THE CURIOUS CASE OF STAKEHOLDER THEORY: CALLING FOR A MORE REALISTIC THEORY

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Abstract

Stakeholder Theory — Stakeholder Theory Reform — Information Disclosure — Director's Discretion — Codification of Director Duties — New Economy — CSR Movement

Stakeholders are parties who have legitimate interests in or claims on the operations of the firm. They are interrelated, and every company has their unique stakeholder groups. The groups which are most frequently seen in a company law related corporate relationships as such are employees, customers, creditors, local communities, the environment, government and society or the public at large. The stakeholder theory redefines the firm as a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stake into goods and services. The article discusses the advantages and the disadvantages of the theory in depth with possible reform proposal to surmount the disadvantages of the theory. The author also tries to call for a new model which is different from stakeholder theory or shareholder primacy norm, which is opposite to stakeholder theory, and more realistic to modern corporate strategies and operation.

I INTRODUCTION

The use of the term 'stakeholder' to refer to the various interests who participate in a business has been commonly accepted since the publication of Freeman's book *Strategic Management* in 1984.[1] The concept of stakeholders was defined as 'those groups without whose support the organisation would cease to exist'.[2] They have legitimate interests in or claims on the operations of the firm.[3] These stakeholders are interrelated, and every company has their unique stakeholder

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1 R E Freeman, *Strategic Management: A Stakeholder Approach* (Pitman, 1984).

2 Ibid 31–2.

3 A B Carroll, *Business and Society: Ethics and Stakeholder Management* (South Western, 1989) 57.

groups. However the groups which are most frequently seen as such are employees, customers, creditors, local communities, the environment, government and society or the public at large. The stakeholder theory was defined by Clarkson who stated that:

> the firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stake into goods and services.[4]

Contemporary stakeholder approach arguments have always been paralleled by the emergence of the global corporate social responsibility (CSR) movement.[5] According to stakeholder theory, the directors are required to consider the interests of the company's stakeholders apart from the interests of the company shareholders. The directors must not only manage the corporation for the betterment of the shareholders, but also in the interests of a multitude of stakeholders, clearly including the shareholders, who can affect or be affected by the actions of the company.[6] The theory is defined by the CLRSG as the pluralist theory,[7] which views the corporation as a locus in relation to wider external stakeholders' interests besides shareholders' interests. The stakeholder theory is embraced in many continental European jurisdictions (most notably Germany) and Japan.[8]

Donaldson and Preston argued that the stakeholder theory can be subdivided into descriptive, instrumental and normative approaches.[9] The descriptive approach decides whether stakeholder interests should be taken into account, while the instrumental approach is concerned with the impact stakeholders may have in terms of corporate effectiveness. The normative approach is concerned with the justifying whether corporations should take stakeholders' interests into account even in the absence of any obvious benefits to shareholders.

It is argued that a consideration of stakeholders' interests enables the creation of long-term favourable conditions for the company to be more competitive. It is

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4 M Clarkson, 'A Risk Based Model of Stakeholder Theory' (Paper presented at Proceedings of the Second Toronto Conference on Stakeholder Theory, Centre for Corporate Social Performance and Ethics, University of Toronto, 1994).

5 C A Williams and J M Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38 *Cornell International Law Journal* 493, 494.

6 R E Freeman, 'A Stakeholder Theory of the Modern Corporation' in T L Beauchamp and N E Bowie (eds), *Ethical Theory and Business* (Prentice Hall, 5th ed, 1997) 69.

7 Company Law Review Steering Group, *Completing the Structure* (2000) [3.5].

8 L L Dallas, 'Working Toward a New Paradigm' in L E Mitchell (ed), *Progressive Corporate Law* (Westview Press, 1995) 35, 39.

9 T Donaldson and L E Preston, 'The Stakeholder Theory of the Corporation: Concept, Evidence, and Implications' (1995) 20 *Academy of Management Review 65.*

useful to regard 'the company' as 'the company as a whole', a coherent body in which the various stakeholders are bound together through the business.[10] The long-term focus on creating value for various stakeholders will enable the directors to devote themselves to improving the long-term interests of the corporation, and does not exclude long-term value-enhancing strategies.[11] Taking social responsibilities into account in the development of corporate strategies is another advantage of adopting the stakeholder theory model. 'The evolution of CSR theory provides a sort of social responsibilities and performance paradigm that is, in essence, a solid foundation for corporate social management and stakeholder engagement.'[12] Very early discussions of the CSR concept suggested that CSR is about attending to stakeholder rights and to taking proactive, voluntary steps to avoid harm or wrongful consequences to stakeholders.[13] CSR theory suggests that corporations should recognise obligations beyond their shareholders, based on the stakeholder theory.

This article is arranged as follows: Part II discusses the term stakeholder. A systemic argument on origins, definition and types of stakeholders will be provided. Several main stakeholders key to corporate strategy and company law framework will be further discussed. Part III examines stakeholder theory as a systemic model which is broadly adopted in continental European countries and Japan. The advantages and the disadvantages of the theory will be presented in depth with possible reform proposal to surmount the disadvantages of the theory. In the conclusion, the author tries to call for a new model which is different from stakeholder theory or shareholder primacy norm, which is opposite to stakeholder theory, and more realistic to modern corporate strategies and operation.

II WHO ARE STAKEHOLDERS?

One of the biggest conceptual challenges in a revision of the shareholder and stakeholder debate is defining the term 'stakeholder'. The stakeholders of a company make up a web, both within the company among themselves and with the company itself. The idea of the stakeholder approach is rooted in a

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10 J Parkinson, 'Reforming Directors' Duties' (Policy Paper 12, Political Economy Research Centre, University of Sheffield, 1998).

11 R Aggarwal and A Chandra, 'Stakeholder Management: Opportunities and Challenges' (1990) 40 *Business* 48, 49.

12 R T Byerly, 'Seeking Global Solutions for the Common Good: A New World Order and Corporate Social Responsibilities' in Istemi Demirag (ed), *Corporate Social Responsibility, Accountability and Governance* (Greenleaf Publishing, 2005) 122.

13 See the initial argument for CSR in H R Brown, *Social Responsibilities of the Businessman* (Harper and Row, 1953); A B Carroll, 'The Pyramid of Social Responsibility: Towards the Moral Management of Organizational Stakeholders' (1991) 34 *Business Horizons* 39, 39–48.

succession of efforts to improve relations between businesses and parties who are affected by businesses.[14] The efforts date back at least to the beginning of the 19th century when Robert Owen attempted to humanise the working environment in his mills.[15] Christian thinking has also had a great influence on the formation of the stakeholder approach. Themes like 'human imperfection, human novelty, self-consciousness and responsibility and action on the basis of absolute principles'[16] can be found in both Christian and stakeholding arguments. Furthermore, stakeholder theory creates more 'elbow room' for directors in making decisions that refrain from harm or contribute to other social objectives by providing an 'escape hatch' from conflicts of conscience in the workplace.[17] This is particularly appealing if the value system of the firm is consistent with Christian value and ethics.[18] The related academic research dates back to the 1950s when Goyder put forward the idea of a social audit and criticised the shareholders' ownership and primacy.[19]

The actual term 'stakeholder' first appeared in management literature in an internal memorandum at the Stanford Research Institute,[20] in 1963, and was meant to generalise the notion of the stockholder as the only group to whom management need be responsive.[21] In the United Kingdom, the stakeholder concept was first endorsed in the Wilkinson Report on *The Responsibilities of the British Public Company* in 1973.[22] The term 'stakeholder', which refers to the various interests who participate in a business, has commonly been accepted since the 1980s as a result of the landmark book in business literature,[23]

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14 A T Kearney and S Deakin, 'Company Law as an Instrument of Inclusion: Re-Regulating Stakeholder Relations in the Context of Takeovers' (Working Paper No 145, Economic and Social Research Council Centre for Business Research, University of Cambridge, 2000) 1 <http://www.cbr.cam.ac.uk/pdf/WP145.pdf>.

15 Many similar attempts followed this first try including profit-share at J & J Taylor; governance by trust at the Zeiss works and the John Lewis Partnership; health and safety monitoring by Mackenzie King in Canada and conflict resolution by the Whitely councils in Britain.

16 Kearney and Deakin, above n 14, 2

17 S B Rae and K L Wong, *Beyond Integrity: A Judeo-Christian Approach to Business Ethics* (Zondervan Publishing House, 2nd ed, 2004) 159.

18 Ibid.

19 See G Goyder, *The Responsible Company* (Blackwell, 1961); G Goyder, *The People's Church: A Layman's Plea for Partnership* (Hodder and Stoughton, 1966); G Goyder, *The Responsible Worker* (Hutchinson, 1975); G Goyder, *The Future of Private Enterprise: A Study in Responsibility* (Blackwell, 1951).

20 It is currently named SRI International Inc.

21 E Sternberg, 'The Defects of Stakeholder Theory' (1997) 5 *Scholarly Research and Theory Papers* 3.

22 Confederation of British Industry Company Affairs Committee 1973 quoting Sir Adrian Cadbury, *The Company Chairman* (Prentice, 2nd ed, 1995) 146.

23 See, eg, M B Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating

Freeman's *Strategic Management.*[24] 'Stakeholders' were defined as 'those groups without whose support the organisation would cease to exist', and originally included shareowners, employees, customers, lenders and society.[25]

A *The Definition of Stakeholders*

It is helpful to understand the term 'stake' in order to clarify the definition of a stakeholder. 'A stake is a claim. The claim is an assertion on a title or a right to something'.[26] The *Oxford English Dictionary* definition of stakeholding records the first use of the term in 1708 in the context of a bet or deposit: to have a stake in; to have something to gain or lose by the turn of events, to have an interest in, especially to have a stake in the country. The theory of stakeholding in the corporate context posits that those who participate in or are affected by the company, as individuals and groups, all merit consideration and involvement in its decision-making – they have a stake in it.[27]

The definition of 'stakeholder' is not set in stone. Carroll defines stakeholders as 'those groups or individuals with whom the organisation interacts or has interdependencies' and 'any individual or group who can affect or is affected by the actions, decisions, policies practices or goals of the organisation'.[28] Similarly, according to the definition given by Ernst & Young, stakeholders can be defined as 'those individuals or groups who have an interest in, and can influence, the activities of the company'.[29]

Corporate Social Performance' (1995) 20 *Academy of Management Review* 92, 105; Donaldson and Preston, above n 9, 65.

24 Freeman, above n 1. For some examples to demonstrate the acceptance of the term in major academic writings see A F Alkhafaji, *A Stakeholder Approach to Corporate Governance: Managing in a Dynamic Environment* (Quorum Books, 1989); J W Anderson, *Corporate Social Responsibilities* (Quorum Books, 1984); J J Brummer, *Corporate Responsibility and Legitimacy: An Interdisciplinary Analysis* (Greenwood Press, 1991); S N Brenner and E A Molander, 'Is the Ethics of Business Changing' (1977) 58 *Harvard Business Review* 54; M B E Clarkson, M C Deck and N J Shiner, 'The Stakeholder Management Model in Practice' (Paper presented at the Annual Meeting of the Academy of Management, 1992); K E Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) *Business Ethics Quarterly* 53.

25 Freeman, above n 1, 31–2.

26 Carroll, above n 3, 56.

27 See J Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (Cavendish Publishing, 2001) 93.

28 Carroll, above n 3, 60.

29 See Ernst and Young, 'Governance and Sustainability Stakeholder Communication' (2000) <http://www.ey.com/global/download.nsf/South_Africa/Stakeholder_communication/$file/Stakehol.pdf >.

In management literature, the definition of a stakeholder may be presented either in a narrow view or in a broad view. In the broad view of the definition, Freeman's initial classic statement claimed that 'a stakeholder in an organisation is any group or individual who can affect or is affected by the achievement of the organisations' objective'.[30] This is probably the broadest definition, leaving the notion of a stake and the field of potential and possible stakeholders unambiguously open to include virtually anyone.[31] However, this broad definition of stakeholders is very impractical and makes the 'stakeholder theory' fairly complicated to implement. In contrast, Clarkson defined stakeholders as voluntary or involuntary risk-bearers; this is probably one of the narrowest definitions in the literature: 'voluntary stakeholders bear some form of risk as a result of having invested some form of capital (human or financial) or something of value, in a firm. Involuntary stakeholders are placed at risk as a result of a firm's activities. But without the element of risk there is no stake.'[32] This narrow version of the stakeholder definition introduces 'risk' and narrows the stakeholder field to those with legitimate claims; this definition is more directly related to the companies' core economic interests.[33] Directors, in the narrow version of the stakeholder definition, will focus on a limited group of legitimate stakeholders.

The most famous and frequently cited definition was given by Evan and Freeman in their benchmark essay,[34] in which the 'stakeholders are those groups who have a stake in or claim on the firm'.[35] However, this definition was circular and uninformative. Therefore, they further defined stakeholders as 'groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions'.[36] However, this definition still lacks clarity. Did they mean to express the idea that in order to be a stakeholder, an individual or an organisation must both be able to be benefited or harmed, and have rights that may be violated or respected? Or did they intend to say either/or?[37] If they do mean the former, as it turns out, rights are nonsense and

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30 Freeman, above n 1, 46.

31 R K Mitchell, B R Agle and D J Wood, 'Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts' (1997) 22 *Academy of Management Review* 853, 856.

32 Clarkson, above n 4.

33 Mitchell, Agle and Wood, above n 31, 857.

34 W M Evan and R E Freeman, 'A Stakeholder Theory of the Modern Corporation' in M Snoeyenbos, R Almeder and J Humber (eds), *Business Ethics* (Prometheus Books, 3rd ed, 2001) 101–14.

35 Ibid 102.

36 Ibid 115.

37 G Mason-Riseborough, 'Stakeholders and Stakeholder Theories: An Analysis' <http://www.geocities.com/griseborough/55.htm>.

the definition implies that there will be no one qualified to be a stakeholder.[38] Therefore, in the author's opinion, the definition should be modified to refer to groups and individuals who benefit from or are harmed by, or whose rights are violated or respected by, corporate actions.

B *Type of Stakeholder and how to Define their Status*

In the modern business environment, many individuals are qualified to be business stakeholders. There are individuals or groups who have legitimate interests in or claims on the operations of the firm.[39] Directors always have to answer the question of 'who are our stakeholders' in order to manage the entire stakeholder group efficiently and comprehensively. However, answers to the question are largely dependent on individual cases. Therefore, the question arises as to who stakeholders are, and whether we can find any norms to judge if an individual or a group is a stakeholder.

As for the types of stakeholders, the stakeholder group can be divided into primary stakeholders and secondary stakeholders according to the relationship between their interests and the company.[40] The primary stakeholders are defined as the parties who have a real, direct and tangible interest in the company.[41] They interact with company as input providers and are always ultimately affected by the state of the company, and the effects could be either beneficial or adverse. They also count in 'strictly business' terms;[42] without them the business simply could not function. Typical primary stakeholders are investors, employees or the managers who are at the centre of the whole stakeholders' network. The secondary stakeholders are described as the parties who have a remote or indirect interest such as the suppliers, local media, local government and business service providers.[43] Also, stakeholders groups can be divided into internal and external stakeholders. Internal stakeholders are those who are members of the company, like employees, and external stakeholders are those who are not part of the firm but still have an interest in the company such as local communities. Another analysis classifies the stakeholders as either economic power stakeholder or political power stakeholder, according to the

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38 Ibid.

39 Carroll, above n 3, 57.

40 The classification is also made by Goldenberg, in See also P Goldenberg, 'Institute of Advanced Legal Studies Company Lecture-Shareholder v Stakeholder: The Bogus Argument' (1998) *The Company Lawyer* 33, 37 when he spoke of 'groups that have market relationship with a company' who are 'on the inside track' and 'public pressure' and 'interest groups' to whom directors may feel it in the company's interests to respond.

41 A Darling, 'A Political Perspective' in G Kelly, D Kelly and A Gamble (eds), *Stakeholder Capitalism* (Palgrave, 1996) 17.

42 Dean, above n 27, 103.

43 Ibid.

power of the stakeholder in the company.[44] By economic power we mean the 'ability to be informed due to market place decision',[45] and economic power stakeholders always include customers, suppliers and creditors. By political power we mean 'the ability to influence due to use of the political process',[46] and political power stakeholders include government and consumer advocates. Some academics have also argued that economic and political stakeholders are inherently connected,[47] and some stakeholders, like foreign governments, are in the middle of them.

Another division, suggested by Wheeler and Sillanpää,[48] is the one between social and non-social classes of stakeholder. They are distinguishable by the fact that the former can be communicated with directly by the company while the latter cannot.[49] Non-social stakeholders always include the natural environment and non-human species plus environmental pressure groups and animal welfare organisations acting as their representatives.[50] The problem with this classification is the uncertainty in the definition of society.[51] Alternatively, stakeholders can be divided into contractual and community stakeholders by examining whether the stakeholder has any contractual relationship with the company. Contractual stakeholders mainly include employees, customers and suppliers; community stakeholders mainly refer to the government, as well as the local community.

However, the scope of stakeholder group will be different from business to business, and it is dangerous to impose generalised and uniform norms when judging whether a party is a stakeholder. Therefore, rather than presenting criteria by which to admit certain individuals or groups into the category of stakeholders, it might be more logical to outline several types of stakeholder who are key to the running of all sorts of businesses.

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44 R E Freeman, 'Stockholders and Stakeholders: A New Perspective on Corporate Governance' (1983) 3 (Spring) *California Management Review* 88, 93.

45 Ibid.

46 Ibid.

47 These authors do not pay adequate attention to the positions of shareholders and directors and hence to the question of corporate governance. C E Lindbloom, *Politics and Markets: The World's Political Economic Systems* (Basic Books, 1977); A O Hirschman, *Exit, Voice, and Loyalty Responses to Decline in Firms, Organizations, and States* (Harvard University Press, 1970).

48 D Wheeler and M Sillanpää, *The Stakeholder Corporation: A Blueprint for Maximizing Stakeholder Value* (Pitman Publishing, 1997) 167–8.

49 Dean, above n 27, 103.

50 Wheeler and Sillanpää, above n 48, 167–8.

51 For example, does it mean past and/or future society? Does it mean local and/or international society?

C *Overview of the Stakeholder Groups and their Relationships with the Company*

According to the conception of 'corporate governance' given by Julien and Rieger,[52] corporate governance is the system within an organisation that 'protects the interest of its diverse stakeholder groups. The best approaches recognise that stakeholders are more than shareholders, and include customers, employers, suppliers, retirees, communities, lenders and other creditors.'[53] Furthermore, a company's profitability depends on its relationships with a variety of groups: consumers, government, workers and suppliers being the most obvious ones.[54] These stakeholder groups are typical across various kinds of companies or businesses. In the next section, their roles and relationship between them and the company will be discussed.

1 *Employees*

The employees have an interest in the company since it provides their livelihood presently and potentially in the future. They belong to a key group of people in the stakeholder groups, who are able to enhance the sustainability of the company they work for by using their own convictions and experience in order to contribute to innovation and alteration. They include the people who create, invent and produce products, deliver their professional services to the company, create its profits and represent it to the external world.[55] Cheffins outlined two economic reasons why a company's employees are important stakeholders.[56] Firstly, the employees can 'take up much the same position as shareholders presently occupy'.[57] In that case, the workers would act as a firm's 'residual claimants', meaning that they would be entitled to the net profits generated by the company.[58] Secondly, workers can 'forego the ownership route and instead

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52 R Julien and L Rieger, 'The Missing Link in Corporate Governance: Risk Manager's Role in Corporate Governance' (2003) 50 *Risk Management* 32, 33.

53 Ibid.

54 D Willetts, 'The Poverty of Stakeholding' in G Kelly, D Kelly and A Gamble (eds), *Stakeholder Capitalism* (Palagrave, 1996) 23.

55 J Williamson, 'A Trade Union Congress Perspective on the Company Law Review and Corporate Governance Reform since 1997' (2003) 41(3) *British Journal of Industrial Relations* 511, 514.

56 B R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, 1997) 553–5.

57 Ibid 555.

58 For more discussion about 'worker ownership' see J Nelson-Jones, *Employee Ownership: Legal and Tax Aspects* (Fourmat Publishing, 1987) ch 1; C Cornforth and R Paton, 'Worker Cooperatives and the Democratization of Work in Western Europe' in J D Wisman (ed), *Worker Empowerment: The Struggle for Workplace Democracy* (Bootstrap Press, 1991) 59; H Hansmann, 'When does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy' (1990) 9 *Yale Law Journal* 1749;

merely influence and shape management policy by working with those in charge'.[59] The employees would choose those empowered to make managerial decisions in the same manner that shareholders select the board of director in a typical company.[60] Some stakeholding theorists even suggest that workers, together with shareholders, should be recognised as the residual claimants of the company. In practice, the employees might be invited to join the board of directors and take part in the meetings when the management wants to consult the employees in corporate decision-making.[61]

The employees can be also divided into substitutable and non-substitutable employees based on the services they are providing to the company as stakeholders. The key point is that specialised employees are likely to be scarce and hard to substitute. Professional football players, for example, would be the non-substitutable employees in their football clubs. Non-substitutable employees are also hired in high-technology based companies like software or pharmaceutical companies, where the employees are specialists in certain areas and are very difficult to replace. When the company tries to create long-term well-organised relationships with its employees, these non-substitutable employees are especially important since they are crucial to the running and development of the entire company. However, at the same time, the power of the employee organisation by substitutable employees, for example as exercised by strikes, can easily put the company into difficulties.

The importance of employees' positions depends on the fact that employees create net profits and sustain the beneficial running of the company. Any negative actions by employees will have bad consequences for the company. The company has to guarantee the occupational rights of the employees, an area that is regarded as one of the most important, comprehensively legislated and well regulated elements of good stakeholder management.[62]

It is worth introducing the economic principle of 'assets specificity'[63] to clarify

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P Turnbull, *The Dynamics of Employee Relations* (Macmillan, 1994).

59 Cheffins, above n 56, 555.

60 Ibid.

61 For more discussion about 'employee participation in corporate decision-making' see D I Levine, 'Demand Variability and Work Organization' in B Bowles and H Gintis, *Schooling in Capitalist America: Educational Reform and the Contradictions of Economic Life* (Basic Books, 1976) 159; J Backhaus, 'Workers' Participation Stimulated by the Economic Failure of Traditional Organization: An Analysis of Some Recent Institutional Developments' in H G Nutzinger and J Backhaus (eds), *Codetermination: A Discussion of Different Approaches* (Springer-Verlag, 1989) 247.

62 Wheeler and Sillanpää, above n 48, 223.

63 See O E Williamson, *Economic Organization: Firms, Markets and Policy Control* (Wheatsheaf Books, 1986) 142–4; O E Williamson, *Markets and Hierarchies: Analysis*

the strong implications of employees' interests for the economic aspect of firm-stakeholder relationship. Assets specificity is a 'measure of asset redeployability and give rise to the hazard of bilateral dependency'.[64] McGuinness defined the principle as the extent to which 'the investments made to support a particular transaction have a higher value to that transaction than they would have if they were redeployed for any other purpose'.[65] Assets specificity can take several forms, of which human, physical, site, and dedicated assets are the most common.[66] The interests of employees are always related to the human assets specificity which indicates that investment in relationship-specific human capital often arises through a learning-by-doing process.[67] The relationship between employees and firm is characterised by certain externalities on both sides: there are costs to each that are not included in the legal employment contract. These hidden contracts will lead to a situation of 'assets specificity' when employees invest time and effort in developing assets specific to a particular employer and vice versa.[68] Such cost of specificity can create moral hazard for both parties as a result of bilateral dependency.

2 *Creditors*

Apart from raising money by means of shares, companies frequently, either at the time of their incorporation or subsequently, raise money by borrowing.[69] The borrowed money is the so-called loan capital provided by creditors, including banks and other financial institutions. The creditors can be divided into secured and unsecured creditors, or voluntary and involuntary creditors. Money invested by secured creditors is always secured upon taking charge of some of the company's assets which gives them priority payment in case the company goes into insolvency. Security always gives the secured creditors access to information and control over the conduct of the debtor's business that

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and Antitrust Implications (Free Press, 1975); T McGuinness, 'Markets and Managerial Hierarchies' in G Thompson, J Frances, R Levacic and J C Mitchell (eds), *Markets, Hierarchies and Networks* (Sage, 1994) 66–81; O E Willliamson, *The Economic Institutions of Capitalism* (Free Press, 1985); O E Williamson, 'The Modern Corporation: Origins, Evolution, Attributes' (1981) 19 *Journal of Economics Literature* 1537.

64 O E Williamson, *The Mechanisms of Governance* (Oxford University Press, 1996) 13.

65 T T McGuinness, 'Markets and Managerial Hierarchies' in G Thompson et al (eds), *Markets, Hierarchies and Networks* (Sage, 1994) 66, 68.

66 See O E Williamson, 'Credible Commitments: Using Hostages to Support Exchange' [1983] *American Economic Review* 519.

67 P L Joskow, 'Asset Specificity and the Structure of Vertical Relationship: Empirical Evidence' in O E Williamson and S G Winter, *The Nature of the Firm: Origins, Evolution, and Development* (Oxford University Press, 1991) 117, 126.

68 A Crane and D Matten, *Business Ethics* (Oxford University Press, 2nd ed, 2007) 265.

69 J Birds et al, *Boyle and Birds' Company Law* (Jordan, 6th ed, 2007) 264.

could not be achieved by exclusive reliance on personal covenant.[70] This priority in information collection is extremely prominent when the secured creditors are large banks, who employ professional legal and financial experts to advise upon and draw up the legal arrangements relating to secured lending.[71] In contrast, the rights of unsecured creditors are always limited compared to those of secured creditors.

Creditors satisfy the financial needs of companies, enabling them to develop and broaden their businesses. The creditors need to be provided with creditable annual reports and accounts, meanwhile, they seek assurance from various management accounts and forecasts that no calls are made for the repayment of funds and the company is able to borrow at the best possible rate in the future.[72] In essence, they need reassurance that a company will meet its obligation to them and some safeguards against risks that will reduce the likelihood of this happening. Besides, maintaining good relationships with creditors will be beneficial to corporations since it reduces borrowing costs. It also promotes shareholder value and the success of the entire company.

3 *Suppliers*

Companies get resources or services and other input from suppliers in order to operate their business. In the form of 'site assets specificity', the buyers and seller are in a 'cheek-by-jowl' relationship with one another, reflecting *ex ante* decisions to minimise inventory and transportation costs.[73] Once sited, the realisation of buyer-supplier relationship is a key component in determining a firm's competitive success.[74] Also under the situation of the 'dedicated assets specificity' when general investments by a supplier that would not otherwise be made but for the prospect of selling a significant amount of their product to a particular customer, the termination of the contract prematurely would leave the supplier with significant excess capacity. The suppliers in the form of both 'site assets specificity' and 'dedicated assets specificity' are acting as very important stakeholders in the business. The companies and suppliers can be seen to be mutually dependant on each other for their own success. Late payment from companies to suppliers, especially small-scale suppliers, can sometimes put the supplier into severe financial difficulties, or else the supplier might refuse to

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70 R M Goode, 'Is the Law too Favourable to secured creditors?' (1983–1984) 8 *Canadian Business Law Journal* 53, 56.

71 J Hudson, 'The Case against Secured Lending' (1995) 15 *International Review of Law and Economics* 47, 56.

72 C A Mallin, *Corporate Governance* (Oxford University Press, 3rd ed, 2010) 66.

73 Joskow, above n 67, 126.

74 K W Artz, 'Buyer-Supplier Performance: The Role of Asset Specificity Reciprocal Investments and Relationship Exchange' (1999) 10 *British Journal of Management* 113.

supply the company in the future.[75] In terms of their position as stakeholders, suppliers will change to creditors of the company if they are not paid on time or paid the amount specified on the contract. Unpaid suppliers are normally regarded as trade creditors as opposed to secured finance creditors. Although suppliers do not fall into the key stakeholder groups defined in the last section, they are one of a group of crucial external stakeholders who play a key 'connecting role' in the entire company production chain.

In the Japanese *keiretsu* system and also in German industrial networks system, suppliers always build up their long-term relationships with corporations. These systems are said to have produced greater long-term economic success than the Anglo-American system of competitive contracting. The network of the supply and consumption will definitely produce benefits of coordination and avoid the costly bureaucracy associated with a single vertically integrated firm operating through the production chain.[76] A well-organised chain of suppliers will not only encourage investment in supplying firms, but will also make the information flow more rapid due to established relationships of trust and mutual dependency.[77] The mutual obligations of the suppliers and consumers make the transactions more reliable and less complicated which is beneficial to the long-term interests of the company.

4 *Customers*

Customers are members of the general public who are interested in the company as a source of products and services.[78] They are the most important stakeholders in the business, since if customers do not buy business will cease to exist. Customer confidence and spending are important indicators of economic activity as well as business prosperity.[79] The interests of customers will always prevail when companies consider their product design, delivery and product services. The satisfaction of customers is of fundamental importance to most organisations, and is often measured directly through the use of customer surveys or questionnaires. It is important to realise that customers have the 'bargain power' from threat of being substituted from competitive rivalry. Companies have to do their best to neutralise the power of substitutes and win the loyalty of their customers.

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75 Mallin, above n 72, 66.

76 Dean, above n 27, 55.

77 R Dore, 'Goodwill and the Spirit of Market Capitalism' in V Buckley and J Michie (eds), *Firm, Organisations and Contract* (Oxford University Press, 1996) 375.

78 J H Farrar and B M Hanningan, *Farrar's Company Law* (Butterworth, 4th ed, 1998) 13.

79 J W Weiss, *Business Ethics: A Stakeholder and Issue Management Approach* (Thomson South-Western, 3rd ed, 2003) 136.

Customers normally do not have the ability to put pressure on companies through their purchasing,[80] but the company itself will try to build up its customer loyalty through various marketing exercises ranging from supermarket discount cards to bank product cross-selling. The customer group could be thought to constitute a legitimate and important stakeholder group since it is logically admissible to consider firm-customer interactions in this way.[81] Therefore, customers will get used to a familiar product and will want to buy it in the future.[82] Fair treatment, honest trading and attention to the requirements of the customer group are vital if repeat orders and customer recommendations are to be secured.[83] That is also the reason why constant attention to customers is proclaimed as a key feature of most business strategies, in order to turn a one-shot transaction into the start of a continuing relationship. In those cases, companies will also succeed by outperforming their competitors in providing superior value to their customers. Conversely, if the company does not pay close and continuous attention to satisfying their customers, those customers will turn to competitors, resulting in the loss of market share and, ultimately profitability.[84] Furthermore, the products provided by the company will also largely depend on the requirements of its local customers. Customers are increasingly aware of the social, environmental and ethical aspects of corporate behaviour, and will be inclined to consume in the companies who are acting in a socially responsible manner.[85]

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80 See Sustainability essay on 'Who are Stakeholders?' (16/03/2009) <http://www.sustainablility.com/issues/who-are-stakeholders.asp>.

81 J A Fitchett, 'Consumers as Stakeholders: Prospects for Democracy in Marketing Theory' (2005) 14 *Business Ethics: A European Review* 14, 18.

82 Mallin, above n 72, 66–7.

83 Dean, above n 27, 5.

84 A Crane and D Matten, *Business Ethics: A European Perspective Managing Corporate Citizenship and Sustainability in the Age of Globalization* (Oxford University Press, 2004) 267.

85 Mallin, above n 72, 66–7. The group of customers who are considered to be stakeholders in strategic management regimes may also include future customers apart from current customers in consideration of the long-term interests of the company. For example, BT, the UK's largest telecommunications company, has a reputation for building respectable customers loyalty. BT's largest community programme is *Future Talk* in Education, an initiative which is designed to improve young people's communications skills. Similarly, the Co-Operative Bank engages its customers in fully-fledged campaign programmes demonstrating the bank's stance on a range of important issues. The bank dedicates considerable resources to running hard-hitting campaigns and making donations which link to customer spending. As a result, they have established very respectable customer relations and built a loyalty link between the company and its customers.

5 *Local Communities*

Local communities also have a number of interests in the companies operating in their region.[86] Firstly, the considerable tax and fee revenues yielded by companies may constitute a part of sustained income to the local community. Secondly, companies will employ large numbers of local people, and in the interest of sustaining employment level it is important that companies in the locality operate in an efficient way.[87] Thirdly, the companies located within the region will probably engage in charitable work or make donations which will benefit the local community.

Of course, the effects of the company on the local community can be either positive or negative. Companies are always able to help with socio-economic development.[88] They are able to sustain the employment level of the local community, with the consequence that the unemployment rate might rise should the company fail or get into financial difficulties. Local communities will also be concerned that companies in their region act in an environmentally friendly way to avoid pollution and other environmental damage.[89]

For example, ASDA, with its 241 stores, 19 depots and more than 100,000 employees throughout the United Kingdom, is in a strong position to establish and make progress in changing the neighbouring local communities. By recognising the expectations of their customers beyond basic supermarket services, a 'store of community' initiative was launched. ASDA stores demonstrate their social and community relationships by engaging with local schools, charities, the emergency services, MPs and local suppliers.[90] On their

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86 For example, Merck Sharp and Dohme (Ireland) Ltd, a subsidiary of Merck and Co Inc, one of the largest and most successful healthcare companies in the world has had a considerable effect in Ballydinem its local community. Since 1976 Merck Sharp and Dohme have invested over 500 million pounds, employed over 430 staff and consumed over 600 000 gallons of water daily in Ballydine. The company is officially recognised for the excellence of its environmental management systems and its commitment to clean production, receiving both the Good Environmental Management Award and the Clean Technology Award.

87 Mallin, above n 72, 66–7.

88 P Kapelus, 'Mining, Corporate Social Responsibility and the "Community": The Case of Rio Tinto, Richards Bay Minternals and the Mbonambi' (2002) 39 *Journal of Business Ethics* 275, 276.

89 Of course, there will be environmental groups working to ensure that companies operate to both national and international environmental standard, such as the CERES Principles and the Global Reporting Initiative (GRI) Sustainability Guidelines.

90 For more relevant information, see the company website <www.asda.co.uk>. ASDA donated over £4 million in 2000 via fundraising and gifts in kind, and by supporting *National Math Year 2000,* ASDA's Big Sum initiative, giving children the chance to

side, the stores obtain benefits via an increase in sales, and a good reputation for social responsibility has followed.

6 *Government*

Overall, states whose governments have 'good corporate governance, regular certainty and an appropriate mix of policy tools including clear and enforceable regulatory standards, economic instruments and voluntary initiatives'[91] will be hugely attractive when companies are selecting the location of investment in order to promote and strengthen their prospective business case for sustainable developments. On the other hand, the government also has interests in the company. For example, the government will outline various aspects of fiscal policies, such as capital allowances, incentives for investing in different industries or different parts of the company, and taxation raised from companies. Besides, governments always endeavour to ensure that companies act in a socially responsible way by taking account of social, ethical and sentimental considerations.[92] Of course, it is also the responsibility of the company to analyse corporate trends for various purposes including employment levels, monetary policies and market supply and demand of goods and services.[93]

Apart from the important stakeholders mentioned above, international organisations, non-government organisations and the media are also relevant to the company and can be ranked as stakeholders. From the discussion above, we can conclude that the company and its stakeholders always affect each other, and it is useful to describe the interaction as a web as demonstrated by the following figure:

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develop their math skills — an initiative which attracted 15 500 school kids. Thirty-seven MPs visited their stores as a result, and the company increased their sales and reputation.

91 R Cowe, *Developing Value: The Business Case for Sustainability in Emerging Markets* (SustainAbility, 2002) 5.

92 S Sheikh, *Corporate Social Responsibilities: Law and Practice* (Cavendish Publishing, 1996) 168–9.

93 Mallin, above n 72, 66–7.

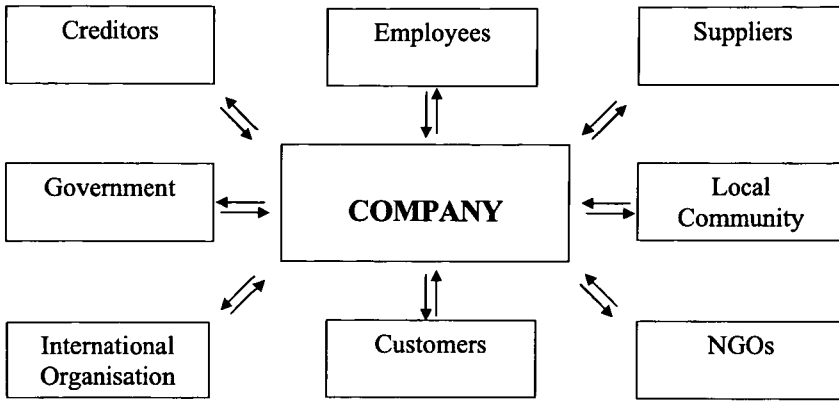

Figure One: Stakeholder Model of the Corporation[94]

An efficient 'Input-Output Relation' is also in operation in this network view of the 'stakeholder model', keeping the stakeholders closely connected. A strong theme of shared value can be established among customers, employees and suppliers for total quality management to work proficiently.[95] In an 'Input-Output Model', the company stakeholders, investors, employees and suppliers are described as contributing inputs and transforming them into outputs for the benefit of customers via the black box of the company. This can be illustrated by the following figure:

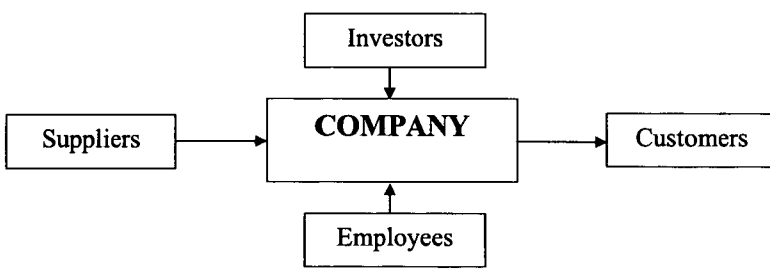

Figure Two: The Input-Output Model[96]

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94 Donaldson and Preston, above n 9, 69.
95 Wheeler and Sillanpää, above n 48, 264.
96 Donaldson and Preston, above n 9, 69.

Furthermore, if the company directors and shareholders are also included in the entire relationship web, the blueprint for the understanding and institutional arrangement of the relationships among primary stakeholders, secondary stakeholders, shareholders and directors (economic actors and corporate participants) in the entire corporate governance system will turn into a director-centralised model, as illustrated by the like the following figure illuminates:[97]

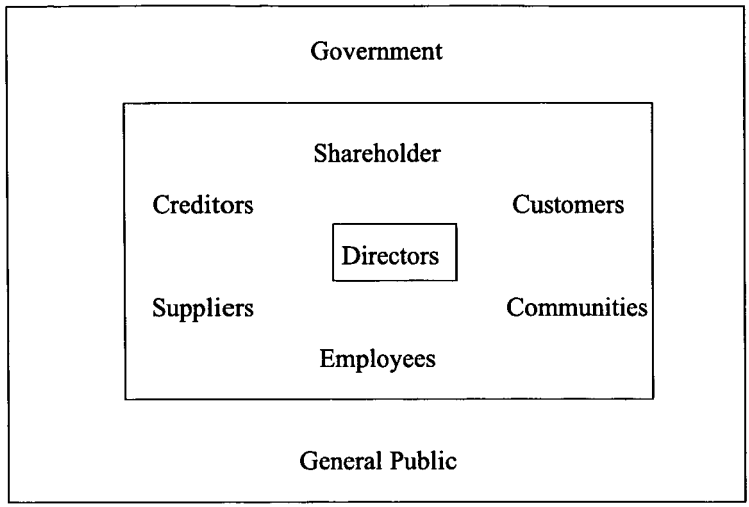

Figure Three: Shareholder, Stakeholder and Directors in Corporate Governance System[98]

It is obvious in this figure that directors and managers always retain control of the entire corporation. The interests of various stakeholders are either directly or indirectly dominated by the directors' decisions, even though sometimes the effect is remote and indistinct.

For a general public commercial company, stakeholders' expectations towards the company and the company's potential accountability to stakeholders can be analysed from the table below:

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97 S Letza, X Sun and J Kirkbride, 'Shareholding Versus Stakeholding: A Critical Review of Corporate Governance' (2004) 12 *Corporate Governance* 242, 242– 3.

98 Ibid 243.

Shareholders	**Expectations of Stakeholder from the Company**	**Nature of Accountability by the Company**	**Public Sector Laws/ Regulators**
Employees	Remuneration, employment security, conditions, training	Company Reports, employment news, bargaining information	Labour and Equal Opportunity
Creditors	Liquidity and solvency of company, value of security, cash generation, timely repayment	Cover ratios, collateral, cash forecasts	Credit and Insolvency
Suppliers	Stable and enduring relationship	Payment according to terms	Fair Trading
Customers	Quality service, safety, value for money	Sales literature, advertising, servicing	Trade Practices
Local Community	Safety of operations, contribution to the community	Safety reports, press reports	Community/Local Tax/Environmental

Table One: Stakeholders' Expectation Towards the Company[99]

III STAKEHOLDER THEORY

In the stakeholder theory, a paradigm for modern corporate law, directors are required to consider the interests of stakeholders apart from the interests of shareholders. The stakeholder theory is at a societal level of corporate governance. It is concerned with values and beliefs and the appropriate relationships between the individual, the enterprise and the state and it involves a discourse on the balance of responsibility, accountability and power

[99] D G Woodward, F Edwards and F Birkin, 'Organizational Legitimacy and Stakeholder Information Provision' (1996) 7 *British Journal of Management* 340; S Turnbull, 'Corporate Governance: Its Scope, Concerns and Theories' (1997) 5 *Corporate Governance* 180.

throughout society.[100] The directors play the role of guardians of the interests of various stakeholders.

The stakeholder theory is the dominant model in jurisdictions such as Japan and Germany. In Germany, for example, according to the dominant opinion, company directors have a duty to take into account the interests of all relevant stakeholders, including the general public.[101] Although the shareholder primacy norm is traditionally adopted theory in the United Kingdom and the United States, there are many evidences in which directors are actually considering the interests of stakeholders dating from the landmark decision in the English case *Evans v Brunner Mond* (one of the first applications of such a liberal approach).[102] Evans sued on behalf of himself and all other shareholders of the defendant company Brunner Mond and Co for a declaration that a resolution, passed by the defendant company at an extraordinary meeting, was *ultra vires* the objects and powers of the company. However, the donation was held by the court to be *intra vires* as the purpose was incidental to the main clause which was to 'do all such business and things as may be incidental or conducive to the attainment of above objects, or any of them'. Eve J accepted the evidence of the company's directors that donating £100,000 to universities or scientific institutions for the furtherance of scientific education and research would be 'conductive to, and indeed necessary for, [the company's] continued progress as chemical manufacturers', and refused to retrain such donations at the instance of a shareholder, finding that they would be within the 'incidental or conductive' provision of the objects clause in the company's memorandum. The resolution was 'that the directors are authorised to distribute to such universities or other scientific institutions in the United Kingdom as they may select, for the furtherance of scientific education and research, the sum of out of the investment surplus reserve account'.

Similarly, the *AP Smith Mfg Co v Barlow* case justified the AP Smith Manufacturing Company's charitable contribution to Princeton University on the grounds that it was aiding public welfare by transferring the sum of $1500 from the corporation's treasury to the university as a contribution towards its maintenance.[103] Also, in the case *Shlensky v Wrigley,*[104] the directors of the

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100 B Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press, 2009) 229.

101 E W Ercklentz, *Modern German Corporation Law, Dobbs Ferry* (Oceana Publications, 1979) 196–8.

102 *Evans v Brunner, Mond and Co Ltd* [1921] 1 Ch 359. *Evans v Brunner Mond and Company Ltd* [1921] 1 Ch 359.

103 *AP Smith Manufacturing Co v Barlow* 13 NJ 145 (1953); *AP Smith Mfg Co v Barlow* 13 NJ 145 (1953).

104 *Shlensky v Wrigley*, 237 NE 2d 776 (Ill Ct App, 1968).

Chicago Cubs baseball team refused to install lights at the Wrigley Field stadium because night games would have a deleterious effect on surrounding community, although this decision might decrease profits of shareholders.[105] The court reaffirmed and upheld the directors' decision by reasoning that corporate directors have discretion to sacrifice shareholders' profits when they are advancing certain stakeholders' interests. The court implicitly recognised that corporate directors could serve parties other than shareholders; in this case, the community at large. It is concluded by Clark that the *Wrigley* case 'suggests that in practice courts will allow directors to temper business decision making with their perceptions of social values'.[106]

Also in the United States, some judges question the dominant shareholder primacy norm. The Court of Chancery in Delaware, the most influential state in the arena of corporate law, stated that directors owe duties to the corporate enterprise and have 'an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximise the long-term wealth creating capacity'.[107] In *Revlon Inc v MacAndrews & Forbes Holdings Ltd* the court held that fiduciary duties owed by directors are to the corporation and the shareholders.[108] Mentioning the 'corporation' and the 'shareholders' indicates that the judicial explanation of the directors' duties to maximise best interests of the company does not equal an exclusive duty to the shareholders only. In *Green v Hamilton International*,[109] the fiduciary duties of directors were judged to be owed to the community of all groups with interests in the corporation, not solely to shareholders.[110] In an extra-curial context, in the judgment of *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp*,[111] Chancellor Allen stated that essentially what can be seen as shareholder primacy held sway in the 19th century and co-existed with what the judge called, 'the social entity view', namely, directors have to consider the needs of stakeholders besides shareholders.

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105 Ibid 778.

106 R C Clark, *Corporate Law* (Little Brown, 1986) 139–40.

107 *Geyer v Ingersoll Publications Co* 621 A 2d 784, 787–8 (1992).

108 *Revlon Inc v MacAndrews and Forbes Holdings Ltd* 506 A 2d 173, 176–82 (1986, Del). See also *Simons v Cogan* 549 A 2d 300, 302–4 (1988, Del).

109 *Green v Hamilton International* 437 F Supp 723 (1977, NY).

110 Ibid 729.

111 *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* (Del Ch WL, 277613, 30 December 1991).

Legislatively,[112] the trend towards a stakeholder view started in 1983 with amendments to Pennsylvania's Business Corporation Law, where it was stated that the management of a company incorporated in Pennsylvania could, in making corporate decisions, consider the effect of such acts on 'employees, suppliers, customers and communities in which offices or other establishments of the corporation are located'.[113] Since then, the majority of states have 'other constituency'[114] statutes which authorise the directors to consider the welfare and interests of non-shareholder constituencies either in the particular context of a takeover contest or more generally.[115]

Globally, the OECD report on *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, produced by the Business Sector Advisory Group on Corporate Governance, recognised that a company's central mission is the long-term enhancement of shareholder value. However, companies operate in the context of the larger society, and there may be different societal pressures and expectations which may have impacts on their financial objectives.[116] Meanwhile, it is affirmed in the OECD *Principle of Corporate Governance*[117] that 'the corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprise'.[118] This not only affirms that the rights of stakeholders depend to a broad extent on legal provisions and they have a right of redress for any violations of their rights, but it also defines the role of stakeholders in the long-term future of businesses.

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112 For discussions on the relevant arguments of English Law J Zhao, 'Modernising Corporate Objective Debate towards a Hybrid Model' (2011) 62 *Northern Ireland Legal Quarterly* 361; J Zhao, 'Promoting More Socially Responsible Corporations through UK Company Law after the 2008 Financial Crisis: The Turning of the Crisis Compass' (2011) 22(9) *International Commercial and Company Law Review* 275.

113 15 Pa Cons Stat 515 (a) (1), 1716 (1995); see also S M H Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Directors' Duties' (1991) 21 *Stetson Law Review* 161, 161–3.

114 In particular, 31 states have been identified in adopting constituency statutes.

115 See G Subramanian, 'The Influence of Anti-Takeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching' (2002) 150 *University of Pennsylvania Law Review* 1795, 1801, 1827–8.

116 OECD report on '*Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*', A report to the OECD by the Business Sector Advisory Group on Corporate Governance, OECD, Paris.

117 OECD, *OECD Principle of Corporate Governance 2004,* Paris (2004).

118 Ibid.

A *Defining the Company's Interests in 'Stakeholder Theory'*

Many commentators have criticised the 'historic misconception' that directors should be responsible solely for the shareholders.[119] The debate surrounding the issue of corporate responsibility to the community as a whole has been ongoing for many years.[120] In the 1970s, Nader and others of the same ideological bent engaged in CSR arguments.[121] Comprehensive attacks on the assumption of shareholder primacy also came from Parkinson, who proposed in his book *Corporate Power and Responsibility*,[122] and also a few articles.[123] It is argued that the time has come for the law to change in order to ensure that directors take account of countervailing social responsibilities in their decision-making.

In the context of individual companies, 'stakeholder theory' proposes that all parties affected by the activities of a company should be given a place in corporate decision-making.[124] This could be achieved by direct participation, by representation at board level or by other appropriate consideration of their interests.[125] The idea of 'stakeholder theory' is to require the directors to ensure that their decisions are fair, just and in keeping with the respect for or protection of the stakeholders' justified right.[126]

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119 P Goldenberg, 'The RSA's Tomorrow's Company Inquiry and Director's Duties' (1995) *Business Law Review* 152.

120 For more discussions about 'stakeholder theory' advocating multilateral cooperation as the corporate governance paradigm, see W W Bratton, 'The Economic Structure of the Post-Contractual Corporation' (1992) 87 *Northwest University Law Review* 180, 208–15; J C Coffee, 'The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups' (1988) *Wisconsin Law Review* 435; J H Matheson and B A Olson, 'Corporate Law and the Longterm Shareholder Model of Corporate Governance' (1992) 76 *Minnesota Law Review* 1313.

121 See, eg, R Nader, *Taming the Giant Corporation* (Norton, 1976); C D Stone, *Where the Law Ends: The Social Responsibility of Corporate Behavior* (Harper and Row, 1975).

122 J E Parkinson, *Corporate Power and Responsibility: Issue in the Theory of Company Law* (Clarendon Press, 1993).

123 J Parkinson, 'Company Law and Stakeholder Governance' in G Kelly, D Kelly and A Gamble (eds), *Stakeholder Capitalism* (Palgrave, 1996) 142; J Parkinson, 'Inclusive Company Law' in J de Lacy (ed), *The Reform of United Kingdom Company Law* (Cavendish Publishing, 2002) 43; J Parkinson, 'Model of the Company and the Employment Relationship' (2003) *British Journal of International Relations* 481; Parkinson, above n 10; See also T Hadden, *Company Law and Capitalism* (Weidenfeld and Nicolson, 2nd ed, 1977) ch 12–4.

124 J Dean, 'Stakeholding and Company Law' (2001) 22 *Company Lawyer* 66, 69.

125 N C Smith, *Morality and the Market: Consumer Pressure for Corporate Accountability* (Routledge, 1990) 54–84.

126 A B Carroll, *Business and Society — Ethics and Stakeholder Management* (South-Western Publishing, 2nd ed, 1993) 32–3.

Meanwhile, it is crucial to realise that stakeholder theory seeks to achieve a balance of risks and rewards.[127] The directors of the company should provide 'a good service' and 'a good life'[128] to the community and to the various stakeholders in the company due to the social pressure.[129] The advocates of the 'stakeholder approach' contend that such a model will enhance both social justice and economic property, provided that trusting relationships exist to foster investment and development and thereby produce rewards for all stakeholders.[130] Responsible business is good business in the long term, positively affecting customer relations, employee attitudes, and ultimately the share price and cost of capital.[131] The adoption and application of the stakeholder theory will result in increased wealth for the whole of society and it has been likened to a win-win situation when businesses correctly implement the strategy.[132] The instrumental power of stakeholder theory suggests that stakeholder management can be employed to achieve shareholder value and a balance between the different stakeholder groups' interests is essential in ensuring that organisations continues to be viable and achieve other performance goals.[133]

B Interpreting Stakeholder Theory with Legal and Economic Theories

It is broadly accepted that a company is far more than its shareholders. It constitutes a web of relationships between employees, suppliers and other groups of stakeholders. It also involves a whole range of production, sale, marketing and other functions.

The stakeholder theory can also be justified by referring to a property model, an organic model, a contractual model and an agency model.[134] Firstly, unlike the

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127 Dean, above n 124, 69.

128 A Berle, *Twentieth Century Capitalist Revolution* (Macmillan, 1954).

129 Sheik, above n 92, 16. The idea was advanced by Berle and Means in the 1930s, when they said that 'the modern corporation should be a "social institution" involving the interrelation of a wide diversity of economic interests including the owners who supply capital, the workers who create and the consumers who give credence to the company's products': see A Berle and G Means, *The Modern Corporation and Private Property* (Macmillan, 1933).

130 Dean, above n 124, 69.

131 Tricker, above n 100, 352.

132 S Cooper, *Corporate Social Performance: A Stakeholder Approach* (Ashgate, 2004) 13.

133 N A Shankman, 'Refraining the Debate between Agency and Stakeholder Theories of the Firm' (1999) 19 *Journal of Business Ethics* 319.

134 See, eg, E W Orts, 'A North American Legal Perspective on Stakeholder Management Theory' in F M Patfield (ed), *Perspective on Company Law* (Kluwer Law International, 1997) vol 2, 166; K Greenfield, 'From Right to Regulation in Corporate Law' in F M Patfield (ed), *Perspective on Company Law* (Kluwer Law International, 1997) vol 2, 3–5;

narrow property model which only views those who provide capital directly to the firm as proper stakeholders, a broad property model expands the conception of property to include the 'reliance interests' of other groups such as employees, suppliers and local communities.[135] In the broad model, the directors are required to consider the interests of any individuals or organisations who put aspects of their property at risk.[136] Besides, the investment of personal property may include either human capital or other forms of financial investments.[137] Therefore, the arguments for the stakeholder approach can be justified by reference to these 'reliance interests'.[138]

The 'organic model' argues that the public company functions as a social institution with an independent existence, rather than as the private property of its shareholders.[139] According to this model, 'ownership', 'control' and 'public interests' should be separate from each other in the exercise of corporate power.[140] This gives the directors the rights for some latitude to pursue other purposes in their daily performance, which are more socially responsible than purely pursuing shareholder wealth maximisation.

Within the contractarian model the broad definition of stakeholder theory uses the metaphor of contract, 'expanding the relevant universe of strictly legal and enforceable contract to include *quasi*-contract, *relational* contract or *implicit* contract'[141] with employees, suppliers, local communities, governments and other stakeholders. Many independent contracts are made with creditors, employees, suppliers, customers and other stakeholders. Therefore the company

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M A O'Connor, 'Global Capitalism and the Evolution of American Corporate Governance Institutions' in F M Patfield (ed), *Perspective on Company Law* (Kluwer Law International, 1997) vol 2, 89.

135 J W Singer, 'Jobs and Justice: Rethinking the Stakeholder Debate' (1993) 43 *University of Toronto Law Journal* 475; J W Singer, 'The Reliance Interests in Property' (1988) 40 *Stanford Law Review* 611.

136 Orts, above n 134, 174.

137 M M Blair, *Ownership and Control: Rethinking Corporate Governance for the 21st Century* (The Brooking Institution, 1995) 202–322.

138 J S Ziegel, 'Creditors as Corporate Stakeholders: The Quiet Revolution — An Anglo-Canadian Perspective' (1993) 43 *University of Toronto Law Journal* 511; See also *Credit Lyonnais Bank Netherland, NV v Pathe Communications Corp,* 1991 WL 277613 n 55 (Del Ch, 1991).

139 Dean, above n 124, 66–7; See also M Stokes, 'Company Law and Legal Theory' in W Twining (ed), *Legal Theory and Common Law* (Blackwell, 1986) 155; D Millon, 'Theories of the Corporation' (1990) 193 *Duke Law Journal* 20; M Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1985) 88 *West Virginia Law Review* 173.

140 Parkinson, above n 122, 23.

141 Orts, above n 134, 174.

can be regarded as a complicated nexus of contracts,[142] resulting from the intersection of all the interests of the shareholders and stakeholders.[143]

Finally, in agency and trust theory, which emphasises the nature of the corporate entity, it is argued that agency and trust relationships pervade the entire stakeholder web. This approach combines the contractual and property models and allows flexibility in defining the term stakeholder.[144] Permission to consider different interests will be granted in various situations.[145] The agency model also allows the consideration of the various interests of relevant stakeholders in the pluralist tradition depending on the circumstances and ethics of each particular business decision.[146]

C *The Advantages of the Stakeholder Approach*

In recent years the Anglo-American 'shareholder primacy' model is moving, to a certain extent, to the 'stakeholder model' in considering the interests of other stakeholders, taking the adoption of ESVP as a good example in the UK Companies Act 2006. The question arises whether that is such a positive move. The advantages of the stakeholder theory will be discussed in the following section:

1 *Creating Long-term Favourable Conditions to More Successful Companies*

The objectives that companies are legally required to pursue are determined by the duties imposed on directors to operate the business in the interests of the 'company as a whole'. The ultimate objective or the overriding goal of the firm is to maximise total long-term market value. It would, de facto, be coherent to consider 'the company', and especially 'the company as a whole' as a separate entity which includes the various parties that are bound together in carrying on the business — that is, not only the shareholders, but also the employees,

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142 M C Jensen and W H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 310–22.

143 See, eg, A A Alchian and H Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777; H Demsetz, 'The Structure of Ownership and the Theory of the Firm' (1983) 26 *Journal of Law and Economics* 375; E F Fama and M C Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301; R H Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

144 Orts, above n 134, 174–5.

145 E W Orts, 'Shirking and Sharking: Agency Law' (Working Paper No 24, The Wharton School of the University of Pennsylvania, Department of Legal Studies, 2004); E W Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 *Washington and Lee Law Review* 1565.

146 Such as the interests of environment; see E W Orts, 'Reflective Environmental Law' (1995) 89 *Northwestern University Law Review* 1227.

lenders, customers and suppliers.[147] The directors are required to serve the interests of these groups as a means to advancing the interests of the shareholders. Jensen put it simply when he stated that 'the change in the total long-term market value of the firms is the scorecard by which success is measured'.[148] To the author's opinion, the stakeholder theory is helpful in creating more cooperative relationships within the company. These relationships are to the mutual advantage of the parties, and adoption of the stakeholder model generates legitimate expectations that each side will seek to advance the interests of the others.[149] Moreover, a long-term focus will enable the directors to devote their efforts to improving the long-term interests of the stakeholders because they do not have to exclude long-term value-enhancing strategies.[150]

In the case of employees, if they do not feel themselves to be components of a trustworthy network of internal relationships or they do not understand the direction and objective of the organisation, they are unlikely to deliver their best work.[151] Good employee relations can lower a company's employee turnover rate and improve employee motivation.[152] An over-emphasis on share price, which is the common and dominant principle in shareholder primacy jurisdictions, will encourage short-termism in employment relationships, which in turn acts as a brake on innovations and productivity growth.[153] A positive relationship between stakeholders' interests and competitiveness in terms of human resources management is important, although for some companies the additional costs might still outweigh the benefits at least in the short-term.[154] Soloman put special emphasis on company employees when he stated that 'what makes a corporation efficient or inefficient is not a series of well-oiled mechanical operations but the working interrelationships, the co-ordination and rivalries, team spirit and morale of the many people who work there and are in turn shaped and defined by the corporation'.[155] In the new economy era, companies are more and more dependent on intangible assets in order to create value and promote their performance. Development in work organisation and

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147 Parkinson, above n 10.

148 M C Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2001) 14 *Journal of Applied Corporate Finance* 8.

149 Parkinson, above n 123, 149.

150 Aggarwal and Chandra, above n 11, 49.

151 Dean, above n 27, 54.

152 P L Cocran, 'The Evolution of Corporate Social Responsibility' (2007) 50 *Business Horizons* 449, 450.

153 Williamson, above n 64, 513.

154 European Commission, *European Competitiveness Report 2008*, Luxembourg (2009) 109 ('*Competitiveness Report*').

155 R Soloman, 'The Corporation as a Community' in B Castor (ed), *Business and Society: A Reader in the History, Sociology, and Ethics of Business* (Oxford University Press, 1996) 195.

technology place an increasing premium on the skills and knowledge of the workforce in achieving company success, and these skills and knowledge increase the firm's competitiveness.[156] The company which develops a respected employment reputation can benefit from a wider pool of talent. The link between corporate strategic policies on employees and human capital seems to be relevant for enterprises of all sizes and is likely to grow as a result of the knowledge economy.[157]

As far as customers and suppliers are concerned,[158] companies are developing various means in order to build up the loyalty of the individual members of these groups, such as standardised wholesale discount contracts, discount cards and bank product cross-selling. It will be beneficial to both sides to have a continuing, cooperative relationship based on trust.[159] Dore pointed out three advantages to long-term relational supply contracting: 'firstly, the relative security of such relations encourages investment in supplying firms; secondly, the relationships of trust and mutual dependency make for a more rapid flow of information; thirdly, a by-product of the system is a general emphasis on quality. What holds the relation together is a sense of mutual obligations.'[160] Long-term cooperative relationships between the company, customers and suppliers could accelerate movement along the supplier-firm-customer chain.[161] Therefore, the company will benefit from the long-term relationship if the directors consider the interests of customers and suppliers, two significant stakeholders, in their efforts to construct a more successful company.

Likewise, a respected reputation from the media, as an external stakeholder, will positively promote the company.[162] A good relationship with the local community and the government via the directors' responsibilities will make operation and development much easier. Besides, companies will find it more expedient to raise capital if the creditors realise that the directors' primary duties are owed to them in certain circumstances – for example, the company is insolvent, especially as far as unsecured creditors are concerned. A virtuous circle will be established in the entire national or international system of business operation.

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156 Williamson, above n 64, 513.

157 European Commission, above n 154, 109.

158 Although interests of these stakeholders' might diverge in particular cases, they will be argued together in this section since the argument is focused on the entire supplier chain.

159 Parkinson, above n 123, 150.

160 Dore, above n 77, 375.

161 Evan and Freeman, above n 34, 103.

162 For more discussion about media and corporate reputations and corporate strategy see K F Brickey, 'From Boardroom to Courtroom to Newsroom: The Media and the Corporate Governance Scandals' (2008) 3 *Journal of Corporation Law* 625.

Furthermore, an efficient relationship with various stakeholders benefits the company in reducing the costs on the frequent changeover, training and cultivation of new employees, suppliers, customers and others. With the development of long-term relationships between the various stakeholders, levels of loyalty, quality and delivery times that were impossible before will suddenly become feasible, bringing great potential for business expansion especially if they are included as conditions in long-term contracts.[163] Therefore, stakeholder theory makes the directors consider the full range of communities from whom they need loyalty, and avoid misunderstandings about the human dynamic of business caused by an imbalance in the directors' thinking.[164] Moreover, in the author's opinion, long-term and reliable relationships with suppliers and lifetime employees are extremely important in the current knowledge-based economy, a world in which inventions, techniques and industrial secrets are important for the continued development and survival of the company.

2 *Socially Responsible Corporations*

CSR is a 'concept whereby companies integrate social and environmental concerns in their business operations and interaction with their stakeholders on a voluntary basis'.[165] More often, its meaning is expressed in 'moralistic catchwords', as well as basic definition statements such as 'human dignity, equality, and the social good', although these definitions might themselves be unclear and subjective.[166] Making corporations engage in good CSR policy is another advantage in adopting stakeholder theory. CSR can contribute to a number of social, environmental and economic policy objectives.[167] What good CSR policies can bring includes:

> the advisements of competitive advantage, better reaching market segments like ethical consumers and socially responsible investors and enhanced opportunities for strategic alliance or other partnership as major business opportunities for corporations with external constituencies, and, for an internal point of view, enhancement of labour rations and employee commitment, and the achievement of overall better financial and strategic results.[168]

It is recognised that one major development in the market sector in the last 20 years, ie, the rapid growth of CSR and socially responsible investment performance of institutional investors, has had the practical effect of bringing

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163 Aggarwal and Chandra, above n 11, 49–50.

164 A Campbell, 'Stakeholders: The Case in Favour' (1997) 30 *Long Range Planning* 446.

165 European Commission, 'Prompting a European Framework for Corporate Social Responsibility', Green Paper and COM 366, Brussels (2001).

166 W C Fredrick, 'From CSR1 to CSR2 — The Maturing of Business and Society Thought' (1994) 53 *Business and Society* 51.

167 European Commission, above n 154, 106.

168 C Keinert, *Corporate Social Responsibility as an International Strategy* (Physica-Verlag, 2008) 90.

social, environmental and ethical concerns into the realm of Anglo-American corporate governance.

The CSR movement has been a major factor in moving corporate governance theory in the direction of a stakeholder model by requiring companies to go beyond the creation of short-term shareholder wealth in pursuit of broader objectives such as sustainable growth, equitable employment practices, and long-term social and environmental well-being.[169] There is evidence that businesses of all sizes are taking CSR seriously.[170] The triple bottom line of CSR is taken as a point of departure,[171] focusing on people and planet dimensions, in particular human rights, labour rights and environmental protection.[172] CSR is often divided into four areas: workplace, market-place, environment and community, although these areas inevitably overlap in practice. Effective CSR requires dialogue and partnership with stakeholders such as trade unions, public authorities, non-governmental organisations and business representative organisations.[173]

The recent growth of institutional investor activism in social investment in the United Kingdom has been regarded as a leading initiative in Western countries.[174] CSR is not so much about what the enterprise do with their profit, but how they make that profit.[175] Almost 80 percent of UK pension scheme members now require their schemes to operate a social investment policy.[176] In May 2002 the Department of Trade and Industry (DTI) published its first report

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169 Williams and Conley, above n 5.

170 G Lynch-Wood, D Williamson and J Ramsay, 'The Case for Regulating Corporate Social Responsibility in SMEs' (Paper presented at Small and Medium Sized Enterprises and Corporate Social Responsibility: Identify the Knowledge Gaps, Durham Business School, University of Durham, 15–16 December 2005).

171 The 'Triple (P) Bottom Line' encompasses three areas of profit and loss evaluation: profits, people and planet. See J J Graafland, S C W Eijffinger and H Smid, 'Benchmarking of Corporate Social Responsibility: Methodological Problems and Robustness' (2004) *Journal of Business Ethics* 137, 138.

172 K Buhmann, 'Corporate Social Responsibility: What Role for Law? Some Aspects of Law and CSR' (2006) 6(2) *Corporate Governance: The International Journal of Effective Board Performance* 188, 189–90.

173 European Commission, above n 154, 107.

174 See University of Amsterdam and KPMG Global Sustainability Services, *KPMG International Survey of Corporate Sustainability Reporting 2005* <http://www.kpmg.nl/>; European Sustainable Responsible Investment Forum, *Socially Responsible Investment among European Institutional Investors: 2003 Report* (2003) <http://www.eurosrif.org/>; CSR Europe, *Investing in Responsible Business — The 2003 Survey of European Fund Managers, Financial Analysts and Investor Relations Officers* (2003).

175 European Commission, above n 154, 107.

176 I Jones and M Pollitt, 'Understanding How Issues in Corporate Governance Develop' (2004) 12 *Corporate Governance* 162.

on CSR. In the report, the DTI defined CSR in the following terms:

> a responsible organisation does three things: (1) it recognises that its activities have a wider impact on the society in which it operates; (2) it takes account of the economic, social, environmental and human rights impact of its activities across the world; (3) it seeks to achieve benefits by working in partnership with other groups and organisations.

Directors of socially responsible companies have a network of related duties towards various stakeholders. For a socially responsible company, it is important to ensure diversity in the workforce and provide suitable conditions for employees; it is also crucial to minimise the impact of products and process on the quality of land, air, water and the ecosystems that make up the environment, and to maximise the positive impact of the companies' operations through support for and involvement in the local communities where it operates.[177]

It is acknowledged that the law limits the ability of businesses to maximise their profits at the expense of others. For example, elaborate legal provisions are designed to ensure that consumers are not misled, the health and safety conditions of employees are not in danger, and excessive damage to the natural environment is avoided.[178] In other words, moral, environmental or social policy interests should not be overridden in the pursuit of private commercial gains. If company directors take social responsibilities into account, it becomes more sensible to define the ultimate purpose of directors' duties as 'maximisation of the total creation of wealth'.[179] For example, if a company director focuses on the local employment problem as a corporate strategy and the problems are virtually eliminated as a consequence, local government and the local community will pay more attention to this company and give them a more favourable investment environment, hoping to encourage further local investment and to settle more local social problems. The employees will also trust the company and be willing to work there because of its respected local reputation.

If we discuss this problem in a broader sense, CSRs are also helpful to companies' performance in achieving their social objectives based on participatory social policies.[180] Carroll suggested that one way of assessing the

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177 R Smerdon, *A Practical Guide to Corporate Governance* (Sweet and Maxwell, 2nd ed, 2004) 250–1.

178 Parkinson, above n 123, 147.

179 See more discussion on the corporate objectives of social welfare and total wealth creation in G Kelly and J Parkinson, 'The Conceptual Foundation of the Company: A Pluralist Approach' in J Parkinson, A Gamble and G Kelly (eds), *The Political Economy of the Company* (Hart Publishing, 2000) 113, 131.

180 Sheikh, above n 92, 19.

social performance of companies is to measure the social objectives they implement.[181] Social audit systems and financial accounting procedures are two means of assessing corporate social performance.[182] Specifically, they measure the social performance of a company, including employment opportunity programs, conditions of work in the workplace, pollution control, job satisfaction and the quality of working life, the ethical performance of corporate executives and community and urban redevelopment programmes.[183] Local government makes frequent assessments of corporate social performance in order to promote and monitor the status of directors' duties in term of their CSRs. Meanwhile, the media and other related organisations will regularly publish the results of such assessments, which can have a significant impact on the reputation and development of the company.

CSR, which is still often of a voluntary nature, largely parallels the concept of 'stakeholder theory', which emphasises the intertwined relationship between enterprise and individuals and organisations larger than the ones traditionally accounted for by businesses and professionals.[184] CSR is able to justify its existence since it has successfully proven how social and environmental corporate engagement can substantially benefit society and the enterprise itself.[185] The adoption of stakeholder theory seems to be a logical step towards the development of more ethical corporations.

3 *The New Economy and Stakeholder Theory*

The New Economy can also be defined as 'the Information Economy', 'the Second Industrial Revolution' or 'the Post-industrial Society'. It finally arrived in the 21st century after it had been heralded for a long time.[186] The New

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181 A Carroll, 'A Three-Dimensional Conceptual Model of Corporate Social Performance' (1979) 4(4) *Academy of Management Review* 497, 498; See also G Steiner, *Business, Government, and Society: A Managerial Perspective* (Random House, 1985) 159–160.

182 For more discussions on social audits, see, eg, D Linowes, 'Let's Get on with the Social Audit: A Specific Proposal' (1973) 44 (Winter) *Business Horizons* 29; A H Kizilbash, 'Social Auditing for Marketing Managers' (1979) 8 *Industrial Marketing Management* 1; M A Tipgos, 'A Case Against Social Audit' (1976) 58 *Management Accounting* 23; S M Natale and J W Joseph, 'The Social Audit and Ethics' (1994) 9 *Managerial Auditing Journal* 29; V Ross, 'Faith, Hope and Social Audit' (1977) 50 *Canadian Business* 59; see V P Filios, 'Corporate Social Responsibility and Public Accountability' (1984) 3 *Journal of Business Ethics* 305; V P Filos, 'Review and Analysis of the Empirical Research in Corporate Social Accounting' (1986) 5 *Journal of Business Ethics* 291.

183 See Sheikh, above n 92, 19; ch 9.

184 D Crowther, *Perspective on Corporate Social Responsibility* (Ashgate Publishing, 2004) 236.

185 Keinert, above n 168, 43.

186 P Sadler, *Building Tomorrow's Company: A Guide to Sustainable Business Success* (Kogan Page, 2002) 17.

Economy focuses on talent, knowledge and information based on mobile devices such as email, the internet and intranet facilities which make the so-called 'dot com' companies fast-moving and able to act simultaneously in the global market. This economy is global, and will steadily enhance the globalisation of business.[187] Successful companies in the new economy will engage effectively with key stakeholders in the markets for goods and services, finance, labour and political patronage.[188] In the new economy, the basic issue in the corporate governance debate arises again. This debate is on should corporate directors view themselves solely as the stewards of their investors' capital and so aim to maximise shareholder value, or as custodians of their companies' 'human capital' and thus concentrate more on protecting the interests of their employees.[189] In the new economy era, people play an increasingly significant role in the corporate governance system since we are in the midst of a transformation from an industrialised to an information-oriented society.

As for employees, the information now available to consumers will result in a demand for customised products that will inevitably result in a more demanding role for employees in terms of their initiative and creativity. Investment in knowledge or intellectual capital and talent will greatly increase innovation within the company. The value of intellectual property has become increasingly important in the knowledge-based economy. Like electricity, the knowledge and talent of employees exists only when they are being used.[190] Directors should identify and encourage the development of 'human assets' in terms of their individual employees, in order to contribute to the company's success via employees' highly individual talents and creativity.[191]

As for consumers, the most influential consequence of information revolution is the diversification of consumer tastes and preferences.[192] With the rapid

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187 As Hobsbawm pointed out in the book *The New Century,* 'we are certainly a single global economy compared with thirty years ago, but we can say with equal certainty that we'll even more globalised in 2050, and very much more in 2100. ... It is a historical process that has undoubtedly speeded up enormously in the last ten year, but it is a permanent, constant transformation'.

188 S Zadek, N Hojensgard and P Raynard, 'The New Economy of Corporate Citizenship' in S Zadek, N Hojensgard and P Raynard (eds), *Perspectives on the New Economy of Corporate Citizenship* (The Copenhagen Centre, 2001) 19.

189 J Aoi, 'To Whom Does the Company Belong? A New Management Mission for the Information Age' in D H Cew (ed), *Studies in International Corporate Finance and Governance System: A Comparison of the US, Japan and Europe* (Oxford University Press, 1997) 244, 246.

190 P Drucker, *Managing for the Future* (Butterworth-Heinemann, 1992) ch 15.

191 Aoi, above n 189, 247.

192 Ibid.

transition of information, customers in the new economy will demand both higher-quality and more specialised products. Their requirements may also include certain crucial modifications to production lines, such as flexible manufacturing and better inventory controls. Efficient information channels along the consumer-firm-supplier chain must be maintained in order to help corporations to keep up with continuous change in consumers' updated demands. The improvements and efforts from corporations may enhance the integration of the companies with suppliers and customers and give the companies legitimacies in pursuing long-term interests of the company.

The massive shift in manufacturing capacity from Western economies to those countries that offer access to cheaper labour will continue to be a main trend in the new economy. This will not only create jobs in local communities in developing countries but also cause serious employment problems for unskilled workers in more advanced economies.[193] However, this transition may also create social problems concerning employment in developing countries. For example, in the Bhopal incident, 20 000 local employees and local residents were killed or harmed by a chemical leak from an American-owned chemical factory in the city.[194] The leak could have been prevented if procedures, management and maintenance had been more rigorous. A second example is the use of child labour,[195] by multinational companies in their factories in the Third World to facilitate cheap production of the products they sell in the Western market. This issue became an international scandal in the 1990s and the first decade of the new millennium.[196] Therefore, in developing countries with a lack of a very systemic employment law, consumer protection law, environmental law and insolvency law, directors should pay closer attention to basic rights of stakeholders in order to secure the health and safety of the employees and customers. The directors should give their local managers sufficient training concerning legislative requirements and local regulations.

It is claimed that 'participation and intervention at local, national and global levels' are important in order to 'unleash extraordinary development benefits

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193 Sadler, above n 186, 19.

194 See I Eckerman, *The Bhopal Saga — Cause and Consequences of the World's Largest Industrial Disaster* (University Press, 2004); See also 'Bhopal Gas Tragedy: Fact Sheet', *Hindustan Times* (India), 3 December 2004; S R Weisman, 'Bhopal a Year Later: An Eerie Silence', *The New York Times* (New York), 5 December 1985, 5.

195 For more discussions on child labour see C Grootaert and R Kanbur, 'Child Labour: An Economic Perspective' (1995) *International Labour Review* 187; K Basu, 'Child Labour: Cause, Consequence and Cure, with Remarks on International Labour Standards' (1999) 37 *Journal of Economic Literature* 1083.

196 C Fisher and A Lovell, *Business Ethics and Value: Individual, Corporate and International Perspective* (FT Prentice Hall, 2006) 53.

and real social and environmental gains'.[197] A positive balance between benefits and costs can be obtained in the new economy only if 'societies are fully able to take advantage of the arising opportunities by encouraging socially and environmentally responsible business conduct'.[198]

A *Disadvantages of Considering the Interests of Stakeholders*

Although it is beneficial for directors to consider the interests of stakeholders, there remain objections to the 'stakeholder theory' which make the theory difficult to fully implement in practice.[199]

1 *Balancing Stakeholders' Interests*

Diverse stakeholders want to lead the company towards conflicting objectives, and therefore compete for the company's achievements.[200] Given a number of complicated explicit and implicit contractual relations that exist in business, it is likely that all corporations will face a number of mutually exclusive social, ethical or environmental responsibilities.[201] In practice, this could be problematic because a 'win-win strategy for one group may force a win-lose or even a lose-lose situation elsewhere'.[202] It is impossible and impractical for each of the stakeholders to get the totality of what they want. Therefore, Evan and Freeman pointed out that these interests need to be balanced when he said, 'the stakeholder theory does not give primacy to one stakeholder group over another,

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197 J D Wolfensohn, 'Foreword' in S Zadek (ed), *The New Economy of Corporate Citizenship* (The Copenhagen Centre, 2001).

198 Ibid.

199 For more discussions about the defects of the stakeholders model see Sternberg, above n 21; G Vinten, 'Shareholder versus Stakeholders — Is There a Governance Dilemma' (2001) 9 *Corporate Governance* 36; Aggarwal and Chandra, above n 11; M A Schilling, 'Decades Ahead of Her Time: Advancing Stakeholder Theory through the Ideas of Mary Parker Follett' (2000) 6 *Journal of Management History* 224; M E V Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27; Argenti, 'Stakeholders: The Case Against' (1997) 30 *Long Range Planning* 442.

200 G Mason-Riseborough, 'Stakeholders and Stakeholder Theories: An Analysis' <www.geocities.com/griseborough/55.htm>.

201 J Unerman and M Bennett, 'Increased Stakeholder Dialogue and the Internet: Towards Greater Corporate Accountability or Reinforcing Capitalist Hegemony' (2004) 29 *Accounting, Organizations and Society* 685; R Gray et al, 'Struggling with the Praxis of Social Accounting: Stakeholders, Accountability, Audits and Procedures' (1997) 10 *Accounting, Auditing and Accountability Journal* 325; G Lehman, 'A Legitimate Concern for Environmental Accounting' (1995) 6 *Critical Perspectives on Accounting* 393; D Neu, H Warsame and K Pedwell, 'Managing Public Impressions: Environmental Disclosures in Annual Reports' (1998) 23 *Accounting, Organizations and Society* 265.

202 A L Friedman and S Miles, *Stakeholder: Theory and Practice* (Oxford University Press, 2006) 182–3.

though there will surely be times when one group will benefit at the expense of others. In general, however, management must keep the relationships amongst stakeholders in balance.'[203]

However, it was argued by Sternberg that 'balancing stakeholder benefits' is an unworkable objective.[204] Directors will be asked to violate the prior obligations to shareholders that they undertook in accepting their jobs;[205] 'inciting betrayal of trust is a particularly ironic feature in a theory that is supposed to promote better conduct.'[206] He enumerated several reasons for this argument. Firstly, the number of people or organisations whose benefits need to be taken into account is infinite. However, their number should be limited if a balance is to be struck.[207] Secondly, stakeholder theory does not explain what should count as a benefit for the purpose of balancing benefits.[208] Thirdly, stakeholder theory provides no guidance as to how the balance is to be struck.[209]

2 *Unpoliced Managerial Discretion of Directors*

It is neither realistic nor desirable to expect a court to sit in judgment on whether company directors had struck what the court considered to be an appropriate balance,[210] since the disadvantages of a process in which judges are required to review complex issues of business judgment in terms of uncertainty, disruption and direct legal costs, would undoubtedly outweigh the benefits.[211] In order to avoid these consequences courts will only ask whether the directors honestly believed their decisions to achieve an appropriate balance, rather than asking whether a course of conduct is in the interests of the company.[212]

Therefore, the discretion of the directors is always too broad, which might even result in them being held personally responsible for companies' liabilities.

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203 Evan and Freeman, above n 34, 108–9.

204 Sternberg, above n 21, 4.

205 Vinten, above n 199.

206 Sternberg, above n 21, 5.

207 Ibid 4.

208 Ibid.

209 Ibid 5.

210 J Parkinson, 'Inclusive Company Law' in J de Lacy, *The Reform of United Kingdom Company Law* (Cavendish Publishing, 2002) 43, 50.

211 Parkinson, above n 10.

212 Accordingly, as Lord Wilberforce explained in *Howard Smith Ltd v Ampol Petroleum Ltd*:

> There is no appeal on merits from management decisions to courts of law nor will the courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

[1974] AC 821, 832; [1974] All ER 1126, 1131 (Lord Wilberforce).

Besides, the full rein given to directors could make them arrogant, unresponsive and extravagant in respect of salaries, perks and the firm's premises.[213]

When Evan and Freeman tried to explain how to balance the interests of various stakeholders, he argued that it is up to managers to decide which 'normative core' they will use, for the particular corporation.[214] Few effective norms are offered in academic formulations of 'stakeholder theory' which directors are able to consult in their judgements. Directors are responsible for interpreting as well as implementing the notion of balancing the interests of their stakeholders, and they are left free to pursue their own arbitrary ends.[215] In this respect, Evan and Freeman promote the idea that, strictly speaking, there are a large number of stakeholder theories rather than one single stakeholder theory.

3 *Potential Shareholders' Investment*

Potential investors will be less willing to place their capital at the disposal of a corporation if they are aware that part of their return might be diverted by the board of directors to other stakeholders at the cost of their own benefits.[216] Tyler argued that many new financial products that attract investors and increase the liquidity and efficiency of capital markets exist only because of the exclusive fiduciary protections to corporate shareholders.[217] The adoption of 'stakeholder theory' will also make it impossible for investors to calculate the economic risk that the board would distribute the traditional equity returns to other patrons of the corporation prior to investment because of the vagueness and uncertain application of any multilateral fiduciary duties.[218]

However, encouraging investment can also be beneficial to stakeholders. For example, more domestic and international investments will increase the company's orders from the local suppliers, thereby enhancing their business. This will also enable the local government to obtain more revenue, and resolve employment problems.

B *Reform Proposals to Surmount the Disadvantages of the Theory*

Taking stakeholders' interests into account in corporate strategy is a way to build 'a good business, one that earns good returns for its investors, has a

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213 Sternberg, above n 21, 5.
214 Evan and Freeman, above n 34, 108–9.
215 Sternberg, above n 21, 5.
216 Weide, above n 199.
217 R B Tyler, 'Other Constituency Statutes' (1994) 59 *Missouri Law Review* 372, 412.
218 Weide, above n 199, 73–4.

capable and motivated workforce, enjoys a fine reputation with its customers and the community, and is regarded by its suppliers as a good company to do business with'.[219] Several suggestions have been made in order to establish a more harmonised corporate governance system as follows.

1 *Information Disclosure*

In order to promote stakeholders' interests, companies should incorporate stakeholder-friendly business strategies by providing quantitative assessments of reporting practices, indexes, and ratings that link governance with responsibility.[220] Corporate social reporting, a crucial part of CSR, discloses non-financial information on the various activities undertaken by companies in order to discharge their social responsibilities.[221] The disclosure of this specific information in order to protect the interests of various stakeholders from unlawful depletion of corporate funds has been partly enshrined in legislation. In fact, many of the world's largest companies have started to produce social, environmental or sustainability reports in addition to their financial reports.[222] In 2008, 207 companies from the Global Fortune Top 250 companies (83 per cent of the total) published corporate responsibility information, either as a separate report or as part of the annual financial report. Among them, 197 companies (nearly 80 per cent of the total) published a separate report compared to 52 per cent in 2005, 45 per cent in 2002, 35 per cent in 1999 and 13 per cent of the Global 100 in 1993.[223] In terms of the form taken by corporate responsibility reports, the most remarkable modification has been publishing the information as a separate (stand-alone) report rather than as individual environmental, social, or health and safety reports which are separate from each other.

In 2008, almost 79 per cent (compared to 70 per cent in 2005) of the global G250 reports were published as sustainability (social, environmental and economic) reports with a publicly disclosed system for managing, measuring and reporting.[224] It is argued that in the absence of a systematic approach for managing and monitoring corporate responsibility initiatives, companies are in

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219 J Kay, 'The Stakeholder Corporation' in G Kelly, D Kelly and A Gamble (eds) *Stakeholder Capitalism* (Palgrave, 1996) 125.

220 A Kolk, 'Sustainability, Accountability and Corporate Governance: Exploring Multinationals' Reporting Practice' (2008) 18 *Business Strategy and Environment* 1; See also C Deegan, 'The Legitimizing Effect of Social and Environmental Disclosure — A Theoretical Foundation' (2002) 15 *Accounting, Auditing and Accountability Journal* 282.

221 Sheikh, above n 92, 176.

222 Williams and Conley, above n 5, 497.

223 KPMG International, *KPMG International Survey of Corporate Responsibility Reporting 2008* <http://www.kpmg.com> 13–4.

224 Ibid 28.

danger of issuing reports that do not reflect their true performance.[225] Furthermore, more than half of the corporations included information on stakeholders in their corporate responsibility reports. With the rapid promulgation and popularisation of sustainability reports, the needs and interests of stakeholders will be more widely considered by directors.

2 *Redefining of the Discretions of the Directors*

Difficulty in enforcement was one of the fundamental reasons why the CLRSG rejects the 'stakeholder theory' largely because of the excessive discretions available to directors. Therefore, guidance on how to achieve equilibrium is needed in order to make the stakeholder theory useful in business strategy and directors' decision-making. It is suggested by Freeman that directors should search for similarities of action, interests and objectives between stakeholder groups, or for common elements between strategic programmes in order to integrate them.[226] However, a system or mechanism has not been provided to integrate the overall strategic programme with the individual stakeholder interests and desired strategic directions.

When the directors face such difficulties in balancing the interests of various stakeholders, relevant countermeasures will largely depend on the features of individual businesses. Therefore, directors' discretions are extremely hard to avoid. Based on an interview conducted by Dean,[227] directors who claim to make their assessments by reference to the long-term good of the company do not appear to feel that they lack a guiding principle in their daily work, although they may weigh other considerations in the balance against returns to shareholders.[228]

There are other approaches suggested in the literature to make the aim of balancing interests achievable. For example, Frederick, Davis and Post proposed six stages towards this goal, including 'mapping stakeholder relationships, mapping stakeholder coalitions, assessing the nature of each stakeholder interest, assessing the nature of each stakeholder's power, constructing a matrix of stakeholder priorities and monitoring shifting coalitions'.[229] Practically, an economic-based approach can be recommended in

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225 Ibid.

226 Freeman, above n 1.

227 Dean, above n 27, 222–8.

228 Ibid 228.

229 W C Frederick, K Davis and J E Post, *Business and Society* (McGraw-Hill, 6th ed, 1996). Ryan also put forward an argument for a well-designed stakeholder model whereby competing claims can be identified and measured so that the best outcome and the least harm will be accorded to each, thereby ensuring that justice will be accorded to each

order to make the implementation of these six stages more efficient. In order to satisfy its stakeholders, the company should identify the extent of each stakeholder's contribution and match this with their inducements.[230] The basic principle should be mutual benefit for 'voluntary stakeholders', while the core principle should be reduction or avoidance of harm and/or the creation of offsetting benefits for 'involuntary stakeholders' who may be affected adversely, for example, by pollution or congestion.[231]

As for the directors' discretions towards creditors, Keay argued that this duty should arise where a company's situation is such that directors can reasonably expect that the action upon which they are about to embark could lead to the insolvency of the company.[232] Therefore, the duty requires the directors to estimate whether their action would lead to insolvency. This is apparently a difficult task for the directors, and it imposes them the *ex post* duties which they may not have expected when they were appointed by the company. Therefore, apart from including creditors' interests in the codification of directors' duties, it will be practical and useful to define terms such as 'insolvent', 'taking every possible step', 'potential loss', 'near insolvent', 'doubtful solvent', 'risk of solvent' and 'financial instability'.

3 *Modified Codification of Directors' Duties*

A modified and codified legislation concerning directors' duties would serve to increase accessibility and decrease flexibility and uncertainty in the law. The CLRSG also regarded the issue of accessibility as a great concern and its aim was to develop a statement which was short, simple and accurate enough to give comprehensive and useful guidance to directors and others.[233] Such a statement will simplify the work of directors and judges in applying the law. Moreover, it will also help to protect stakeholders' interests more efficiently. The author agrees with 'Goyder's proposal'[234] and 'Kay's analysis'[235] of company's

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constituent; see L V Ryan, 'The Evolution of Stakeholder Management: Challenges and Potential Conflict' (1990) 3 *International Journal of Value-Based Management* 105, 117.

230 Friedman and Miles, above n 202, 184.

231 Ibid.

232 A Kaey, 'The Director's Duty to Take into Account the Interests of Company Creditors: Where is It Triggered' (2001) 25 *Melbourne University Law Review* 318, 334–8. A related argument can also be found in the comments of *Nicholson v Permakraft Ltd* (1985) 3 ACLC 453, 460; S Schwarcz, 'Rethinking a Corporation's Obligations to Creditors' (1996) 17 *Cardozo Law Review* 647, 671–2; V Finch, 'Directors' Duties: Insolvency and the Unsecured Creditors' in Alison Clarke (ed), *Current Issues in Insolvency Law* (Steven & Sons, 1991) 106.

233 Company Law Review, *Final Report vol 1* (2000) [3.14]; Developing the Framework (2000) [3.37].

234 G Goyder, *The Just Enterprise: A Blueprint for the Responsible Company* (Adamantine,

interests, in which they suggest a new 'general purpose'[236] clause in the following terms: A director shall at all times act in the manner he considers in the exercise of his business judgment best fitted to advance the interests of the company, including the interests of customers, employees, shareholders, investors, suppliers, environment and the local community.[237] Generally, several intentions should be achieved, including fair prices, high quality and reliable products for customers, fair returns and beneficial profits for investors, fair wages and satisfactory working conditions for employees, protection of the environment for the local community, and an efficient role for the company in resolving social problems. Of course, even though this argument is just theoretical, it has to be emphasised that the legislators need to pay attention to the discretions of the directors when they draft the code for directors' duties regarding stakeholders in order to enforce those duties. It is believed a reform in the codification of directors' duties will partially eradicate many of the difficulties encountered when balancing the interests of different stakeholders.

VI CONCLUSIONS: CALLING FOR A MORE REALISTIC MODEL

However, theory is clear, life is a muddle.[238] The corporate governance model in each country is not able to fit perfectly into the two archetype corporate governance models: shareholder primacy norm and stakeholder theory. Both advantages and disadvantages have been considered on the classic shareholder primacy norm and stakeholder theory with solid theoretic arguments for both of the theories. As part of the national business framework, a corporate governance system has significant national-persistent path dependence sources, which include not only random historical accidents but also other components of the national business system and complementary elements within the matching social and political systems.[239] The persistence of those sources contributes to

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1993) 56.

235 Kay, above n 219, 137.

236 For more discussions on the 'general purpose' clause see Dean, above n 27, ch 1.

237 It was suggested that the interests of the company included:

> The payment of returns to shareholders and investors sufficient to remunerate past investment and encourage future investment in the company, the development of the skills and capabilities of employees and suppliers of the company, the achievement of stability and security in the company's employment and trading relationships and the provision of goods and services of good quality to the company's customers at fair prices and the enhancement of the company's reputation for high standards of business conduct.

Kay, above n 219, 137.

238 B H McDonnell, 'Convergence in Corporate Governance-Possible, but not Desirable' (2002) 47 *Villanova Law Review* 341, 364.

239 R H Schmidt and G Sprindler, 'Path Dependence, Corporate Governance and Complementarity' (2002) 5 *International Finance* 311.

the stability of domestic corporate governance systems; and the further diversity of corporate ownership and governance among the worlds' advanced economies.[240] It is argued that a domestic corporate governance system is composed of various complementary elements; meanwhile, it is also complementary to other domestic governance systems, such as the financial system, the political system and so on. Such institutional interdependencies obstruct the transformation of one single institution within the regime. Therefore, even if the corporate governance convergence is going to happen, the convergence is far more complicated than moving to a single archetype model. It will be worthwhile for future researchers to have more study on the trend of the development of a more realistic model.

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[240] L Bebchuk and M J Roe, 'A Theory of Path Dependence in Corporate Governance and Ownership' (2000) 52 *Stanford Law Review* 121.