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Corporate Governance and Corporate Social Responsibility : A Brief Survey of Corporate Governance, its Measures and Impact, and Why It Should Be Socially Responsible

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Préambule

La gestion financière responsable vise la maximisation de la richesse relative au risque dans le respect du bien commun des diverses parties prenantes, actuelles et futures, tant de l'entreprise que de l'économie en général. Bien que ce concept ne soit pas en contradiction avec la définition de la théorie financière moderne, les applications qui en découlent exigent un comportement à la fois financièrement et socialement responsable. La gestion responsable des risques financiers, le cadre réglementaire et les mécanismes de saine gouvernance doivent pallier aux lacunes d'un système parfois trop permissif et naïf à l'égard des actions des intervenants de la libre entreprise.

Or, certaines pratiques de l'industrie de la finance et de dirigeants d'entreprises ont été sévèrement critiquées depuis le début des années 2000. De la bulle technologique (2000) jusqu'à la mise en lumière de crimes financiers [Enron (2001) et Worldcom (2002)], en passant par la mauvaise évaluation des titres toxiques lors de la crise des subprimes (2007), la fragilité du secteur financier américain (2008) et le lourd endettement de certains pays souverains, la dernière décennie a été marquée par plusieurs événements qui font ressortir plusieurs éléments inadéquats de la gestion financière. Une gestion de risque plus responsable, une meilleure compréhension des comportements des gestionnaires, des modèles d'évaluation plus performants et complets intégrant des critères extra-financiers, l'établissement d'un cadre réglementaire axé sur la pérennité du bien commun d'une société constituent autant de pistes de solution auxquels doivent s'intéresser tant les académiciens que les professionnels de l'industrie. C'est en mettant à contribution tant le savoir scientifique et pratique que nous pourrons faire passer la finance responsable d'un positionnement en périphérie de la finance fondamentale à une place plus centrale. Le développement des connaissances en finance responsable est au cœur de la mission et des intérêts de recherche des membres tant du Groupe de Recherche en Finance Appliquée (GReFA) de l'Université de Sherbrooke que de la Chaire Desjardins en finance responsable.

La finance responsable (ou durable) vise donc notamment à développer des modèles, des produits et des services ainsi qu'à orienter les marchés financiers et les décisions en matière de fiscalité dans une perspective durable et responsable. À cet effet, les Professeur(e)s Frank Coggins, Claudia Champagne et Lyne Latulippe ont publié en 2018 aux Éditions *Thompson Reuters* un recueil de textes s'intitulant « Éléments de la finance responsable : une approche multidimensionnelle ». Ce collectif contribue à mieux définir et délimiter la finance responsable en la décloisonnant dans une perspective multidimensionnelle. Il regroupe des textes d'universitaires de différentes disciplines ainsi que de spécialistes de l'industrie financière, propose des pistes pour tendre vers une meilleure finance, vers une finance plus responsable. Le présent cahier de recherche constitue l'un des textes (chapitres) tirés de ce collectif.

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Most debate around corporate governance has focused on the impact of Corporate Social Responsibility (CSR) on performance. This chapter focuses on why the owners of corporations should take care of the society's interests while protecting themselves from expropriation by managers.

Corporate governance can be defined as a set of protection mechanisms that capital providers (i.e., owners) put in place in order to get a fair return on their investment. Hence, corporate governance relies heavily on managers' observance of the duty of loyalty to act in the shareholders' best interests. However, the empirical evidence (briefly discussed below) suggests that these mechanisms are not always efficient in reducing the agency problem between managers and shareholders, and often exacerbate the problem. A reason for this failure is that the mechanisms have focused on the utility function of shareholders and have neglected the utility function of other stakeholders. The owner of a corporation can prevent the manager from investing in social projects that do not increase her/his wealth, even if this increases the wealth of the manager or the employees or the society. However, under-investment in social projects might undermine market confidence. For example, if the customer is not happy with the quality of the product, he/she may decide not to buy the good, in which case the corporation receives nothing, the employee has no salary and the shareholder has no profit; as a consequence, the firm receives no further funding, which might lead to its collapse. In this chapter, I argue that managers and owners have a duty of loyalty to employees, the society and the environment. In particular, the owner should not prevent the manager from investing in socially responsible projects that have value for employees and the society, even if those projects do not increase the owner's wealth. In a sense, corporate governance should be socially responsible.

In section 1, I introduce the agency problem and the need to solve it using corporate governance mechanisms. Section 2 proposes a brief survey of corporate governance mechanisms. In section 3, I present the main corporate governance measures used in the finance and economic literatures and discuss the empirical evidence related to these measures and their limits. In section 4, I discuss the rationale for considering the interests of all stakeholders and why owners of corporations have a duty of loyalty to the society. This duty of loyalty should be manifested in corporate socially responsible investments. Section 5 concludes.

1. INTRODUCTION: THE AGENCY PROBLEM AND THE NEED FOR CORPORATE GOVERNANCE

In an influential work, Berle and Means (1932) argue that the modern corporation is no longer (only) a place for carrying out private business but is a new form of property tenure where the owners of the corporation are not running the daily business activities. This is known as the "separation of ownership and control." In this new property structure, owners who were once the managers of their corporation have traded their legal position of private ownership for the role of residual claimant on capital returns. The day-to-day decisions are now made by an entity (i.e., the agent or the manager) who is not the owner (i.e., the principal) of the corporation. This separation of ownership and control, first proposed by Adam Smith (1776/1937), introduces an agency problem: both the agent and the principal are utility maximizers, but the agent may not focus fully on the principal's interests but, rather, serve her/his own interests. An agency problem is the "problem of inducing an agent to behave as if he were maximizing the principal's welfare" (Jensen and Meckling, 1976, p. 309). In corporate finance, an agency problem refers to the conflict of interest between a company's shareholders (principal) and its management (agent). The solution to the problem, known as corporate governance, should align interests and lead to corporate efficiency.

According to empirical evidence, a practical consequence of the lack of corporate governance is the limit on external capital supply to corporations. Specifically, when investors provide external financing, they face the risk that the return on their investment will never materialize. If the country does not offer investor protection against ex-post resource misallocation (i.e., expropriation from managers or the controlling shareholders), then the ex-ante flow of capital to corporations, and thus to the country's total investments, will be limited. This results in market inefficiencies and slow market development (LaPorta, Lopez de Silanes, Shleifer and Vishny, 2000; Shleifer and Wolfezon, 2002). In fact, modern corporate governance has emerged as a response to the failure of important companies, the extent of whose problems was not revealed by their published accounts, which could affect investor confidence in the market. In particular, the collapse of prominent banks in the United Kingdom in the 1990s (e.g., Maxwell, the Bank of Credit and Commerce International) put governance issues on the public agenda for the first time (Cadbury, 2000).

2. DEALING WITH THE AGENCY PROBLEM

2.1 Product-market competition as a response to the agency problem

One could argue that, with the increase in economic openness and integration, product-market competition will increase and force firms to be efficient, and that managers of corporations will have no choice but to maximize the principal's utility. In Hart (1983), for example, the existence of empire-building and effort minimization, both consequences of the separation of ownership and control, characterize managerial slack, which is in conflict with value maximization, the goals of the owners. Hart (1983) argues that competition acts as a *disciplinary* mechanism, by decreasing firms' profits. Thus, managers should increase their level of effort and maximize profit or they will lose their job with the exit of the corporation from the market. This suggests that competition will gradually take care of the divergence of interests between managers and owners, and that we should not worry about the agency problem.

In practice, however, competition alone cannot ensure that competitive profit will not be diverted by managers. As noted by Shleifer and Vishny (1997, p. 738):

> While we agree that product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance. One could imagine a scenario in which entrepreneurs rent labor and capital on the spot market every minute at a competitive price, and hence have no resources left over to divert to their own use. But in actual practice, production capital is highly specific and sunk, and entrepreneurs cannot rent it every minute. As a result, the people who sink the capital need to be assured that they get back the return on this capital. The corporate governance mechanisms provide this assurance.

> Product market competition may reduce the returns on capital and hence cut the amount that managers can possibly expropriate, but it does not prevent the managers from expropriating the competitive return after the capital is sunk. Solving that problem requires something more than competition […]

In summary, product-market competition may resolve managerial slack (or shirk) but not necessarily managerial expropriation. As discussed in Shleifer and Vishny (1997), much of corporate law development in the 18th and 19th centuries in Europe was focused on addressing the problem of managerial expropriation rather than on shirking and empire-building. The owners of a corporation can establish incentives and monitoring mechanisms that will limit the divergence of interests with management. These control mechanisms – or corporate governance – are the various ways in which the providers of capital ensure that they get a fair return on their investment (Shleifer and Vishny, 1997).[1]

2.2 Monitoring

This section discusses monitoring as a control mechanism intended to increase managers' efforts towards maximizing the value of the firm and to reduce the consumption of perquisites (or non-pecuniary benefits, which is a form of expropriation). Perquisites comprise the "charm" of secretarial staff, the kind and amount of charitable contributions, personal relations with employees (e.g., love and respect), large office size and supplies, and so forth (Jensen and Meckling, 1976). Although not all of these perquisites are necessarily value-reducing (i.e., they may increase managerial pleasure in running the company), they often lead to excessive administrative expenses and suboptimal investment decisions. In practice, the amount of perquisites consumed is not proportional to the manager's stake in the company. In fact, the lower the manager's cash flow rights (percentage of the firm owned by the manager), the higher the perquisites and the lower the firm value. The owners of the corporation can increase monitoring to reduce managerial opportunity. Mechanisms for doing so include restrictions on the use of excess cash flow, external auditing of financial accounts, board control of

1. Note that the agent can incur some bonding costs to signal its willingness to work towards securing the best interest on the principal. Therefore, the costs resulting from the agency problem are borne by both the principal and the agent (Jensen and Meckling, 1976).

managerial decisions, incentive contracts (this will be discussed in the next section) and so forth. Internal monitoring of managers is ultimately carried out by the board of directors. In theory, boards of directors are composed of managers as well as internal and external directors, including audit experts. Empirical evidence suggests that the presence of a strong board prevents managerial wrongdoing. Xie, Davidson and Dadalt (2003) investigate the relationship between earnings management and board characteristics. Their results suggest that earnings management is particularly low when the board includes independent outside directors with financial competence, corporate executives and, on the audit committee, investment bankers, and when board members meet regularly on corporate matters. These results are supported by Cornett, Marcus and Tehranian (2008).

The impact of board monitoring on firm performance has been the subject of much debate. In particular, the need for an increased level of outside representation on the board has been questioned (see, e.g., Bhagat and Black, 2000; Hermalin and Weisbach, 1998). One argument against board effectiveness relates to the endogenous relationship between the board and firm performance. Specifically, board structure (i.e., audit, compensation, nomination and executive committees) may affect management decisions and therefore the financial performance of the firm. Inversely, firm performance could influence the appointment of future board members; that is, only firms that generate sufficient revenues can afford the top choice from the corporate board of directors market. Consequently, the real influence of boards of directors is difficult to establish. Another argument is so-called CEO duality and insider-dominated boards, which could lead to managerial entrenchment (see, e.g., Fama and Jensen, 1983). When the CEO also serves as board chairman (CEO duality), top management has de facto greater power over outside directors, who are supposed to be in charge of overall company management. The practical consequence of CEO duality is increased agency costs, because the board's ability to oversee managers is greatly reduced. However, some authors (e.g., Brickley, Coles and Jarrell, 1997) view CEO duality as a response to economic pressure and hold that combining the two titles will result in efficient decision-making. According to this efficiency theory of CEO duality, the combining of titles is often part of an incentive scheme to attract high-performing CEOs. The evidence is mixed, however, often supporting the efficiency view but not rejecting the entrenchment hypothesis (see Dey, Engel and Liu, 2011). A third argument against board effectiveness is the presence of busy directors on the board (Fich and Shivdasani, 2005). Busy directors (those with directorships in several firms) are associated with weak corporate governance (they are unable to provide management with efficient incentives), lower (firm's) abnormal returns and lower market-to-book ratios.

In summary, the board should be adequately structured (with independent directors, no busy directors, external audit, clear definition of the CEO's role on the board so as to limit entrenchment, etc.) in order to provide managers with an efficient set of incentives (such as a compensation plan or a threat of dismissal).

2.3 The incentive contract

Another way to align the interests of managers with those of shareholders is to grant managers a long-term incentive contract. For example, assume a manager is embarking on an investment project that will give him a net personal benefit of $100 but will cost shareholders a net wealth of $200. An incentive contract will compensate the manager 100+$10 if he does not undertake the value-reducing project. An appropriate incentive contract might be a package of incentives that includes share ownership, stock options, salary, a threat of eviction if the expected profit is low (Jensen and Meckling, 1976). A positive relationship has been found between managerial pay (e.g., salary, stock options or bonuses) and firm performance (Jensen and Murphy, 1990). This raises the question of the optimal incentive contract. If pay is weakly sensitive to performance, managers may not be willing to undertake riskier projects that will potentially generate wealth for shareholders. However, if pay is highly sensitive to performance, the volatility of pay (and thus managerial risk) is high, which contradicts the hypothesis of managerial risk aversion, as managers should tolerate risk in order to accept such incentive contracts. Further, with high pay-to-performance sensitivity, managers may negotiate such incentive contracts when they know that the firm's earnings are likely to rise, or they may even maneuver earnings to increase their pay. Indeed, managers have discretion over reported earnings; therefore, the effect that earnings have on managerial compensation may exacerbate the managerial–shareholder agency problem. Bergstresser and Philippon (2006) emphasize this and show that CEO pay-for-performance schemes are associated with increased manipulation of reported earnings and that corporate insiders sell off extensive quantities of the firm's shares during years of large accruals. In summary, incentive contracts can give rise to extreme accounting manipulations and thus to accounting scandals (e.g., Adelphia, Enron, Worldcom). Thus, incentive contracts alone may not be able to solve agency problems.

2.4 Ownership by a large shareholder (concentrated ownership)

One factor that exacerbates the divergence of interests between managers and shareholders is the presence of dispersed ownership, whereby a single shareholder has limited cash flow rights. Practically, dispersed ownership is characterized by the spread of numerous minority shareholders across a broad geographic region. A minority shareholder may fail to attend the annual meeting to vote for policy changes and defend her/his rights, for several reasons: (1) he/she does not possess enough power to influence the vote, (2) the headquarters is many miles from her home (and she cannot vote by mail), or (3) the marginal cost of attending the meeting offsets the return on her investment in the firm (cash flow rights). As a result, it becomes costly for a minority shareholder to enforce managerial discipline. With dispersed ownership, the agency problem is likely to be substantial. However, a large shareholder with significant cash flow rights is likely to spend time and money to monitor the manager of the corporation, as the monitoring costs might be lower than the benefits she gets from her cash flow rights. Concentration of ownership in the hands of few shareholders is therefore an important dimension of corporate governance. But corporate governance by large shareholders has its costs. Indeed, large shareholders are utility maximizers, and they may as well focus on their own benefits rather than on the objectives of other minority shareholders. Therefore, there is a potential for expropriation of minority shareholders by large shareholders.

Ownership becomes concentrated if an investor buys a significant proportion of the firm's shares; if a small group of investors, often including managers, buy out the company with debt (leverage buy-out, or LBO); or if the company acquires another company with debt or equity (also known as takeover). Often, management can take actions to prevent a takeover, thereby reducing the likelihood of ownership concentration by outside investors. These actions, also known as "anti-takeover provisions", include supermajority provisions requiring more than 50% of the votes to change corporate boards, golden parachutes, supermajority requirements for approval of mergers, poison pills that give shareholders of the target company the right to buy new shares of the (target or acquirer) company at a discount, diluting the acquirer's ownership in the target company, and so forth. The literature suggests that, very often, managers implement takeover defense to serve their own objectives rather than those of the shareholders (Shleifer and Vishny, 1997).

In summary, although ownership concentration might reduce agency conflicts, it may not be materialized through the market for corporate control as managers could implement anti-takeover devices, and when these materialize they can lead to the expropriation of minority shareholders. Sometimes, the law must intervene to protect minority shareholders from expropriation by managers as well as by large shareholders.

2.5 Government support: Laws to protect shareholders

A corporation can establish an appropriate contract to potentially solve the agency problem, but in the absence of a law to enforce the contract there is no guarantee that managers will return the profit to shareholders. In general, shareholders provide the firm with external capital in exchange for legal rights vis-à-vis the firm's assets. The most important right is the right to vote on key corporate issues such as election of the board of directors and mergers and acquisitions. In dispersed ownership, however, as previously noted, voting rights can be expensive to exercise and enforce. Usually, managers have significant power in corporate decisions, such as whether to return the company's excess cash flow to shareholders or use it to increase the size of the company through new acquisitions (managerial empire-building); whether to consume the private benefits of control (e.g., increase one's office size, travel by private jet); whether to reveal important corporate information; or whether to consult shareholders on important corporate matters. Therefore, the existence of laws protecting shareholders' rights and the extent to which these laws are enforced determine the strength of corporate governance.

The extent and enforcement of investors' legal rights vary widely across countries (Shleifer and Vishny, 1997). Laws protecting shareholders can take various forms, including prohibition of managerial self-dealing (excessive compensation, theft from the firm, etc.), compliance with the company's charter, restriction on managers' actions concerning corporate decisions (managers must consult the board of directors before making any significant decisions). Despite the existence of laws protecting shareholders, violation of an equity contract (in particular, managerial self-dealing) may be hard to detect, unlike the violation of a debt contract (i.e., default). Therefore, the law is partly efficient (as it prevents the clearest violations) and can gradually be enhanced in light of new corporate issues. For example, following the 2000–02 corporate scandals involving Enron, WorldCom and Tyco, the United States passed a new law governing publicly and privately held companies that is intended to improve investor protection and market confidence: the Sarbanes-Oxley Act 2002, or SOX. Indeed, that series of scandals has highlighted serious issues in corporate governance – for example, the lack of auditor independence, lack of accounting transparency, analyst conflict of interest, board member incompetence, and inadequate compensation contracts focused on stock options.

3. THE QUALITY OF CORPORATE GOVERNANCE MEASURES

3.1 The main corporate governance measures discussed in the economic literature

In this section, I discuss the quality of corporate governance measures and how they are related to agency problems and firm performance. This discussion of corporate governance measures is not intended to be exhaustive and will focus on the main measures found in the finance literature, namely IRRC (Investor Responsibility Research Center), ISS (Institutional Shareholders' Service), CLSA (Credit Lyonnais Security Asia) and S&P (Standard and Poors) governance measures. IRRC focuses on US companies; CLSA, ISS and S&P cover companies around the world.

In an influential study, Gompers, Ishii and Metrick (2003) – GIM – use the IRRC coverage of companies' charter and bylaw provisions to identify 24 unique takeover provisions, which they divide into five categories: tactics for delaying hostile takeovers, (shareholder) voting rights, director/officer protection, other takeover defenses, and state laws limiting takeover bids. The governance (G) index is formed by adding one point if the company has a defense provision, zero if it does not. Thus, the G-index lies between 0 and 24. According to GIM, high protection (i.e., larger values of the G-index) can make takeovers prohibitively expensive; this reduces the effectiveness of the control from the market and thus is less shareholder-friendly (or it empowers managers). GIM acknowledge that the IRRC data do not represent an exhaustive listing of provisions and is a noisy measure of corporate governance, but they argue that one should not worry about any systematic bias in these data. GIM find that firms with the most takeover provisions (i.e., with the weakest shareholder rights) have higher agency costs (managerial shirking, overinvestment and perquisites consumption), and thus lower market value. GIM conclude that governance causes unexpected firm operating performance, which in turn is associated with stock returns movement. However, while supporting GIM's finding on governance and agency costs, Core, Guay and Rusticus (2006) do not find any causal relationship between GIM's weak corporate governance measure (higher G-index) and lower stock returns. Bebchuk, Cohen and Ferrell (2009) construct an entrenchment index (E-index), which focuses only on six takeover provisions from the 24 IRRC unique provisions. Of these six core provisions, four set constitutional limits on the extent to which shareholders can impose their will on management (staggered boards, limits to shareholder bylaw amendments, and supermajority requirements for mergers and charter amendments). The two other core provisions are known to prevent hostile takeovers (poison pills and golden parachutes). Bebchuk, Cohen and Ferrell's (2009) results support GIM's finding that firms with higher takeover protection have lower valuation and large negative abnormal returns, but they find that the other 18 IRRC provisions (combined into the other (O) index) are uncorrelated with reduced valuation and negative abnormal returns. They conclude that only a few corporate governance provisions play a key role in the link between corporate governance and firm valuation.

The CLSA corporate governance ratings have been issued since 2001 for firms across global emerging markets. Selection criteria for firms are size and investor interest. The ratings of firms are based on responses by financial analysts to governance questions divided into seven categories (before 2012): management discipline, transparency, independence, accountability, responsibility, fairness, social responsibility. Since 2012, two categories (accountability and responsibility) have been removed and one new category has been added (sustainability, or E&S, for environment and social), for a list of six categories. Before 2012, the social responsibility category was weighted 10% in the CLSA aggregated governance score, while the other six categories had an equal weight of 15%. Since 2012, the CLSA aggregated governance score has attributed 10% to the E&S category, which is environmentally and socially oriented, and an equal weight of 18% to the other five categories (excluding accountability), which are mostly shareholder-oriented. Several researchers have used these ratings in recent work (e.g., Durnev and Kim, 2005; Khanna, Kogan and Palepu, 2006; Doidge, Karolyi and Stulz, 2007; Chen, Chen and Wei, 2009). The ISS started providing corporate governance ratings in 2002 for US companies and in 2003 for companies in other developed markets. The ISS compiles ratings by examining firms' annual reports, regulatory filings and websites. The ratings are based on more than 50 corporate governance attributes. For each attribute, a firm is given a one or a zero, whether or not it meets a threshold of the implementation of the attributes (see Aggarwal, Erel, Stulz and Williamson, 2009). These governance attributes can be divided into four categories: Board, Audit, Anti-takeover, and Compensation and Ownership. Several recent studies have used the ISS corporate governance measure (e.g., Chhaochharia and Leaven, 2007; Aggarwal, Erel, Stulz and Williamson, 2009; Aggarwal, Erel, Ferreira and Matos, 2011). The S&P transparency and disclosure ratings were issued for 1,443 firms in 2003. The firms were selected from global developed and less developed markets. Based on an examination of annual reports and Securities and Exchange Commission (SEC) filings, a firm is given a one if it discloses one of the 98 disclosure items and a zero otherwise. The items are divided into three categories: 28 items on ownership structure and investor relations, 35 items on board process and management structure, and 35 items on financial transparency and information disclosure. These ratings have been used in the financial and economic literature (e.g., Khanna, Palepu and Srinivasan, 2004; Durnev and Kim, 2005; Doidge, Karolyi and Stulz, 2007; Cosset, Somé and Valéry, 2016).

In general, the CLSA, ISS and S&P governance measures have been successful in explaining firms' operating as well as market performance (for more detail, see the references cited above), suggesting some effectiveness of the implemented corporate governance devices in reducing the wedge of interest between shareholders and managers (i.e., the agency problem).

3.2 The main problem with corporate governance: Shareholder focus, neglect of the society

In summary, this review of the main corporate governance measures discussed in leading finance and economic journals (e.g., *Journal of Finance*, *Journal of Financial Economics*, *Review of Financial Studies*, *Journal of Financial and Quantitative Analysis*, *Quarterly Journal of Economics*) has shown that corporate governance measures are shareholder-oriented. In particular, the governance mechanisms are aimed at protecting shareholders from expropriation by managers. These measures and the empirical results associated with them suggest that some firms have implemented appropriate corporate governance mechanisms to protect shareholders' interests. However, the measures also suggest that a large number of firms fail to meet the appropriate corporate governance requirements (mostly those with low governance measures), and thus they present high risk of expropriation of shareholders and low operating/market performance. The financial crisis of 2008 pointed to a failure of the global corporate governance system (Kirkpatrick, 2009), suggesting that the universe of firms with poor governance is large. Yet firms continue to improve their corporate governance mechanisms over time (see Doidge, Karolyi and Stulz, 2007; Hugill and Siegel, 2014). Therefore, one reason for this governance failure could be that governance mechanisms are expensive to implement for some firms, particularly those in less developed markets (Doidge, Karolyi and Stulz, 2007), leaving them with affordable but less productive governance mechanisms. Another reason for the governance failure could be that firms have voluntarily focused on some mechanisms to comply with the requirements but that these mechanisms have few implications for shareholders' rights (e.g., Bebchuk, Cohen and Ferrell's, 2009, O-index). In particular, firms may have focused on the utility function of shareholders and neglected the utility function and impact of other participants on the firm's performance: the employees who affect productivity, the consumers whose product preferences affect the company's sales, people who live near the plant and face noise and/or air pollution. For example, a shareholder-oriented policy to increase the company's earnings by reducing employees' salaries or increasing their working hours clearly goes against employees' interests. As a lack of trust between managers and shareholders leads to high agency costs and lower firm value, a lack of trust between managers and employees (or other participants) may lead to under-performance of the firm, which in turn will affect shareholders' wealth. For many companies, the corporate (governance) system is not sustainable. Companies should re-orient their corporate system to include the utility function of all participants (also known as stakeholders). I discuss this in the next section.

4. THE NEED FOR A NEW PARADIGM

4.1 Managers' duty of loyalty: Its impact on the economy

As discussed above, corporate governance relies heavily on managers' observance of the duty of loyalty. Managers have a duty to act in shareholders' best interests. But what will happen to the economy if this is the only duty of loyalty that managers fulfil?

Imagine an economy consisting of one corporation, one shareholder, one employee, one customer, one state, one land: the shareholder sinks the capital to the corporation and delegates the manager to run it on his behalf. The employee's job is to produce the only good of the economy. The benchmark economy process is straightforward: the corporation borrows the land from the state and produces the good, which is sold to the customer. The corporation receives the price of the good. The manager receives compensation for running the corporation; he/she also pays the employee's salary and pays back the state for the use of its land. The remaining profit is returned to the shareholder. Imagine a scenario where the manager runs the corporation properly but does not return to the shareholder his profit. The shareholder will not be happy with the manager's job and subsequent capital will not be provided; the practical consequence is the collapse of the economy. To prevent this, the state must enforce the corporation's charter and protect its shareholders' rights. Then, corporate governance is needed to maintain the shareholders' confidence and keep the economy functioning.

Let us assume that corporate governance prevents the manager from stealing the shareholder's profit. But the manager can increase his compensation by lowering the employee's salary (self-dealing). If the employee is not happy with his working conditions and decides not to work, the good is not produced and the corporation receives nothing. This will lead to a collapse of the economy. Let us also assume that the customer is not happy with the quality of the good or has concerns about the use of the land that he shares with the corporation. He/she may decide not to buy the good. If he/she does not buy the good, the corporation receives nothing, the employee has no salary, the shareholder has no profit, and subsequent capital is not sunk; again, a collapse of the economy. Therefore, even with good corporate governance, for the shareholder to be assured of getting something from his investment he must ensure that the land is used properly, that the employee gets a fair salary, and that the customer is happy with the good and with the use of the land. In other words, the shareholder should care not only about corporate governance but also about the interests of all those involved in the production process.

This simple example highlights several agency issues: (1) the shareholder lends external capital and expects a fair return, (2) the government lends the land and expects the corporation to use it wisely, (3) the employee provides labor and expects decent compensation, and (4) the customer provides trust and expects a quality product. Even if all agents in the economy are utility maximizers and care mostly about their own interests, the manager's self-dealing is central. For the same reasons that managers do not return the competitive profit to shareholders when the capital is sunk, they may find it easier not to care about the society and "enjoy the quiet life." But it is not only managers who are to blame in the event of a collapse of the economy. As we have seen, if the law protecting shareholders is solid, shareholders may be better off but the society could suffer. Thus, the state should worry about issues concerning the corporation and the society as well as those concerning managers and shareholders. Managers have a duty of loyalty to their employees, the society and the environment, which can also be described as CSR, and the state must enforce that duty of loyalty. I believe that shareholders (the owners of corporations), through the corporate contract, also have a duty of loyalty to the society.

4.2 Owners' duty of loyalty

Before discussing the duty that owners have to the society, we must understand the reason why a firm exists. Firms are created for one of two reasons, broadly speaking: (1) altruism – a company is founded because of a need to fulfill a societal goal (a hospital to heal people, a water company to extract and distribute clean water, a construction company to provide homes, etc.); or (2) strategy – a company is founded to take advantage of an investment opportunity in order to make money. In the altruistic example a company invests in a CSR project as part of its corporate goal, while in the strategic example a company invests in CSR only if this investment increases its corporate wealth. CSR can be defined as the efforts that firms voluntarily make to eliminate, or at least to reduce, the negative impact of their business activities on their stakeholders (Post, Frederick, Lawrence and Weber, 1996).

It is worth noting that the most recent research on CSR focuses on whether or how CSR affects corporate wealth, rather than whether one should invest in CSR even if such investment comes out of the company's excess cash flow. In some cases (as advocated by the stewardship theory of the firm), investment in CSR may be entirely for a social objective. However, when a firm is run by a manager who is supposed to work on behalf of the providers of capital (namely, the shareholders – the owners), the firm will invest in CSR only if this increases shareholders' wealth, or if not investing in CSR will decrease shareholders' wealth. This latter view is advocated by Nobel laureate Milton Friedman in a polemical article, "The Social Responsibility of Business Is to Increase Its Profits' So Long as the Company Engages in Open and Free Competition without Deception and Fraud" (Friedman, 1970). Indeed, managers as agents owe owners of corporations a duty of loyalty to pursue their interests, and spending the corporation's resources on CSR issues may go against that duty.

In this chapter I focus on the modern form of corporation, where managers maximize value for shareholders, by arguing that CSR investment should be considered not only as a factor for increasing value, but also as an important objective of shareholders. Specifically, shareholders protect their rights through corporate governance mechanisms that prevent managers from shirking and expropriating them. These mechanisms are costly and thus are part of shareholders' investment in the company. Since managers are sometimes constrained to work towards maximizing the firm's value, shareholders could design governance mechanisms that are socially responsible in that they allow managers to care about the society. *If corporate governance represents an investment for the firm, then, just as we invest our money in a socially responsible manner, we should invest in corporate governance in a socially responsible manner*.

4.3 Corporate governance as a socially responsible solution to the agency problem

The extent of corporate governance depends on the nature and size of the agency costs involved in ensuring that managers act in the best interests of shareholders. I have identified two broad reasons why a company is created: the altruistic reason, to advance the social goals of the company, versus the strategic reason, to maximize profits. These two reasons determine the nature and the extent of CSR investment. Further, once a firm has been founded, it may undertake CSR projects in response to pressure from the environment (investors, governments, etc.) (Husted and Allen, 2006). Therefore, following Salazar and Husted (2008, chapter 6), I distinguish three motivations for investing in CSR projects: altruistic, strategic and coercive. Under the coercive motivation, managers limit the negative impact of CSR investment on value. Thus, in terms of its impact on firm value, the coercive motivation lies between the altruistic and the strategic. For the sake of clarity, therefore, I focus on only two types of owner, altruist and strategic.

Following Jensen and Meckling (1976), I present a simple framework for a manager investing in CSR. Assume an owner-manager (with 100% stake) of a corporation. The owner decides on the amount of perquisites she/he consumes. Assume that perquisites are non-pecuniary benefits (in particular, loyalty/respect and love) that the owner gets from employees and the society. He spends resources to increase employees' love and loyalty; he also devotes resources to the society, through donations to charitable and environmental organizations, and in return he gets love from the society. For simplicity, assume these resources spending as CSR investment. Although the owner may get love and respect from the society, his company's sales could increase as a result of that love. Therefore, our simple framework allows investment in CSR to return non-pecuniary as well as pecuniary benefits to the owner. The owner will spend his own money (or his firm's money) on CSR projects, regardless of his/her type (altruistic or strategic). The cost to the owner of consuming \$1 of non-pecuniary benefits in the company is \$1 – that is, the owner bears the full cost of CSR projects. The altruist owner invests only in CSR projects that return non-pecuniary benefits, while the strategic owner invests only in CSR projects that increase the company's profits.

Now, assume that the owner decides to sell a portion $1 > \alpha > 0.5$ of her/his company to an outside investor, who now becomes the new owner. The old owner will run the company as a manager with $1 - \alpha$ stake in the company. New investments are ex-post to the provision of external capital. When the capital is sunk by the new owner (the outside investor), the manager (old owner) decides on the amount that will be spent on CSR projects. The presence of a new owner who is not the manager introduces a potential agency conflict, the extent of which depends on the type of owner and type of manager: (1) the owner and the manager are both altruists; (2) the owner and the manager are both strategists; (3) the owner is an altruist and the manager is a strategist; or (4) the owner is a strategist and the manager is an altruist. As a consequence, the provision of corporate governance mechanisms also depends on the size of the agency problem and thus on both type of owner and type of manager.

When the owner and the manager are both altruists, investment in CSR is desirable, although the manager gets the entire non-pecuniary benefits. In the same vein, when both the owner and the manager are strategists, they share $(1 - \alpha)\$$ and $\alpha\$$ of each \$1 pecuniary benefit from CSR investment. In these two cases, we assume that there are no conflicts of interest regarding CSR investments between the owner and the manager (although there may be conflicts about which types of CSR projects to invest in), and thus no serious CSR-related agency problems. However, if the owner is an altruist and the manager is a strategist, or vice-versa, there is an agency problem, because the manager might not be acting in the best interests of the owner. For example, since the manager consumes the entire non-pecuniary benefits, he/she should continue to bear the full cost of CSR projects. However, after the capital is sunk, the cost to the manager of consuming non-pecuniary benefits is no longer \$1, but, instead $(1 - \alpha)\$$. Thus, the new owner will bear a portion of CSR investment but will get nothing in return. Friedman (1970) argues that the manager has no right to invest in CSR as he/she has a duty to work in the best interests of the principal (the new owner). A strategic owner will expend effort on governance mechanisms to ensure that the manager spends less on CSR projects that give him non-pecuniary benefits and that he focuses on CSR projects that increase the owner's wealth. I argue that this governance effort should be socially responsible. In particular, the owner should not prevent the manager from investing in CSR projects that have value for employees and the society even if those projects do not increase the owner's wealth (in light of what was discussed in the last two sub-sections). Further, if the manager is a strategist and the owner is an altruist, the owner should also expend governance effort to encourage investment in CSR projects that benefit the society.

5. CONCLUSION

The introduction of external capital into a corporation establishes an agency relationship between the owner of the corporation and the manager (the agent). This agency relationship gives rise to an agency problem, in that the agent (the manager) may not maximize the principal's welfare but instead pursue her/his own interests. An efficient solution to the agency problem will reduce the conflict of interest between the manager and the owner. Corporate governance concerns the mechanisms that the owner of a corporation implements to ensure that the manager acts in the owner's best interests. However, corporate governance mechanisms are sometimes influenced by the management personnel in place, whom the mechanisms are intended to monitor. Most importantly, even when corporate governance mechanisms are efficient, they may not be very socially friendly as they are focused only on the owner's wealth. In this chapter I have reviewed the main corporate governance mechanisms, how they are measured empirically and how efficient (empirically) they are in resolving the agency problem. I have discussed the impact of corporate governance mechanisms that neglect the society utility function. I have shown that the owner of a corporation should care about the wealth of the society as well as his own wealth. The design of corporate governance mechanisms must allow managers some flexibility to invest in CSR projects that benefit not only the manager and/or the owner, but also the society. Just as an investor should invest his money in a socially responsible way, owners of corporations should invest their resources in corporate governance mechanisms in a socially responsible way, allowing them to serve the society's interests.

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