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Corporate Diversification, Managerial Entrenchment, and Corporate Governance: a Theoretical Framework Based on Agency Theory

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Abstract

The relationship between corporate control mechanisms and managerial entrenchment has generated extensive debate, giving rise to divergent perspectives across competing theories of the firm. Contractual theories, particularly **agency theory**, constitute the dominant theoretical framework in corporate governance research. From this perspective, diversification strategy may be viewed as a managerial instrument through which executives pursue their own interests at the expense of shareholders' wealth maximization. Agency theory therefore examines how corporate governance mechanisms influence firms' diversification decisions.

Accordingly, this article is grounded in the corporate governance literature that highlights the risks associated with excessive managerial discretion in the absence of effective monitoring mechanisms. Its primary objective is to provide a theoretical analysis of the relationship between corporate control mechanisms and managerial entrenchment through the adoption of diversification strategies.

Furthermore, the paper proposes an empirical research agenda in the context of Algerian firms. More specifically, it seeks to examine, first, the extent to which managers may steer firms toward business sectors in which they possess distinctive competencies in order to strengthen their entrenchment and consolidate their position within the organization; and second, the effectiveness of corporate control mechanisms in constraining managerial discretion and limiting opportunistic managerial behavior.

Keywords: Corporate Governance; Diversification Strategy; Managerial Entrenchment; Corporate Control Mechanisms; Agency Theory.

1. Introduction

Over the past few decades, corporate governance has emerged as a central concept in the fields of finance and organizational management. The concept gained particular prominence during the 1980s in response to a series of major corporate and financial scandals that occurred in developed economies. The origins of corporate governance can be traced back to the seminal work of **Berle and Means (1932)**. In the aftermath of the 1929 financial crisis, these authors argued that corporate governance problems stem from the separation of ownership and control.

This separation assigns shareholders a disciplinary role, exercised through monitoring and incentive mechanisms, while decision-making authority is delegated to professional managers. According to Berle and Means, this division contributed to declining corporate performance and shareholder expropriation due to the failure of governance mechanisms to effectively discipline corporate executives.

Berle and Means further argued, as cited by Joon (2005), that ownership in large corporations tends to become increasingly dispersed. Under such ownership structures, shareholders' decision-making power gradually diminishes, thereby allowing managers who hold little or no equity to exercise substantial discretionary authority. They concluded that **"the separation of ownership (shareholders) from control (managers) constitutes the fundamental source of the agency problem."**

To address conflicts of interest between shareholders and managers and to reduce agency costs, corporate governance research has proposed a wide range of governance mechanisms. Among these, ownership structure has been identified as a key determinant of firms' strategic decisions. As Godard (2005) argues, corporate finance research evaluates the impact of strategic choices on firm performance, with diversification strategy representing one of the most extensively investigated strategic decisions.

According to Morris (2014), between the 1960s and the 1980s, many large industrial conglomerates were established with the objective of maximizing shareholder value. Through diversification, firms sought to reduce business risk and achieve economies of scale and scope. However, during the following decade, many of these conglomerates were dismantled under pressure from shareholders, who increasingly viewed excessive diversification as a source of value destruction and advocated a strategic refocusing on firms' core businesses. These contrasting perspectives illustrate the continuing debate over whether diversification primarily serves shareholder interests or managerial objectives.

The relationship between ownership structure and corporate diversification has generated considerable debate, giving rise to competing theoretical perspectives and contrasting empirical findings (Amihud & Lev, 1999). Although previous studies have extensively examined the relationship between diversification and firm performance, considerably less attention has been devoted to diversification as a managerial entrenchment strategy within an agency theory framework. Accordingly, this study investigates why managers may favor diversification as a growth strategy to advance their own private interests.

Montgomery (1994) identifies three major theoretical perspectives for explaining firms' diversification decisions: industrial organization theory, the resource-based view, and agency theory. Among these perspectives, agency theory provides the most appropriate analytical framework for explaining diversification as a managerial response to conflicts of interest between managers and shareholders. Accordingly, this study adopts agency theory as its principal theoretical perspective.

Against this theoretical background, this paper focuses on the managerial motivations underlying diversification decisions from an agency theory perspective. It examines diversification as a potential **managerial entrenchment strategy**, whereby executives seek to expand their discretionary power and consolidate their position within the firm while reducing the effectiveness of corporate governance mechanisms designed to monitor and discipline managerial behavior.

Building upon the theoretical foundations of agency theory, this study addresses the following research question:

To what extent does diversification strategy enable managers to strengthen their entrenchment within the firm while reducing the effectiveness of corporate governance mechanisms intended to constrain managerial discretion?

Unlike previous studies that primarily examine diversification from the perspective of firm performance or shareholder value creation, this study conceptualizes diversification as a governance-related managerial strategy aimed at reinforcing managerial entrenchment. By integrating agency theory with the corporate governance literature, it develops a comprehensive theoretical framework that explains how diversification may simultaneously enhance managerial discretion and weaken the effectiveness of governance mechanisms intended to discipline managerial behavior. In doing so, the paper contributes to the corporate governance literature by offering an alternative theoretical perspective on diversification decisions grounded in managerial incentives rather than exclusively in shareholder value creation.

Overall, this theoretical framework provides the conceptual foundation for understanding the governance implications of diversification decisions and establishes a basis for future empirical research, particularly in the context of Algerian firms.

The remainder of this paper is organized as follows. Section 2 reviews the concept of corporate governance and discusses its theoretical foundations from the perspective of agency theory. Section 3 examines corporate diversification by defining the concept, analyzing its theoretical underpinnings, and highlighting managers' incentives to pursue diversification as a strategy for managerial entrenchment. Section 4 explores the role of corporate governance mechanisms in constraining managerial discretion and discusses how managers may adopt entrenchment strategies to circumvent these governance mechanisms. Finally, Section 5 summarizes the main theoretical findings, outlines the implications of the study, and proposes directions for future empirical research, particularly in the context of Algerian firms.

2. Corporate Governance: A Conceptual Overview

Corporate governance is a multifaceted and complex concept encompassing a wide range of meanings and institutional realities. Since the pioneering work of **Berle and Means (1932)**, through **Coase's (1937)** seminal article *The Nature of the Firm*, and later the foundational contributions of **Alchian and Demsetz (1972)**, **Jensen and Meckling (1976)**, and **Fama (1980)**, the concept of corporate governance has undergone significant theoretical development. Despite this evolution, no universally accepted definition has emerged. Instead, the concept remains context-dependent, with its meaning varying according to the institutional environment, governance arrangements, and the theoretical perspectives adopted. Consequently, the semantic boundaries of corporate governance remain fluid, reflecting the diversity of approaches that have shaped its development within the fields of economics, finance, and organizational management.

3. Diversification Strategy

Throughout their development, firms are required to make major strategic decisions to sustain long-term growth. Among the various strategic options available, diversification has become one of the most widely adopted corporate growth strategies. Rather than limiting their operations to a single line of business, firms are increasingly compelled by competitive pressures to expand into multiple markets and diversify their activities (Capul, 1996).

Diversification therefore refers to the expansion of a firm's business portfolio. As Cartier et al. (2010, p. 46) argue, corporate development may either preserve links with the firm's original business in order to generate synergies or deliberately diversify into unrelated activities to spread risks.

3.1 Definition

Diversification is commonly defined as **"the development of a firm's activities beyond its core business"** (Lehmann-Ortega et al., 2016, p. 532). It represents a firm's strategic decision to enter a new business area or industry. Consequently, a diversified firm operates in at least two distinct strategic business domains, each corresponding to a different value chain. Diversification therefore extends well beyond simple product line expansion.

3.2 Agency Theory Perspective

The pioneering work of Berle and Means (1932) on property rights, subsequently complemented by Jensen and Meckling's (1976) agency theory, suggests that effective shareholder control tends to reduce the degree of corporate diversification, since diversification often serves managerial rather than shareholder interests. From this perspective, diversification benefits managers by facilitating managerial entrenchment through the reduction of personal risk, the enhancement of managerial power and prestige, and increases in compensation and organizational influence.

Agency theory also provides a robust theoretical framework for explaining the relationship between ownership structure and corporate diversification (Amihud & Lev, 1999). Recent research further reinforces the agency theory perspective by showing that managerial entrenchment remains a key determinant of major corporate decisions. Ji, Mauer, and Zhang (2019) argue that diversification interacts with managerial entrenchment by increasing organizational complexity and strengthening managers' influence over financial and strategic decisions. Their findings suggest that diversification may not only reflect efficiency considerations but also serve as a mechanism through which managers preserve their discretionary power.

Initially developed to analyze contractual relationships between a principal and an agent, agency theory addresses two fundamental issues. The first concerns the principal's difficulty in monitoring the agent's actions, while the second relates to differences in risk preferences between principals and agents. As Eisenhardt (1989) argues, agency theory is founded on assumptions regarding the nature of principal-agent relationships. Within organizations, conflicts of interest arise because of information asymmetry, while individual decisions are often driven by opportunistic and self-interested behavior, leading respectively to moral hazard and adverse selection problems.

Agency conflicts are generally mitigated through incentive and compensation mechanisms designed to align managerial and shareholder interests. Although decision-making aims to maximize organizational efficiency, economic actors operate under conditions of bounded rationality. Consequently, governance systems must be designed to optimize either outcome-based or behavior-based control mechanisms (Ducassy & Prévot, 2004).

3.3 Managerial Incentives for Diversification

Managerial entrenchment strategies are implemented to expand executives' discretionary authority by exploiting both their human capital and the firm's strategic assets. Their objective is to weaken governance mechanisms while increasing stakeholders' dependence on the resources under managerial control (Alexandre & Paquerot, 2000).

From an agency theory perspective, managers may choose diversification as a growth strategy for several reasons. First, diversification reduces the risk associated with managers' personal, imperfectly diversified wealth by lowering both financial and employment-related risks, together with their direct and indirect costs. Second, diversification generates private managerial benefits (Amihud & Lev, 1981).

These private benefits arise because managing larger and more diversified firms generally confers greater prestige, influence, and organizational power (Stulz, 1990), particularly when executive compensation is positively related to firm size (Jensen & Murphy, 1990). Diversification may also strengthen managerial indispensability by allowing executives to exploit and preserve their firm-specific organizational and human capital (Shleifer & Vishny, 1989; Penrose, 1959). Furthermore, managers' incentives to diversify depend on the proportion of equity they hold in the firms they manage (Godard, 2005).

Accordingly, diversification is selected as a strategic growth option because it enables managers to expand their relational capital and firm-specific expertise, thereby reinforcing their entrenchment within the organization, increasing job security, and securing higher levels of compensation.

By adopting diversification as a strategic development strategy, managers also benefit from greater information asymmetry. As firms expand into multiple business activities, organizational information becomes increasingly complex, allowing managers to retain proprietary information and making it more difficult for shareholders to accurately assess corporate performance. Consequently, the expansion of diversified activities enlarges the firm's informational capital and creates additional opportunities for managerial earnings manipulation and financial reporting discretion (Ali El Mir & Seboui, 2008).

More recent evidence confirms that executives possessing greater managerial power are more likely to adopt strategic decisions that increase organizational complexity and reduce external monitoring. Adams, Jiang, and Ma (2024) show that entrenched managers tend to exercise broader strategic discretion, thereby reinforcing the agency argument that diversification may generate private managerial benefits beyond shareholder value maximization.

4. Corporate Governance Mechanisms and Managerial Entrenchment

Corporate governance theory posits that a variety of control mechanisms can be employed by shareholders to ensure that managers act in accordance with shareholders' interests. Regardless of their form, these mechanisms pursue the same objective: to constrain managers' opportunistic and self-serving behavior by reducing their discretionary power.

4.1 Internal and External Corporate Control Mechanisms

Although numerous corporate control mechanisms have been identified in the governance literature, establishing an exhaustive classification remains challenging because governance systems evolve according to firms' organizational structures and institutional characteristics. Consequently, corporate governance mechanisms are inherently idiosyncratic.

From an agency theory perspective, two broad categories of managerial control mechanisms can be distinguished: **internal** and **external** governance mechanisms. This traditional dichotomy was originally proposed by Charreaux (1997).

Adopting a broader governance perspective that incorporates additional stakeholders—particularly employees—and emphasizes transaction cost reduction through efficient governance arrangements and organizational forms, Charreaux (1997) further distinguishes between **intentional (institutional)** mechanisms and **spontaneous (contractual)** mechanisms.

By combining agency theory with the contractual approach, a more comprehensive typology of governance mechanisms can therefore be established. External governance mechanisms discipline managerial behavior through market forces, including the product market, financial markets, the executive labor market, and the legal and regulatory environment. Internal governance mechanisms, by contrast, arise from the firm's institutional hierarchy and include shareholder monitoring, mutual monitoring among executives, employee oversight, and board of directors' supervision.

4.1.1 External Governance Mechanisms as Constraints on Diversification

4.1.1.1 Product Market Competition

Competition in product and service markets constitutes an important external governance mechanism by exerting disciplinary pressure on both firms and managers. Intense competition forces firms to survive and grow in increasingly unstable and highly competitive environments. As Bienaymé (1998) argues, contemporary competition is characterized by **"ubiquitous competition,"** driven by the multiplication of market participants, the growing mobility of decision-makers, and continuous comparisons of organizational performance.

Accordingly, competitive market pressure discourages managers from undertaking risky diversification strategies, particularly when expansion into unfamiliar industries is associated with a high probability of failure.

4.1.1.2 Financial Markets

The market for corporate control represents the ultimate disciplinary mechanism available to shareholders. When managers pursue strategic objectives that fail to maximize shareholder wealth, agency conflicts emerge and may ultimately be resolved through hostile takeover threats or actual acquisitions (Caby & Hirigoyen, 2001). Consequently, poorly justified diversification strategies may expose firms to external takeover attempts.

4.1.1.3 The Executive Labor Market

Managers derive career opportunities from the executive labor market but are simultaneously subject to its disciplinary effects. Poor managerial performance may result in dismissal and replacement by more competent internal or external candidates. Accordingly, diversification strategies that reduce firm performance may ultimately lead to the removal of the executive team responsible for initiating them.

4.1.1.4 The Legal and Regulatory Environment

According to Prowse (1994), changes in the legal and regulatory environment are accompanied by corresponding changes in corporate governance mechanisms. Regulatory frameworks impose legal constraints on managerial behavior and therefore limit executives' discretion when considering diversification decisions. The effectiveness of governance mechanisms is consequently contingent upon the institutional environment within which firms operate.

4.1.2 Internal Governance Mechanisms as Constraints on Diversification

4.1.2.1 Shareholder Monitoring

Shareholders acquire monitoring rights through their equity investments. Although all shareholders possess governance rights, controlling shareholders generally exercise considerably greater influence over managerial decisions. Concentrated ownership therefore limits managerial discretion and reduces managers' ability to pursue diversification strategies that may conflict with shareholders' interests. Large blockholders are thus more capable of preventing value-destroying diversification initiatives.

4.1.2.2 The Board of Directors

The board of directors constitutes one of the most important internal governance mechanisms. Besides overseeing managerial decisions, the board contributes to value creation by assisting managers in identifying profitable investment opportunities and designing appropriate corporate strategies (Wirtz, 2008). More importantly, the board is expected to discipline executives by restricting their discretionary authority and preventing managerial entrenchment. Consequently, effective board oversight represents a major constraint on diversification decisions motivated by managerial self-interest.

4.1.2.3 Employees

Employees also represent an important internal governance mechanism because they have a direct interest in improving organizational performance (Fama, 1980). Charreaux (1997) argues that the value of employees' firm-specific investments reflects the intensity of organizational control: the greater these investments, the stronger the monitoring capacity. Owing to their privileged access to internal information, employees may effectively monitor managerial behavior. Consequently, employee resistance to organizational and strategic change may significantly constrain managers' ability to implement diversification strategies.

4.2 Managerial Entrenchment as a Means of Circumventing Internal Governance Mechanisms

Several scholars consider managerial entrenchment to be a strategic response to both internal and external governance mechanisms. Recent governance research also highlights that managerial entrenchment depends on the interaction between executive influence and governance structures. Chatjuthamard et al. (2024) provide evidence that weak monitoring environments and governance arrangements favor the consolidation of managerial power. Such institutional conditions may facilitate diversification strategies that strengthen managerial entrenchment while reducing the effectiveness of corporate control mechanisms.

Walsh and Seward (1990) argue that external governance mechanisms generally become effective only when internal governance mechanisms fail to discipline managers adequately. Accordingly, managerial entrenchment strategies are designed primarily to neutralize internal governance mechanisms—namely shareholder monitoring, board oversight, and employee control—and subsequently to reduce exposure to external governance mechanisms, particularly hostile takeover threats (Gharbi, 2004).

Alexandre and Paquerot (2000) define managerial entrenchment strategies as managerial efforts to expand discretionary authority by exploiting both executives' human capital and the firm's strategic assets. These strategies seek to weaken governance mechanisms while increasing stakeholders' dependence on resources controlled by managers, including firm-specific human capital and informational advantages.

4.2.1 Entrenchment as a Response to Shareholder Monitoring

Ownership concentration and shareholder identity significantly influence the effectiveness of governance mechanisms. As previously discussed, majority shareholders have stronger incentives to monitor management, thereby reducing executives' opportunities for entrenchment.

To escape shareholder control, managers may adopt several entrenchment strategies, among which diversification plays a central role. By investing in firm-specific assets (Shleifer & Vishny, 1989; Castanias & Helfat, 1992), managers become increasingly indispensable to the implementation of corporate strategy, thereby expanding their discretionary authority and making their replacement more difficult.

4.2.2 Entrenchment as a Response to Board Oversight

Managers may also reduce the effectiveness of board monitoring by cultivating strong social relationships with board members, thereby weakening the board's disciplinary role. Furthermore, mergers and acquisitions often allow managers to expand into new business activities and create increasingly complex organizational structures, making executive replacement more costly and difficult.

Renneboog and Zhao (2013) demonstrate that executives possessing substantial social capital are more likely to pursue acquisition strategies. Their extensive networks provide privileged access to valuable information, enabling them to identify favorable market conditions and successfully implement acquisition-based diversification strategies.

4.2.3 Entrenchment as a Response to Employee Monitoring

As previously discussed, employees may constrain managers' strategic decisions because of their privileged access to internal information and their investments in firm-specific assets.

To reduce employee resistance, managers often rely on human resource practices aimed at increasing organizational commitment through competency development, performance-based compensation, and talent retention policies. By fostering employee commitment rather than mere participation, managers secure employee support for the organizational changes associated with diversification strategies, thereby reinforcing their own entrenchment within the firm.

5. Conclusion

This study has examined corporate diversification through the lens of property rights theory and agency theory, with the objective of explaining why managers may adopt diversification as a strategy for strengthening their entrenchment within the firm. Rather than viewing diversification solely as a strategic growth option, the analysis demonstrates that it may also constitute a governance-related managerial strategy through which executives expand their discretionary power, reinforce their organizational position, and reduce the effectiveness of corporate governance mechanisms designed to monitor and discipline managerial behavior. From this perspective, diversification reflects not only strategic considerations but also the underlying incentive conflicts between managers and shareholders that characterize the agency relationship.

The analysis further suggests that corporate governance mechanisms play a central role in limiting managerial discretion and aligning managerial decisions with shareholders' interests. However, managers may respond strategically to these governance constraints by implementing entrenchment strategies that increase organizational complexity, strengthen firm-specific managerial expertise, and ultimately reduce the effectiveness of external and internal monitoring mechanisms. Consequently, diversification should be understood not only as a corporate strategy but also as an important governance issue that influences the balance of power between managers and shareholders.

From a theoretical standpoint, this study contributes to the corporate governance literature in several ways. First, it extends the agency theory perspective by conceptualizing diversification as a governance-related managerial strategy rather than merely as a vehicle for corporate growth or shareholder value creation. Second, it advances the understanding of the interaction between corporate governance mechanisms and strategic decision-making by explaining how diversification may simultaneously increase managerial discretion and weaken governance mechanisms intended to align managerial and shareholder interests. More broadly, the proposed framework provides a coherent theoretical basis for integrating the literature on diversification, managerial entrenchment, and corporate governance, thereby offering new avenues for future research on managerial behavior and strategic decision-making.

Beyond its theoretical contribution, this study also provides practical implications for corporate boards, shareholders, and policymakers. By recognizing diversification as a potential managerial entrenchment strategy, governance actors should evaluate diversification decisions not only according to their expected economic benefits but also in terms of their implications for managerial discretion and the effectiveness of corporate governance mechanisms.

Despite these contributions, the study is subject to certain limitations. As a conceptual paper, it does not provide empirical evidence to validate the theoretical relationships proposed between diversification, managerial entrenchment, and corporate governance mechanisms. Accordingly, the conclusions should be interpreted as theoretical propositions requiring empirical verification rather than as definitive empirical findings. In addition, the analysis is primarily grounded in agency theory and therefore does not explicitly consider alternative theoretical perspectives, such as stewardship theory or stakeholder theory, which may offer complementary explanations of managerial behavior.

Future research should empirically examine the theoretical propositions developed in this study using firm-level data from both developed and emerging economies. Comparative analyses across different institutional environments would enhance our understanding of how ownership structures, legal systems, and governance arrangements influence the relationship between diversification strategies and managerial entrenchment. Particular attention could be devoted to Algerian firms, whose institutional and governance characteristics provide a valuable context for assessing the effectiveness of corporate governance mechanisms in constraining managerial opportunism and promoting long-term shareholder value creation.

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