pi = 0$ is optimal if managerial entrenchment is not to be countered. However, by inspection $V_{SH}(\overline{x}_c(0)) \equiv R\theta_I(p + \tau) = V_{SH}(\widehat{x}_r(0)) \equiv R\theta_I(p + \tau) \leq V_{SH}(\widehat{x}_r(\pi^*))$. When $a\Gamma = \Delta\theta(p + \tau)$, $V_{SH}(\overline{x}_c(0)) = R\theta_I(p + \tau)$ and the result follows.

Assume now that $a\Gamma < \Delta\theta(p + \tau)$, then $V_{SH}(\overline{x}_c(\pi))' > 0$. In this case if managerial entrenchment is not countered, then $\pi = 1$ is the shareholders' optimal choice. As

$$V_{SH}(\widehat{x}_r(\pi_1)) = \frac{R(p + \lambda\tau)(a\theta_I(\Gamma - (p + \tau(1 + \lambda))\Delta\theta) + \Delta\theta\tau\theta_R)}{a(\Gamma - (p + \tau(1 + \lambda))\Delta\theta) + \tau\Delta\theta},$$

and $V_{SH}(\overline{x}_c(1)) = R(-a\Gamma + (p+\tau)\theta_R)$, $V_{SH}(\widehat{x}_r(\pi_1)) > V_{SH}(\overline{x}_x(1))$ only if $a\Gamma > \tau\theta_R(1-\lambda)$. A sufficient condition for $(p + \tau)\Delta\theta > \tau\theta_R(1 - \lambda)$ is that $0 < \tau < \min\{1 - p, p\Delta\theta/(\theta_I - \lambda\theta_R)\}$. ∎

Notes

[1]Dyck and Zingales (2002) provide empirical evidence that social activists effectively use the media to have an impact on corporate policies. Feddersen and Gilligan (2001) and John and Klein (2003) start from this premise to build models of social activism and costly boycotts.

[2]*Washington Post*, August 30, 1987.

[3]See Coffee (1999) for a discussion of recent European (and in particular, Italian) takeover reforms favoring control contestability.

[4]Namely, workers, consumers, local communities and potential pollutees. Although most of the literature has focused on the relationship between firms and *workers* (see Blair 1995, Blair and Roe 1999, and Hansmann 1996), the recent debate on the stakeholder society concept has unveiled the importance of other constituencies.

[5]A further example of shareholders' endorsement of CSR is the following: in the US, The Corporate Sunshine Working Group, an alliance between institutional investors, environmental organizations and unions, is asking the SEC to expand corporate social and environmental disclosure requirements. Also, as reported by the Investor Responsibility Research Center (IRRC), resolutions filed by socially responsible shareholders are often endorsed by institutional shareholders that have long been associated with shareholder-value enhancing activism, like CalPERS. For interesting evidence on shareholder activism on social issues, see IRRC (2000).

[6]For example *Business Ethics*, a publication on socially responsible business, ranks first the need for independent auditors within its list of guidelines to reform US corporations. In a note dedicated to the use of shareholder resolutions by NGOs as a tool of pressure on corporations, Friends of the Earth reports that "socially-oriented shareholders often link social issues to corporate governance issues." The Rose Foundation for the Communities and the Environment has recently used its shareholdings in corporations to pressure in favor of social responsibility, but also for more independent boards (see respectively `http://www.business-ethics.com`, `http://www.foe.org`, `http://www.rosefdn.org`).

[7]According to the Social Investment Forum, socially responsible investment funds as a category support governance-related resolutions (especially those aimed at the removal of poison pills) more than their "conventional" peers. See "Mutual Funds, Proxy Voting, and Fiduciary Responsibility: How do Funds Rate on Voting their Proxies and Disclosure Practices?" Social Investment Forum, April, 2005 available at `http://www.socialinvest.org`.

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[9]B can be thought of as the foregone pollution with respect to the status quo project, the value of preserved employment for a local community, or the value of additional product safety for consumers.

[10]This modeling choice follows Aghion and Tirole (1997)'s lines in capturing the idea that parties in a relationship may have a *partial* congruence of interests over the course of action to be taken.

[11]We thank an anonymous Referee for raising this issue.

[12]This descends from the assumptions that some projects yield a negative payoff to stakeholders, and that projects all look alike ex-ante. Hence, the regulator would not make any recommendation if uninformed.

[13]This seems to be a reasonable description of what determines the extent of regulatory agencies' interference in firms' activity, at least in the perception of social activists. Environmental activists consider the Environmental Protection Agency's budget as a crucial variable to be monitored. Friends of the Earth, a powerful US environmentalist organization, has recently argued that the Bush administration's cuts to the EPA budget may damage EPA's ability to make and enforce recommendations and environmental laws. Among all budget cuts, the most criticized are those to the Office of Science and Technology, which provides scientific backbone to EPA's regulatory decisions and actions, and those to EPA's enforcement office (see http://www.foe.org).

[14] Although many hint at a "natural alliance" between stakeholders and inefficient CEOs (see for instance Hellwig 2000), to us it is not obvious that stakeholders need benefit from managerial inefficiency. For instance, consumers may be better off when a more innovative manager takes over to improve the firm's products. Potential pollutees may well be more aligned to shareholders concerned with future environmental liabilities, rather than to a myopic manager with poor incentives to invest in discovering green production processes. Against common wisdom, hostile takeovers enhancing efficiency in the oil industry often lead to curtailment of excessive exploration. Probably, it is not managerial inefficiency *per se* that pleases stakeholders; managerial concessions do.

[15]Investment in "green expertise" is becoming a fashionable strategy for many corporate officers. In an interview with McKinsey consultants, the C.E.O. of Dow Chemical Company (a leader in the voluntary adoption of environmentally-friendly strategies) stated that he allocates about 25 percent of his time to handling environmental issues. He also reported on his dialogue with stakeholders: "[I created] a panel for the corporation on a worldwide basis. It includes academics, environmentalists, a former EPA director, (...) and it worked: we have learnt from the panel, and they have learnt from us." ("What is Environmental Strategy?", *The McKinsey Quarterly*, 1993, 4: 53–68)

[16]One may object that the raider could as well achieve a commitment to adopt socially responsible policies in case he takes over the firm. Yet, we argue that incumbent CEOs are often in a better position than outside raiders to build privileged relationships with the firm's relevant stakeholder constituencies. This is a realistic assumption in conglomerate and cross-border takeovers, where the raider and the target belong to different industries or geographical areas. For instance, our story well describes the European phenomenon whereby "locally-rooted" CEOs enjoyed the support of media and politicians against foreign raiders in recent takeover contests in the telecoms, banking and energy industries.

[17]Endogenizing the size of the CEO's equityholdings, and thus analyzing the more complex interaction between control contestability, the design of managerial remuneration, and entrenchment-motivated CSR, lies beyond the scope of the paper.

[18]"Implicit contracts are often backed up by the manager's personal reputation rather than the firm's, so that the manager rather than the corporation owns the valuable trust of the other contracting party." See Shleifer and Vishny (1989), page 132.

[19]Whether takeovers can only create value by reducing stakeholder welfare is largely an empirical question: while evidence on the effects on the wage bill is mixed (see Becker, 1995 and Bhagat, Shleifer and Vishny 1990, but also Jarrell, Brickley and Jeffry 1988 and Rosett 1990) casual observations suggest that hostile takeovers

may well benefit natural stakeholders like consumers and potential pollutees, as argued in footnote 14.

[20]A case in point is the battle over Antonveneta, where a locally rooted manager, Gianpiero Fiorani, relied on the support of local communities, part of the media and institutions, in his attempt to seize control of the bank against a competing bid by ABN Amro. The Northern League, a political party representing the interests of Northern Italy's local communities, showed strong concerns that ABN Amro's acquisition might negatively affect the funding of small and medium enterprises in that area. In response to these claims, ABN Amro's CEO Rijkman Groenink publicly pledged that were his bid to succeed he would maintain Antonveneta's support for the local economy, but initially failed to convince the relevant constituencies and to seize control. ABN Amro eventually managed to acquire control of Antonveneta, after Italian judges froze Fiorani's voting rights on the grounds that he had illegaly acquired his toehold in the firm. See *Financial Times*, March 30 and July 29, 2005.
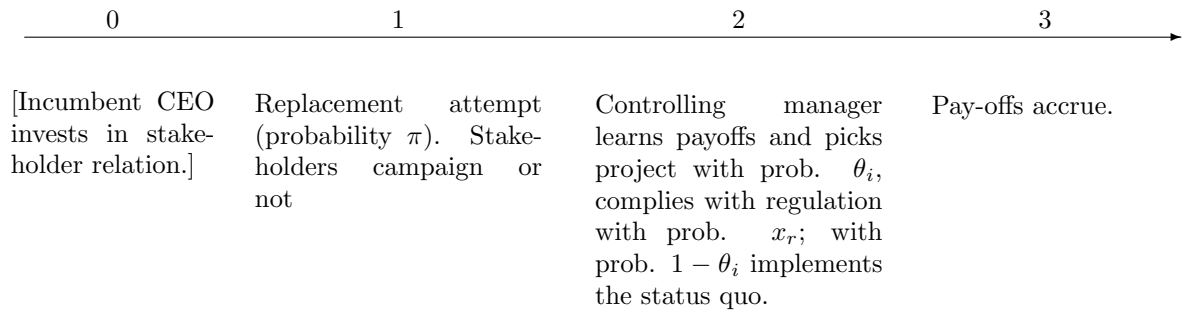
0	1	2	3

[Incumbent CEO invests in stakeholder relation.]

Replacement attempt (probability π). Stakeholders campaign or not

Controlling manager learns payoffs and picks project with prob. θ_i, complies with regulation with prob. x_r; with prob. $1 - \theta_i$ implements the status quo.
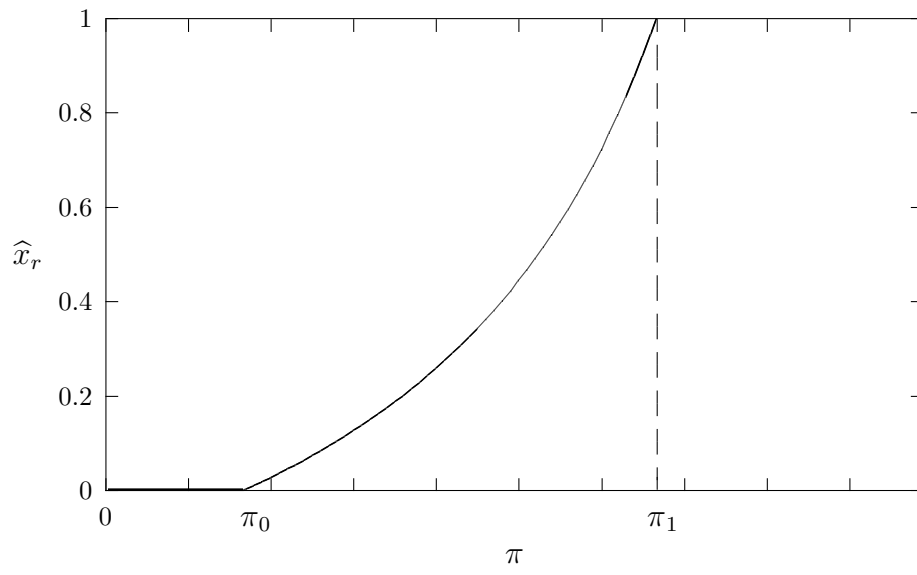
Pay-offs accrue.

Figure 1: The timeline.

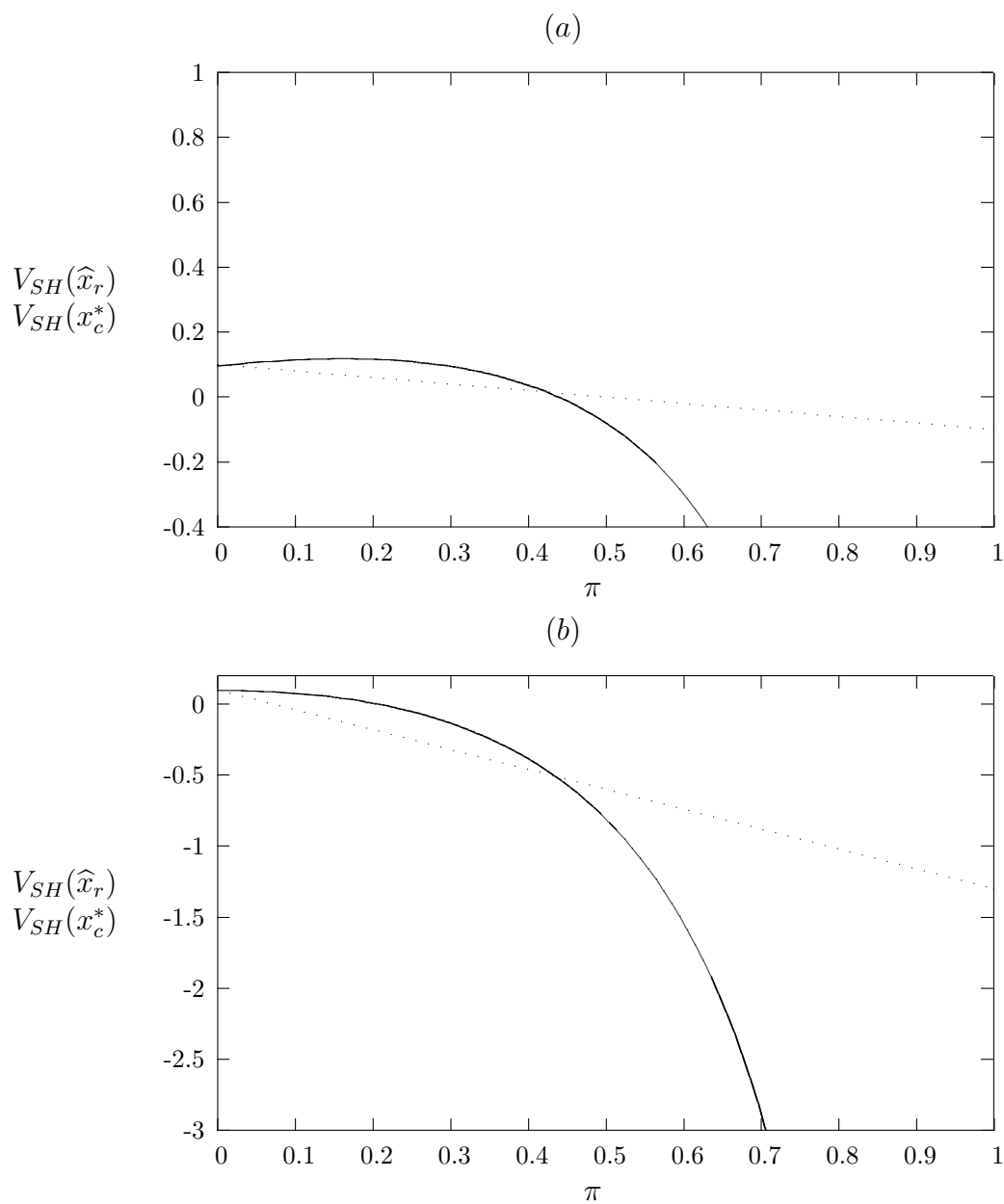Figure 2: The function $\widehat{x}_r(\pi)$.

Figure 3: The continuous (dotted) curve represents shareholder value when entrenchment is (not) countered. In panel (a) shareholders preempt entrenchment: $\pi^* = 0.18$ and $\widehat{x}_r(\pi^*) = 0.49$, while in panel (b) they set $\pi^* = 0.017$ and $\widehat{x}_r(\pi^*) = 0.03$.

		Projects	
		1	2
Congruence	λ	$(p+\tau)R, B$	$pR, 0$
	$1-\lambda$	$(p+\tau)R, 0$	pR, B

Table 1: Expected monetary profits and private benefits accruing to shareholders and stakeholders depending on the selected project and the degree of congruence λ.